REITs - Frequently Asked Questions

FINANCIAL SERVICES SECTOR REPORT

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This report answers many of the basic investor questions regarding Real Estate Investment Trusts (REITs). We believe REITs are the easiest way for individual investors to invest in real estate. REITs provide individual investors with a number of similar benefits to investing in real estate properties without many of the downfalls. These downfalls include daily management of the property, putting a large portion of assets in one investment, and difficulty in selling a real estate investment.

REITs were created in the United States in 1960 when Congress first authorized them as a means to provide smaller investors with an easy way to invest in commercial real estate. In Canada, companies began operating as REITs starting in 1993. Despite this long existence, investors have numerous questions. Below are answers to some of the most frequently asked questions concerning REITs.

Question: Why should individuals invest in REITs?

Answer: REITs provide investors with many benefits. First, due to their relatively attractive dividend yields, REITs are a good source of income for an investment portfolio. Second, as the REIT raises rents and acquires more investment properties, the REIT can increase the dividend. And finally, as the dividend grows over time, the stock price will likely also grow. However, we note that REIT common dividends can be reduced should earnings decline.

Question: What are Funds From Operations (FFO) and how does FFO differ from earnings per share and net income?

Answer: Funds From Operations (FFO) are essentially net income prior to non-cash and non-recurring items such as depreciation expense and amortization, and gains and losses from property sales. Unlike buying a computer, which declines in value in a matter of months, well-maintained real estate tends to appreciate over time. As a result, REIT analysts look at net income prior to depreciation and other non-cash and non-recurring items to determine the amount of cash available for the company to pay dividends. Analysts call this Funds From Operations, or FFO. Most REIT investors and analysts use FFO as the primary earnings measure for REITs. We note many external stock market quotation systems continue to use earnings per share in order to calculate the price/earnings ratio for REITs; this can result in a price/earnings ratio that is often significantly different than the price/FFO multiple calculated utilizing the FFO figure. In our opinion, REIT investors should focus on FFO as the primary earnings measure for REITs as we believe FFO provides investors with a more accurate assessment of the recurring cash flows being generated by a REIT than earnings per share.

Question: Why have REITs historically provided above-market dividend yields?

Answer: U.S. REITs are required to pay at least 90% of their taxable income in dividends. However, investors should be aware that taxable income is after depreciation expense. So even though a REIT may pay more than 90% of its taxable income in dividends, the typical REIT will pay out only 65% to 90% of the cash it generates (after paying expenses), or Funds From Operations (FFO).

Question: Why are U.S. REITs required to pay out at least 90% of their taxable income in dividends?

Answer: Congress intended REITs to be a mutual fund of real estate so that individual investors could gain the benefits from investing in a diversified portfolio of real estate. As long as REITs meet certain requirements, including paying at least 90% of their taxable income in dividends, they do not have to pay corporate income taxes.

Question: What are the implications for investors in REITs that pay out more than 100% of its taxable income?

Answer: First, if a REIT pays out more than 100% of its taxable income, then a portion of the dividend in excess of taxable income is considered a return of capital. The return of capital component is not taxed in the year it is received, but rather is taxed when the REIT shares are sold. For instance, let's say REIT ABC's dividend included a return on capital component of $0.38 per share. Investors who purchase ABC would reduce their cost basis in ABC by $0.38 per share.

Despite being considered a return of capital for tax purposes, it is not the same as return of capital in a typical bond mutual fund. Unlike the bond fund, ABC still has the same amount of investment property that can earn the same rental revenue as before the dividend was paid.

Question: Why do REITs periodically issue shares?

Answer: REITs are required to pay out most of their earnings in the form of dividends. Therefore, REITs typically need funds from sources other than earnings to grow their business through acquisitions and development. These other sources include issuing debt and issuing additional shares. This is in the normal course of business for REITs. Over time, we expect share counts to gradually increase as the companies continue to grow their property portfolios.

Question: Do corporations receive the Dividend Received Deduction when investing in REITs?

Answer: No. Dividends received by corporations are not deductible under federal law. For more information on the Dividend Received Deductions, please speak with a tax professional.

Question: Do REIT dividends qualify for the reduced common dividend tax rate?

Answer: No. Because REITs do not generally pay corporate taxes, the majority of REIT dividends continue to be taxed as ordinary income.

Question: What are the differences between mortgage REITs and equity REITs?

Answer: Mortgage REITs are similar to banks. Mortgage REITs make money by lending to borrowers to purchase real estate. We do not recommend mortgage REITs because they typically use large amounts of debt to finance their operations, and mortgage REIT earnings are often more sensitive to interest rate movements. Equity REITs are similar to landlords. They invest in real estate and make money from rental payments received from the tenants. Most equity REITs manage the properties themselves and tend to specialize in specific property types.

Question: What is the difference between a publicly traded REIT and a private/non-traded REIT?

Answer: There are important differences between public REITs that trade on a stock exchange, and private/non-traded REITs. We recommend clients avoid private REITs. Private REITs have the following negative characteristics when compared to publicly traded REITs, which we believe hurt shareholders and make private REITs unsuitable for clients:

• Limited liquidity for private REITs - leading to potential difficulty in selling a private REIT; • High selling commissions, dealer management fees and offering expenses – meaning less money invested in actual real estate and more money being paid in commissions; • Significant fees paid to affiliates – potentially creating conflicts of interests for private REITs; • Less transparency and public market scrutiny compared with publicly traded REITs. • Lower levels of insider ownership when compared to many public REITs. • Many private/non-traded REITs require investors to make a minimum initial investment; additionally, a number of private/non-traded REITs also require prospective investors to meet minimum net worth thresholds.

Risks

We believe the biggest risk to investing in REITs today is the lingering impact from the recent

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economic recession. As a result of the recession, rents and occupancy levels in commercial real estate fell, resulting in a decline in property values. In addition, if interest rates rise and REIT dividend yields move back toward their historical averages, REIT share prices could also decline. Other risks to investing in REITs include a considerable increase in the amount of new construction (which would reverse the favourable demand-supply characteristics of the current market) and the potential for large common stock issuances. We note that because of their high payout requirement, REITs generally need to raise capital in order to finance their growth plans. These capital raises can impact the common share price of the REIT.

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