Canadian Stock Investing

Are REIT payouts safe?

By Vikram Barhat | 24/03/15

Real estate investment trusts are attracting increased regulatory scrutiny with regard to the transparency of the payouts they make to unitholders.

REITs, which own and operate income-generating real-estate assets, must distribute their taxable income to investors to avoid a business-level tax. Consequently, investors bear the tax burden. Interest and lease income distributed by REITs is fully taxable, while dividends qualify for tax credits, and only half of capital gains are taxable.

In some instances, a portion of a REIT's distributions may come from sources other than cash flows from operations. It's important, then, for REITs to disclose where the money is coming from to finance the distributions. "These disclosures should highlight the risks and their impact on the issuer as well as the sustainability of distributions," says Huston Loke, director of corporate finance at the Ontario Securities Commission. An OSC report released in January on disclosure of REITs distributions provides examples of deficient disclosure.

If there's one thing investors should be able to count on other than death and taxes, it's REIT distributions, says Catherine Ann Marshall, an independent real-assets consultant and vice-chair of the CFA Society Toronto's alternative-investments committee. "The value proposition of the REIT market is stable distributions, and every REIT management team knows this," says Marshall. "The moment the market gets a whiff that imbalances between cash flows and cash demands might force a cut in distributions, the stock gets hit."

The stability and sustainability of a REIT's distributions depends on the quality of assets in its portfolio and its ability to manage funds, says Marshall, who formerly managed REIT units and debentures as a member of the investment team responsible

for interest-sensitive investments at Genus Capital Management.

"REIT distributions should be sustainable and dependable if they are based on a diversified portfolio of investment-quality real estate," she says. "If management is injecting too much risk, possibly in the form of excessive leverage or too much portfolio concentration, then the dependability of the distribution is in doubt."

Marshall says investors should invest in REITs whose management teams have long track records in all market conditions and have the confidence of the analysts as demonstrated by consistent "Outperform" ratings.

Investors should get some comfort from the fact that cash-flow changes are pretty foreseeable with enough information and that "the one-year forecast as calculated by a good analyst is reliable," says Marshall.

To understand a REIT's quality and stability of distributions, investors should typically look at adjusted funds from operations, or AFFO, says Russil Lea, a portfolio manager at Nicola Wealth Management in Vancouver. "AFFO is a key measure when assessing payout ratios," he said. "This is the purest form of cash flow."

AFFO is an effective gauge of the cash that is generated from operations after the deduction of the capital expenditures incurred to lease and properly maintain properties. AFFO, therefore, is a better predictor, than simple earnings, of a REIT's future capacity to pay dividends and a more precise measure of residual cash flow available to shareholders.

The AFFO figure that companies disclose is located in the management's discussion and analysis (MDA) portion of their financial statements. For example, you can find it on page 50 of the 2013 annual report of Riocan, Canada's largest REIT.

There are some red flags investors should look for when considering a REIT, says tax expert Jack Mintz, who serves as the Palmer Chair in Public Policy at the University of Calgary. "Look at how much cash flow is being distributed," he says. If it's a large percentage, he adds, there's not much capital available for new acquisitions or improvements.

Like Marshall, Mintz emphasizes the importance of high-quality assets. "Even in downturns, some commercial property income isn't affected as much." Mintz says large companies are often in A-type property and continue to lease during weaker economic periods when low-quality properties can be vulnerable.

The buffer between free cash flow per share and the distribution is another area for investors to focus on, says Marshall. In the early days of the REIT industry in Canada, it was not unusual to see REITs that had distributions greater than 100% of the funds from operations. So as an investor, you had to hope the REIT was going to grow its way out of that situation in order to buy it.

"That," says Marshall, "is not a bet I'd want to make today as I believe the best prospects for growth in the Canadian real estate market are behind us."

Lea suggests that investors consider large-cap REITs, which tend to have more dependable distributions. "There are smaller REITs that have large development books

that may not have the cash flow to match the distributions they are paying out," he says. "These names would need to finish their development projects before their cash flows catch up to their distribution policy. I'd view REITs that have large development capex projects as more capital-gains stories rather than income stories."

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