

RESEARCH REPORT

External Research Program



Examination of the Prospects for, and
Potential Impacts of Real Estate
Investment Trusts on the Multi-Family
Rental Market in Canada



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**EXAMINATION OF THE
PROSPECTS FOR, AND
POTENTIAL IMPACTS OF
REAL ESTATE INVESTMENT
TRUSTS ON THE MULTI-
FAMILY RENTAL
MARKET IN CANADA**

By: Tony Wellman

January 1999

CMHC Project Officer: David Metzak

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A study drawing from the U.S. experience and the views of Canadian practitioners and experts

FINAL REPORT

Prepared for:

Canada Mortgage and Housing Corporation

By

Tony Wellman

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ABSTRACT

Examination of the Prospects for, and Potential Impacts of Real Estate Investment Trusts on the Multi-Family Rental Market in Canada

A Real Estate Investment Trust (REIT) is a tax advantaged investment vehicle set up to own and manage real estate. REITs raise money through publicly listed partnership units (Canada) or through shares (U.S.).

REITs have shown phenomenal growth in the U.S. in recent years. REITs focusing on residential apartments in the U.S. now hold a total of around 1 million rental units. The Canadian REIT industry is very small in comparison. The first two Canadian REITs focusing on residential apartment properties were formed in 1997.

The purpose of the paper is to explore whether the U.S. pattern of REIT growth is likely to be followed in Canada, and to assess whether REITs represent a financing mechanism which can improve rental affordability and the financial viability of regenerating or constructing residential rental units in Canada.

The report concludes that use of the REIT structure in the U.S. has enabled real estate operators and developers to achieve greater access to capital, and lower cost financing for acquisition, construction and renovation. The resulting ability to grow has also enabled them to achieve economies of scale in purchasing, marketing and operations

The lower costs and greater availability of capital has reduced cost pressure on rents for existing owners and enabled projects (including renovation) to go ahead, thereby increasing supply and further moderating pressure on market rents.

REITs could assist in revitalizing the Canadian rental sector by drawing additional players and a new source of funding into the market, and contributing to the upgrading the stock particularly in areas where renovation has been discouraged through rent controls.

The potential for REITs in Canada, however, is limited by legislative and regulatory factors. In addition, a number of market and economic factors are not as conducive to REITs obtaining the competitive advantages that they enjoy in the U.S.

EXECUTIVE SUMMARY

Why look at residential REITs?

Real Estate Investment Trusts (REITs) have shown phenomenal growth in the United States over the last five years. They are transforming both the way investment in real estate takes place, and the structure of ownership in the industry. U.S. REITs have grown from a stock market value of \$8.7 billion in 1990 to \$140 billion by the end of October, 1998. There are over 200 REITs in the United States. 30 of these focus on residential construction. Through aggressive acquisition, they now hold close to 1 million multifamily units. Following mergers now underway, the two largest multifamily property owners in the U.S. will be REITs

The year 1997 saw the birth of the first two Canadian apartment (multi-family) REITs. The Canadian multi-family REIT sector remains small compared to that in the U.S. (under 1.5% of its size, in spite of the fact that the total Canadian rental market equals around 11% of that in the U.S.).

The purpose of this paper has been to explore whether the U.S. pattern is likely to be followed in Canada, and to assess whether REITs represent a financing mechanism which can improve rental affordability and the financial viability of regenerating or constructing residential rental units in Canada.

What sources of information were used in the study?

The information on which the analysis was based was drawn from the following:

- Examination of company reports, websites, press releases and filings with the Security Exchange Commissions in Canada and the U.S., other information available on the internet, academic papers, newspaper and magazine articles, and books.
- Discussions, fax and email communication with those in the industry and related industries in Canada and the U.S.
- A survey of 21 key Canadian players including residential and diversified REITs, other property owners and developers, investment analysts, bankers and brokers, pension fund advisors, and life insurance company portfolio managers. The respondents were asked their views on the prospects for residential REITs in Canada, the impediments to their development, and the impacts,

How is the report structured?

Part 1 examines the phenomenal growth and underlying characteristics of residential (apartment) equity REITs in the U.S.

In Part 2, the focus turns to Canada. Firstly, the origins of the REIT industry in Canada and the key regulatory differences between Canada and the U.S. are examined. After this, the two Canadian residential (apartment) REITs and other companies that are actively building up residential real estate portfolios are discussed.

The results of the survey are then laid out, showing the views of key players on the prospects for, impediments to, and impact of residential REITs in Canada.

Finally drawing from the U.S. experience, the limited Canadian experience, and the views of the survey respondents, suggestions are made as to how things are likely to unfold in Canada.

What impacts are REITs having in the U.S.?

Residential REITs in the U.S. were generally formed from existing private real estate companies seeking increased access to capital for expansion, and to make their assets more liquid. As compared to the previous generation of REITs, they have a low level of debt, typically less than 40% debt to equity. This is attractive to lenders and investors who had withdrawn from rental lending after the real estate crash of the late eighties, and has had the effect of drawing additional funds into the rental sector.

Consistent with their operating approach of holding for the long term, REIT strategy is to focus on tenant satisfaction, and property improvement. REITs acquire properties, upgrade them and add additional tenant services, and recapture the costs through incrementing rents, and introducing efficiencies in operations. This is contributing to the upgrading of the stock in the U.S.

Economies of scale in purchasing, marketing, and general operations; access to lower cost funds; and professional management have enabled REITs to streamline costs while increasing services, thus providing value for money for renters.

While REITs initially focused on acquisition of existing properties as the quickest way to grow, they are increasingly turning to new construction. In this they are driven by a desire to become fully integrated companies as well as by a drying up of suitable properties for acquisition in many markets. Their improved access to capital for new construction is enabling greater rental production than otherwise possible, increasing the supply of rental accommodation. This greater supply, through the impact of market forces should temper upward pressure on rent levels.

The overall impact on volume of affordable stock will be moderated by the following facts:

- As indicated, REITs in the U.S. do not typically compete on price, but on service. Properties are improved, but rents are increased. This can have the effect of diminishing the supply of affordable accommodation.

- Most REITs in the U.S. tend to concentrate on lower middle to high end properties, rather than those at the low end.

What are the prospects and impediments for Canadian residential REITs?

Most respondents to the survey believed that residential REITs will play an increasingly important role in the Canadian rental sector, but that their importance is likely to be modest compared to that in the U.S. They face a number of impediments compared to their American counterparts. The major ones are:

Inability to offer a tax deferred transaction to those from whom they buy property

REIT creation and expansion in the U.S. owes much to the ability of U.S. REITs (by assuming an “UPREIT” structure) to offer a tax deferred transaction to those selling property to them (an option not available to corporations in the U.S.). In Canada, while corporations can offer a stock for property exchange on a tax deferred basis, it is not possible for REITs (and Canadian tax law does not permit the creation of UPREITs). This places REITs at a disadvantage compared to public real estate corporations. (One Canadian residential REIT has developed a leasehold approach to acquisition that does not trigger a tax liability but the mechanism is more limited in its appeal)

The perception of unlimited liability for unitholders

While the Canadian Institute for Public Real Estate Companies (CIPREC) has suggested that there is some protection in common law, it is widely perceived that a REIT unitholder does not have limited liability (e.g. in an environmental disaster) in the same way as a company shareholder. While most investors dismiss it as largely an academic issue, a few industry participants indicated that it *has* caused reluctance to invest in REITs on the part of several of their institutional clients.

The smaller size of the Canadian market

The smaller size of the Canadian market will make it more difficult for residential REITs in Canada to achieve the size required to enjoy the economies of scale in purchasing, marketing, accessing funding, and general management and operations. It also makes it difficult to reach the level of stock market capitalization to offer an attractive investment to institutional investors, i.e. offer satisfactory liquidity and the opportunity to move in and out without having a major impact on the unit price.

Unfavorable rental market dynamics

Where rent controls have been in force in Canada, there is an ingrained culture of cutting costs, and keeping rents low, rather than property improvement and tenant satisfaction. Some respondents argued that tenants, unlike counterparts in the U.S. are not accustomed, or willing to pay more for additional services and improvements. The

environment is thus unsupportive of the REIT strategy of maximizing revenues through increasing services and incrementing rents.

Restricted and limited options to engage in new development

Residential REITs in the U.S. have become fully integrated companies, increasingly involved in new development. Their low debt to equity ratio, experienced management, and the expected stability of income from holdings of existing property, presents them as a good risk to lenders who remain reluctant to lend to developers following the memory of the real estate crash in the U.S. in the late 1980's.

The option for Canadian residential REITs to get involved in new multi-family development and become fully integrated companies is impeded by the legislation, their Declarations of Trust and by market conditions. The Income Tax Act restricts *property improvement* activities of REITs to their own capital properties, precluding their involvement in development for sale. In addition, while "improvement" has of late been considered by Revenue Canada to include new development, this was not always the case, and this could become a grey area if any REIT became extensively involved in construction. In practice, those (non residential) REITs that have entered into new development have done it through partnership arrangements with a developer.

Secondly, rents in many markets in Canada, particularly Toronto, are still well below levels at which new construction is viable. New rental completions in Canada in 1997 were one fortieth of the level in the U.S. in spite of the fact that the number of rental households is only nine times as high.

Less favorable market timing than that enjoyed by U.S. REITs

In the U.S., the perception was widely held that REITs were insulated from the downturns of the market by virtue of the fact that a high proportion of the total return came from dividends. The tumble in the stock market in 1998 has demonstrated (both in Canada and the U.S.) that REITs are vulnerable to stock market conditions. Thus REITs have, to some extent, to prove themselves through a stock market cycle. Further, the entry of the residential REITs has occurred at a time when market sentiment towards real estate has turned less favorable.

More limited access to capital, and less competitive advantage in access than U.S. REITs

Given that a REIT distributes virtually all of its income to unitholders, its access to capital is crucial if it is to have funding for improvements, unanticipated expenses and for expansion. In the U.S., REITs' options for financing are wider than those in Canada, giving them more secure access to capital, and flexibility to minimize their cost of capital.

Some respondents to the survey also argued that whereas in the U.S., an established REIT can achieve a competitive advantage in securing lowest cost capital, in Canada the

universal availability of CMHC insured low cost mortgage debt precludes this. It was felt that CMHC insured debt was generally available to most borrowers, and at a price unrelated to financial strength or credit rating.

Potential Contribution of REITs to affordability and financial viability in Canada

Benefits as realized in the United States

Use of the REIT structure in the U.S. has enabled real estate operators and developers to achieve greater access to capital, and lower cost financing for acquisition, construction and renovation. The resulting ability to grow has also enabled them to achieve economies of scale in purchasing, marketing and operations.

The lower costs and greater availability of capital has reduced cost pressure on rents for existing owners, and enabled projects (including renovation) that would not otherwise have taken place, to go ahead, thereby increasing supply and further moderating pressure on market rents.

The impact on affordability in the U.S. has, however, to some extent been limited by (i) the fact that many apartment REITs focus on more “upscale” property (although this has not been the case to date with Canadian REITs), and (ii) the REIT market strategy of upgrading units and increasing rents.

Limitations to realizing the same benefits in Canada

As discussed, the expansion of REITs in Canada is impeded by legislative and regulatory factors, most particularly the inability to effect a tax deferred exchange of trust units for property, and impediments to becoming fully fledged developers. In addition, a number of market and economic factors are not as conducive to REITs obtaining the competitive advantage that they enjoy in the U.S.

Specific merits of the expansion of REITs given Canadian market conditions:

The further expansion of REITs at this time in Canada could assist in addressing problems specific to the Canadian residential rental sector and contribute to increasing rental availability and affordability and to the improvement of the rental stock. These benefits would be fostered as described below:

Drawing additional players and investors into the Canadian rental sector

The last 30 years has seen the rental sector supported at various times by tax shelter programs, market supply programs and social housing programs.

The ending in turn of each of these means of support has been followed by the ending of an the extended inflationary period in which real estate and ownership of a rental property was viewed as the ideal way to save for retirement for many Canadians.

Thus, there is presently a vacuum in terms of investors in rental markets. Individuals who might in the past have invested their savings in rental property now look to the stock market. Baby boomers reaching retirement age seek a nest egg more liquid than real estate. Residential REITs, through providing an investment choice which has clearly struck the right chord in the U.S., could help to fill this vacuum. With increased size, and a record of dividend growth, they would become increasingly attractive to institutions and could potentially have a place in the growing portfolios of Canadian pension funds, other institutions, and mutual funds.

Improvement of the Stock

Rent controls have left markets in some parts of Canada with a stock which has not been adequately maintained. In Ontario, in particular, with the replacement of rent controls by the new Tenant Protection Act, REITs, with their focus on maintenance, improvement and tenant services could play an important role in upgrading the stock.

Bringing Stability to the Real Estate Sector

The rental sector is traditionally cyclical. High leverage in real estate contributes to periodic high defaults and mass failures of real estate operators and the institutions that provide funding to them. REITs, with their low debt to equity ratio could reduce the risk exposure of financial institutions and mortgage insurers.

SOMMAIRE

Pourquoi envisager une FPI résidentielle ?

Les fiducies de placement immobilier (FPI) affichent une croissance fulgurante aux États-Unis depuis cinq ans. Elles ont transformé tant la manière dont se font les placements dans le secteur immobilier que la structure du capital social dans l'industrie. Les FPI américaines sont passées d'une valeur en bourse de 8,7 milliards de dollars en 1990 à 140 milliards de dollars au mois d'octobre 1998. Il en existe plus de 200 aux États-Unis, trente d'entre elles évoluant en construction domiciliaire. Elles détiennent actuellement, par suite d'acquisitions agressives, près de un million d'unités de collectifs d'habitation. Une fois les fusions en cours bouclées, les deux propriétaires de collectifs d'habitation les plus importants aux États-Unis seront des FPI.

En 1997 voyaient le jour les deux premières FPI (appartements) au Canada. Le secteur des FPI du Canada demeure petit comparativement à celui des États-Unis (il a moins de 1,5 % de sa taille, malgré le fait que le marché locatif total du Canada constitue quelque 11 % de celui des Américains).

Le présent document a pour objet de voir si le Canada pourrait emboîter le pas aux États-Unis et si les FPI pourraient devenir un mécanisme de financement susceptible d'accroître l'abordabilité des logements locatifs et la viabilité financière du réaménagement ou de la reconstruction de logements locatifs du Canada.

Quelles sources d'information ont été utilisées pour l'étude ?

L'information sur laquelle s'appuie l'analyse a été tirée de ce qui suit :

- Dépouillement de rapports d'entreprises, de sites Web, de communiqués de presse et de documents déposés par les commissions du change et des valeurs au Canada et aux États-Unis, d'autres informations sur Internet, des communications savantes, des articles de journaux et de revues, et des livres.
- Discussions, télécopies et messages sur courrier électronique avec les membres du secteur et des entreprises connexes au Canada et aux États-Unis.
- Sondage auprès de 21 intervenants clés du Canada, à savoir des FPI résidentielles et diversifiées, des propriétaires et promoteurs fonciers, des analystes en placements, des banquiers et courtiers, des conseillers en fonds de pension de retraite et des administrateurs de portefeuilles de compagnies d'assurance-vie. Nous avons demandé aux répondants leur point de vue sur les perspectives des FPI résidentielles au Canada, les obstacles gênant leur développement et les répercussions.

Comment le rapport est-il structuré ?

La partie 1 porte sur la croissance phénoménale et les caractéristiques sous-jacentes des FPI résidentielles (appartements) aux États-Unis.

Dans la partie 2, le Canada prend la vedette. Il est d'abord question du secteur FPI au Canada et des principales différences au chapitre de la réglementation entre le Canada et les États-Unis. Nous abordons ensuite les deux FPI résidentielles (appartements) et d'autres entreprises canadiennes qui sont en train de monter un portefeuille de propriétés résidentielles de façon active.

Viennent ensuite les résultats du sondage, assortis des vues exprimées par les intervenants clés sur les perspectives, les obstacles et les répercussions des FPI résidentielles au Canada.

Enfin, à partir de l'expérience américaine, de l'expérience limitée du Canada et des opinions des répondants, des suggestions sont faites sur l'évolution probable du secteur au Canada.

Quelles sont les retombées des FPI aux États-Unis ?

Les FPI résidentielles des États-Unis ont été généralement formées à partir de sociétés immobilières privées qui existaient déjà et qui étaient désireuses d'améliorer leurs liquidités et leur accès à des capitaux pour fins d'expansion. Par opposition à la génération précédente de FPI, leur endettement est faible, soit typiquement moins de 40 % par rapport à l'avoir propre. C'est ce qui attire à nouveau les prêteurs et investisseurs qui s'étaient retirés du marché des prêts au secteur locatif après le krach du marché immobilier à la fin des années 1980, ce qui injecté des fonds supplémentaires dans le secteur locatif.

Selon leur approche basée sur la rétention à long terme, la stratégie des FPI est de miser sur la satisfaction des locataires et l'amélioration des propriétés. Les FPI achètent des propriétés, les améliorent et ajoutent des services aux locataires, puis en recouvrent les coûts par des augmentations progressives de loyers, et rendent l'exploitation plus efficace. Ceci contribue à l'amélioration du parc résidentiel américain.

Les économies d'échelle réalisées dans l'achat, la mise en marché et les opérations générales, l'accès à des fonds meilleur marché et une gestion professionnelle ont permis aux FPI de rationaliser les coûts tout en accroissant les services, soit un bon rapport qualité-prix pour les locataires.

Bien que les FPI misaient surtout initialement sur l'acquisition de propriétés existantes comme le moyen de croissance le plus rapide, elles s'intéressent de plus en plus à la construction. Ceci est dicté par le fait qu'elles veulent ainsi devenir des entreprises entièrement intégrées, et parce qu'il y a une pénurie de propriétés acceptables à acheter sur de nombreux marchés. Cet accès amélioré au capital de construction favorise la production de logements locatifs et en augmente le nombre. Cette offre accrue devrait atténuer l'augmentation des loyers, grâce aux forces du marché.

L'incidence globale sur le volume de logements abordables sera modéré par les faits suivants :

- Comme il est indiqué, les FPI aux États-Unis ne se font pas normalement concurrence sur les prix, mais les services. Les propriétés sont améliorées, mais les loyers augmentent en conséquence. Ceci risque de diminuer l'offre de logements abordables.
- La plupart des FPI aux États-Unis ont tendance à se concentrer sur les propriétés de moyenne qualité et de luxe, plutôt que les bas de gamme.

Quelles sont les perspectives et les obstacles pour les FPI résidentielles canadiennes ?

La plupart des répondants estiment que les FPI résidentielles vont jouer un rôle d'une importance croissante dans le secteur locatif au Canada, quoique leur importance demeurera probablement modeste comparativement aux États-Unis. Elles sont confrontées à certaines entraves, les principales étant :

L'impossibilité de faire reporter l'impôt à ceux qui leur vendent une propriété

La création et l'expansion des FPI aux États-Unis est en majeure partie attribuable au fait qu'elles peuvent transiger avec report d'impôt (par une structure dite «UPREIT») avec ceux qui leur vendent une propriété (option dont ne bénéficient pas les sociétés aux États-Unis). Au Canada, les sociétés peuvent offrir une action contre l'achat d'une propriété, avec report d'impôt, mais ce n'est pas possible pour une FPI (et la législation fiscale canadienne interdit la création d'UPREIT. Les FPI sont donc désavantagées par rapport aux sociétés immobilières publiques. (Une FPI résidentielle canadienne a adopté une approche axée sur la tenure à bail, qui ne déclenche pas de responsabilité fiscale, mais ce mécanisme est moins attrayant.)

L'impression que les détenteurs d'unités ont des responsabilités illimitées

Même si l'Institut canadien des compagnies immobilières publiques (ICCIPI) estime qu'il y a une certaine protection en common law, la croyance populaire veut qu'un détenteur d'unités d'une FPI n'ait pas de responsabilité limitée (en cas de cataclysme, p. ex.) au même titre qu'un actionnaire. Bien que la plupart des investisseurs sont d'avis que cette question relève de la théorie, quelques participants du secteur ont fait savoir que plusieurs de leurs clients institutionnels ont effectivement hésité à placer leur argent dans une FPI pour cette raison.

La plus petite taille du marché canadien

La plus petite taille du marché canadien fera en sorte qu'il sera plus difficile pour les FPI résidentielles d'atteindre l'envergure requise pour bénéficier d'économies d'échelle en ce qui concerne l'achat, la commercialisation, l'accès au financement, la gestion générale et les opérations. Il est d'autant plus difficile d'en arriver au niveau nécessaire de capitalisation à la bourse pour offrir un rendement intéressant aux investisseurs institutionnels, c'est-à-dire offrir une

liquidité satisfaisante et la possibilité de vendre et d'acheter sans effet perturbateur sur le prix de l'unité.

La dynamique défavorable du marché locatif

Lorsque la réglementation des loyers était en vigueur au Canada, on avait tendance, et ceci fait maintenant partie de notre mentalité, à comprimer les dépenses et à ne pas augmenter les loyers, au lieu d'améliorer les propriétés et de satisfaire les locataires. Certains répondants ont présenté l'argument que les locataires, contrairement aux États-Unis, ne sont pas habitués ou disposés à payer plus cher pour des services supplémentaires et des améliorations. Le milieu n'est donc pas propice à l'implantation de la stratégie FPI, à savoir l'optimisation des recettes par la prestation de nouveaux services et l'augmentation progressive des loyers.

Le peu d'occasions de participer à de nouveaux aménagements

Les FPI résidentielles américaines sont devenues des sociétés entièrement intégrées qui oeuvrent de plus en plus dans le secteur de la construction domiciliaire. Grâce à leur faible rapport d'endettement, une gestion chevronnée et la stabilité prévue du revenu provenant de propriétés existantes, elles représentent un bon risque pour les prêteurs qui sont toujours peu disposés à prêter de l'argent aux promoteurs à cause du krach du marché immobilier survenu aux États-Unis à la fin des années 1980.

La possibilité pour les FPI résidentielles canadiennes de participer à la construction de collectifs d'habitation et de devenir des sociétés entièrement intégrées est entravée par les lois, leurs déclarations de fiducie et les conditions du marché. La Loi de l'impôt sur le revenu limite les activités relatives aux *améliorations immobilières* des FPI à leurs propres immobilisations, ce qui les empêche de réaménager en vue de vendre une propriété. En outre, bien que Revenu Canada ait récemment décidé que le terme «amélioration» englobe les aménagements neufs, il n'en a pas toujours été ainsi, si bien que ce pourrait devenir une zone grise si une FPI participait à des projets de construction dans une grande mesure. Dans les faits, les FPI (non résidentielles) qui sont entrées dans ce domaine l'ont fait en association avec un promoteur.

Par ailleurs, les loyers de nombreux marchés au Canada, Toronto en particulier, sont toujours bien en deçà des niveaux auxquels une construction neuve est viable. Les constructions neuves terminées en 1997 étaient à un quarantième du niveau de notre pays voisin, même si le nombre de ménages qui louent un logement n'est que neuf fois plus élevé.

Des conditions chronologiques moins favorables sur le marché que celles dont jouissent les FPI américaines

Aux États-Unis, les gens croyaient en général que les FPI étaient protégées contre le repli du marché parce qu'une forte proportion du rendement total provient de dividendes. La chute de la bourse en 1998 a prouvé (au Canada comme aux États-Unis) que les FPI sont vulnérables aux conditions du marché. Les FPI doivent donc, dans une certaine mesure, faire leurs preuves dans

un cycle boursier. De plus, l'entrée des FPI a eu lieu à un moment où l'immobilier n'est pas vu d'un très bon oeil.

L'accès plus restreint aux capitaux et un avantage concurrentiel moindre que les FPI américaines

Comme la FPI répartit presque tous ses revenus entre les détenteurs d'unités, l'accès aux capitaux est crucial pour financer les améliorations, les dépenses imprévues et l'expansion. Aux États-Unis, les options de financement des FPI sont plus étendues qu'au Canada, ce qui leur garantit plus d'accès aux capitaux et leur donne plus de marge de manoeuvre pour minimiser les frais financiers.

Certains répondants soutiennent que, tandis qu'une FPI bien établie aux États-Unis peut être compétitive grâce à l'accès à un financement peu coûteux, au Canada la disponibilité universelle d'hypothèques peu coûteuses assurées par la SCHL élimine cette possibilité. On estime que les prêts assurés par la SCHL sont à la disposition de la plupart des emprunteurs, à un prix qui n'est pas lié à la richesse ou à la cote de crédit.

Apport potentiel des FPI pour l'abordabilité et la viabilité financière au Canada

Avantages réalisés aux États-Unis

L'utilisation de la structure FPI aux États-Unis a permis aux exploitants et promoteurs d'immeubles d'avoir davantage accès aux capitaux et de bénéficier de bas prix sur le plan de l'acquisition, de la construction et de la rénovation. L'expansion potentielle qui en résulte leur a aussi permis de réaliser des économies d'échelle pour l'achat, la commercialisation et l'exploitation.

Les prix plus bas et la disponibilité accrue de capitaux a diminué les pressions exercées sur les loyers pour les propriétaires et rendu possibles certains projets (rénovations aussi) qui n'auraient pu aller de l'avant autrement, ce qui augmente l'offre et modère les pressions sur les loyers du marché.

L'incidence sur l'abordabilité aux États-Unis a toutefois été diminuée dans une certaine mesure par le fait que bon nombre de FPI constituées d'appartements sont des propriétés de luxe (ce qui n'a pas été le cas jusqu'à ce jour pour les FPI canadiennes) et la stratégie du marché des FPI axée sur l'amélioration des logements et l'augmentation des loyers.

Contraintes au Canada

Comme il est dit précédemment, l'expansion des FPI au Canada a été entravée par les lois et règlements, plus précisément par l'impossibilité d'échanger des unités fiduciaires contre des propriétés avec report d'impôt, et de ne pouvoir devenir des promoteurs à part entière. Qui plus est, certains facteurs économiques n'apportent pas les mêmes conditions dont jouissent les FPI aux États-Unis.

Avantages particuliers de l'expansion des FPI compte tenu des conditions du marché au Canada

L'expansion accrue des FPI au Canada à ce stade permettrait de lutter contre les problèmes qui affligent le secteur résidentiel locatif et serait d'un apport à la disponibilité, l'abordabilité et l'amélioration des logements loués. Ces avantages seraient favorisés comme suit :

Attirer de nouveaux joueurs et investisseurs dans le secteur locatif canadien

Au cours des 30 dernières années, le secteur locatif a été soutenu à divers moments par des abris fiscaux, des programmes d'approvisionnement et le logement social.

Chaque fois qu'on a mis un terme à ces mécanismes de soutien, nous avons été témoins de la fin d'une longue période d'inflation au cours de laquelle l'immeuble et la propriété de logements locatifs étaient considérés comme le moyen idéal d'économiser pour ses vieux jours par beaucoup de Canadiens.

Or, il s'est créé un vide au niveau des investissements dans les marchés locatifs. Ceux qui auraient placé leurs économies dans l'immeuble se tournent maintenant vers la bourse. La génération issue de l'explosion démographique, qui approche de la retraite, veut un placement plus liquide que l'immeuble. La FPI résidentielle, parce qu'elle offre un investissement de choix qui plaît à nombre d'Américains, pourrait combler le vide. Si les FPI prenaient de l'expansion et leurs dividendes connaissaient une croissance soutenue, elles seraient plus attrayantes pour les institutions et pourraient figurer dans les portefeuilles sans cesse grandissants des fonds de pension, d'autres institutions et des sociétés de fonds mutuels.

Amélioration du parc immobilier

À cause de la réglementation des loyers, le parc immobilier de certaines régions du Canada n'a pas été entretenu adéquatement. En Ontario, maintenant que la réglementation a fait place à la nouvelle loi sur la protection des locataires, les FPI, qui accordent de l'importance à l'entretien, aux améliorations et aux services aux locataires, pourraient contribuer à donner une nouvelle vie au parc immobilier.

Stabilité du secteur immobilier

Le secteur locatif a toujours été cyclique. Des risques élevés provoquent périodiquement des faillites monumentales tant pour l'exploitant que pour l'institution prêteuse. Les FPI, dont le rapport d'endettement est faible, pourraient réduire les risques courus par les institutions financières et les assureurs hypothécaires.



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PART 1:
THE U.S. EXPERIENCE

A. Historical Background

REITs have existed in the U.S. since 1960, but the phenomenal growth has occurred in the 1990's. Total stock market capitalization (all REITs) has risen from \$8.7 billion in 1990 to \$140 billion by the end of October, 1998¹.

While the experience of REITs in the nineteen nineties may seem to have little in common with events in the first 30 years, it is important to understand the context and environment leading to the present day explosion in growth, and to take note of the bumps in the road (and some nasty crashes) that occurred in the past that could conceivably have their counterparts in the future.

Real estate ownership and development in the U.S. was traditionally in the hands of small private developers concentrating on local markets. There was little opportunity for the small investor to include investment in real estate in his or her portfolio. The REIT legislation of 1960 was designed to open the door to the private investor by facilitating the creation of public companies that would finance real estate ownership and development through the sale of shares to the public. The main element of the legislation was the exemption from tax at the corporate level if a minimum of 95 percent of income was distributed to shareholders.

REITs boomed in the late 60's to early 70's. Between 1968 and 1972, REIT assets rose from \$1 billion to \$14 billion. The fastest growing REITs were not however equity REITs which bought property, but mortgage REITs which raised money from banks and insurance companies and lent it out at a margin

These mortgage REITs financed their lending with short term debt. Thus when interest rates began to rise in 1972, many began to experience financial difficulties.

The problems of the mortgage REITs were compounded by the real estate recession of 1973-5. Rent-up problems caused developers to default on loans, pushing some mortgage REITs into bankruptcy. Between 1974 and 1975, aggregate REIT assets fell from \$20 billion to \$12 billion. By 1978, they fell to below \$8 billion.

Not surprisingly, REITs fell out of favour. They did not figure significantly in the real estate recovery of the late 70's and early 80's. In fact total assets of REITs remained below \$8 billion until 1984.

The first half of the 80's saw a boom in real estate limited partnerships. Individual investors entered the market motivated by generous tax sheltering.

¹ REIT capitalization actually reached \$160 billion by the end of March 1998, but dropped in the second and third quarters due to stock price declines.

The 1986 Tax Act stemmed the growth in limited partnerships by limiting interest deductibility, lengthening amortization schedules, and restricting passive losses.

This Act also facilitated the development of the modern style REIT by removing restrictions on self-management of properties by REITs. As a consequence, there was a revival of interest in REITs during the real estate boom of the mid to late 80's. As opposed to the earlier period, the growth in REITs was primarily in equity rather than in construction and development loans.

Overbuilding during the eighties brought about the real estate crash of the late eighties to early nineties along with the Savings and Loan (S&L) crisis in which hundreds of S&Ls went under, and in which investors in real estate limited partnerships saw the equity in their investments disappear.

Traditional lenders withdrew from real estate financing, a trend which was accelerated by more stringent construction and mortgage finance related capital requirements and restrictions on S&Ls, commercial banks and insurance companies. As a result, real estate became increasingly illiquid. Owners, unable to sell or refinance turned to the public markets and initiated the revival of REITs.

Initial REIT equity offerings rose from only 8 in each of 1991 and 1992, to 50 in 1993 and 45 in 1994. This surge in REIT IPOs satisfied the market appetite for a while and the market became a little less receptive to new REIT IPOs. Following a few less well received initial offerings, REIT IPO activity dropped off almost completely in 1995-6.

The strong performance of REIT stocks rekindled the market taste for REIT IPOs for private and institutional investors including mutual funds, by 1997, and initial equity offerings picked up again to 26 in 1997, and are continuing at a comparable pace in 1998. There are now (as of March 31, 1998), 191 public equity REITs of which 30 are multi-family apartment REITs,

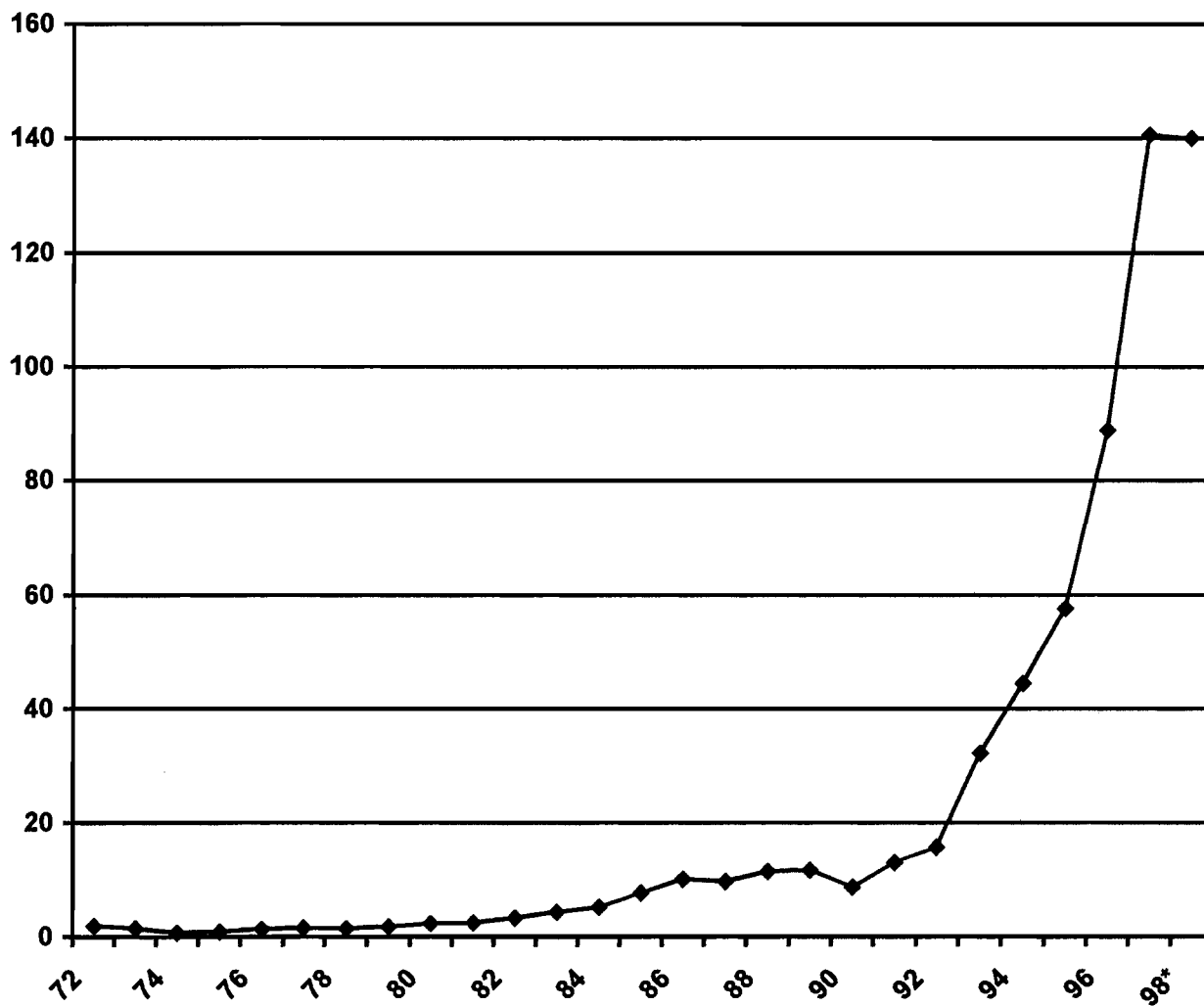
The phenomenal growth in REITS is now being driven by acquisitions. UPREIT and DOWNREITS structures (discussed later in the document) enable sellers to transfer properties to REITS and defer the tax consequences. Capital raised from secondary offerings is being used to pay down the loans outstanding on acquired property.

While new construction has not been a significant priority for most of the new generation of REITs, some are now showing increased interest in new construction in response to a declining supply of suitable properties for acquisition.

As of October 31, 1998, total REIT capitalization was \$140 billion, with apartment REITs accounting for \$22.5 billion² (down from \$25 billion at the stock market peak).

² There are also 4 Manufactured Housing REITS with total capitalization of \$2 billion. These are involved in ownership and operation of manufactured housing communities. I have not included this data in the tables presented.

U.S. REIT Market Capitalization - all REITs (\$B) 1972-1998



* As of October 31, 1998, 1998

Source of data: NAREIT

B. The Nature of REITs

Tax Requirements

The Real Estate Investment Trust (REIT) legislation in 1960 was designed to create a mechanism whereby individuals could invest in the real estate market by buying a transferable share in a pool of properties.

A company can qualify as a REIT and be exempt from taxation at the corporate level if it meets the following requirements:

- It must be a corporation, business trust or similar association;
- It must be managed by one or more directors or trustees;
- It must have at least 100 share holders, and its shares must be fully transferable;
- No more than 50% of the shares may be held by five or fewer individuals;
- It must invest at least 75% of the total assets in real estate assets;
- At least 75% of its gross income must be derived from real estate assets;
- It must pay dividends of at least 95% of REIT taxable income.

Other Characteristics

Present day REITs have other distinct characteristics that distinguish them from the pre 1990's REITs. These include:

- Low leverage- typically less than 40% debt to overall capitalization,
- Focus on one property type only and on specific geographical markets,
- Professional management. Self advised and self-managed (1970's REITs were externally advised and managed,
- Management typically has significant equity interest so their interests are the same as those of investors.
- Clearly defined business strategy.

C. The Apartment REIT Universe

C. 1. Market Capitalization and Apartment Ownership

As of March 31, 1998, there were 30 equity apartment REITs in the U.S. These REITs owned approximately 900,000 apartments, representing close to 5.5% of the total rental apartment universe (structures of 5 units and above) of 16,850,000, in the United States, up from 1% in 1991. The total market capitalization (shares outstanding times share price) of apartment REITs as of March 31, 1998 was \$25 billion. The REIT universe in order of market capitalization is shown below.

	Name	Market Cap \$m. March 31, 1998	Apts owned or part owned Jan 1, 1998	Source- Apts owned (National MultiHousing Council where not stated)
1	Equity Residential Properties Trust	4,800	138,923	
2	Security Capital Pacific Trust	2,200	59,097	March 1998, SEC filing)
3	Apartment Investment and Mgt. Co. (AIMCO)	1,600	123,470*	1997 Annual Report)
4	United Dominion Realty Trust	1,500	62,600	
5	Post Properties, Inc.	1,400	25,412	
6	Avalon Properties	1,300	20,700	
7	BRE Properties, Inc	1,200	18,569	(1997 end, SEC Filing)
8	Security Capital Atlantic*	1,000	21,693	
9	Cambden Property Trust	990	34,669	
10	Bay Apartment Communities	968	17,097	Press release May 7, 98)
11	Merry Land and Investment company	951	29,490	
12	Irvine Apartment Properties	629	15,136	(1997 end, SEC Filing)
13	Gables Residential Trust	600	19,888	(1997 Annual Report)
14	Essex Property Trust	571	10,700	(1997 end, SEC Filing)
15	Charles E. Smith Realty	508	20,555	
16	Summit Properties Inc.	487	14,462	(1997 end, SEC filing)
17	Mid America Apartment Communities	477	30,520	
18	Walden Residential Properties, Inc.	464	42,481	
19	Cornerstone Realty Income Trust	442	12,586	(website stats)
20	Berkshire Realty Co. Inc.	436	18,773	
21	AMLI Residential Properties Trust	381	17,501	(1997 Annual Report
22	Oasis Residential, inc	362	14,241	(website stats)
23	Associated Estates Realty Corporation (April 1, 98)	356	18,920	(April 1, 98 SEC filing)
24	Home Properties of New York inc.	279	18,850	
25	Town and Country Trust	269	13,631	(1997, SEC Filing)
26	Ambassador Apartments, Inc.	216	14,456	
27	Lexford Residential Trust	185	28,929	(April 28, 1998- release)
28	Grove Property Trust	89	3,580	(1997 end, SEC Filing)
29	National Income Realty Trust	67	7,987	(1997 end, SEC Filing)
30	Roberts Realty Investors, inc.	39	1,524	(March, 1998, SEC filing)
	TOTAL	24,792	805,007	

* 40,039 of these are owned or controlled. AIMCO has a minority equity interest in the other 83,431 units.

Sources:

REIT apartment universe, and capitalization: drawn from NAREIT statistics

Apartments owned: National Multi Housing Council, SEC filings and annual reports

It should be noted that an ordering by apartments owned would be very different from the ordering by market capitalization. Aside from the difference in dates used for market capitalization and apartments owned, this difference can be explained by the following factors:

- Market capitalization does not include the share exchange value of *operating partnership units*. These are the "currency" of acquisitions, i.e. property owners selling their property to a REIT generally receive these in payment. They are exchangeable for shares at a later date- see section D.4. (Structuring for Acquisition).
- Market capitalization (i.e. stock value) is influenced by the dividend performance, quality, type and location of the stock, market perception about management etc.

Due to the fast pace of acquisitions and mergers, the picture is changing daily. The statistics in the table above do not reflect significant mergers which are currently announced or in process.

Two which will alter the industry profile significantly are:

- (i) **the merger of Apartment Investment and Management Company (AIMCO) with Insignia** (the second largest property owner (a non-REIT), and the largest property management company). This will give AIMCO the largest portfolio of any apartment REIT, and
- (ii) **the merger of Security Capital Atlantic and Security Capital Pacific.**

Mergers are discussed separately in section E.5.

C.2. Apartment REITs Compared to other REITs

Apartment REITs accounted for 18% of total equity REIT implied capitalization³ as of April 30, 1998, making them the third largest REIT property category, after Industrial/Office and Retail.

The average implied market capitalization of apartment REITS (April 30, 1998) was \$962 million. This compares with \$1,051 million for Lodgings/resorts and \$1,009 million for Industrial/Office REITs

REITs BY TYPE				
Category	No: ⁴	Implied Market Capitalization (\$b)	% of Total REIT Implied Capitalization	Average Implied Market Capitalization (\$ m)
Industrial/ Office	39	39.4	28.3%	\$1,009
Retail	50	31.6	22.7%	\$631
Apartments	26	25.0	18.0%	\$962
Lodging/Resorts	14	14.7	10.6%	\$1,052
Diversified	20	13.0	9.3%	\$649
Health Care	9	5.8	4.2%	\$644
Self Storage	6	5.6	4.1%	\$939
Manuf. Homes	4	2.2	1.6%	\$560
Specialty	7	1.9	1.4%	\$274
All Companies	175	139.2	100%	\$780

Source: NAREIT

When REITs are ranked by size, only 2 apartment REITs appear in the top twenty REITs (Equity Residential Properties (3rd), and Security Capital Pacific Trust (16th)). The largest REIT, Starwood Hotels & Resorts, with \$10 billion capitalization, is twice the size of Equity Residential Properties.

³ Implied market capitalization is actual market capitalization plus value of operating partnership units

⁴ Numbers differ from the tables based on March 31 data because of mergers.

D. Growth, Acquisitions and Consolidation

D.1. Increasing Importance of REITs among Apartment Owners

The National Multi Housing Council which publishes a list of the top 50 apartment owners in the U.S. each year, reported that as of January 1, 1998, a REIT for the first time headed the list. Equity Residential Properties Trust is now the largest apartment owner in the U.S. REITs dramatically increased their rankings in the top 50 list. These rankings, and the positions in the last 2 years are shown below.

The REITs in the top 50 increased their holdings of apartment units from 374,557 units to 632,051 between January 1, 1997, and January 1, 1998, an increase of 69%.

1998 Rank	1997 Rank	Company	1998 Wholly or jointly owned	1997 Wholly or jointly owned
1	6	EQUITY RESIDENTIAL PROPERTIES TRUST	138,923	71,497
4	29	AIMCO	123,323	23,765
7	10	UNITED DOMINION REALTY TRUST	62,600	55,559
15	14	SECURITY CAPITAL PACIFIC TRUST	44,062	42,702
17	31	WALDEN RESIDENTIAL PROPERTIES, INC.	42,481	21,407
21	44	CAMDEN PROPERTY TRUST	34,669	18,279
25	40	MID-AMERICA APARTMENT COMMUNITIES,	30,520	19,280
27	26	MERRY LAND & INVESTMENT COMPANY, INC.	29,490	25,363
31	47	POST PROPERTIES, INC.	25,412	17,996
36	41	SECURITY CAPITAL ATLANTIC INCORPORATED	21,693	19,241
40	-	AVALON PROPERTIES, INC.	20,700	13,368
41	-	CHARLES E. SMITH RESIDENTIAL REALTY INC.	20,555	15,200
49	-	HOME PROPERTIES	18,850	10,916
50	37	BERKSHIRE REALTY COMPANY, INC.	18,773	19,984
TOTAL			632,051	374,557

Source: National Multi Housing Council

D.2. REITs in Property Management

Many REITs also manage properties for third parties. According NHMC statistics, as of January 1, 1998, Equity Residential Properties manages an additional 9,000 units in which it has no ownership interest. AIMCO manages an additional 70,000 units, giving it a total management portfolio of 192,910, i.e. greater than Equity Residential properties.

The merger with Insignia will increase AIMCO's portfolio of units managed for third parties to 143,000 (making it the largest property manager in the country).

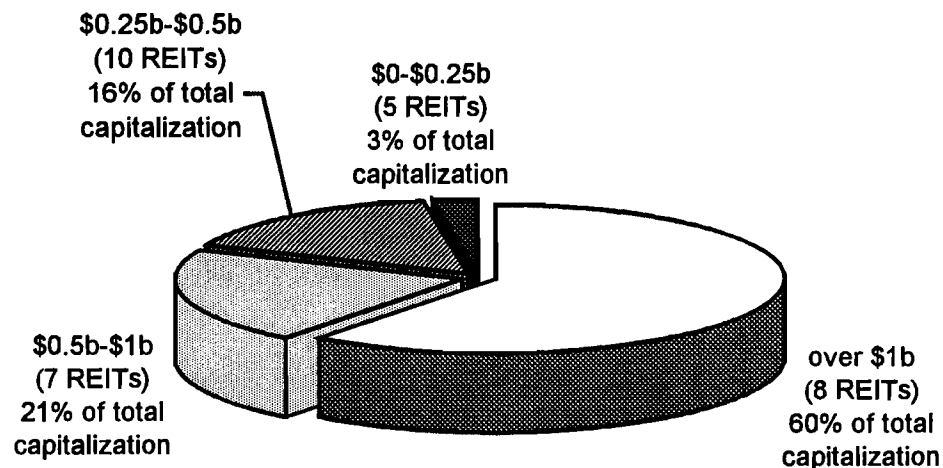
D.3. REIT Emphasis on Growth

A review of Annual Reports of U.S. REITs shows a strong emphasis on growth. The reasons/advantages cited for growth/acquisitions/mergers include:

- Accretive acquisitions giving immediate and long term positive impact on funds from operations
- Achieving brand name image and awareness for their apartment communities
- Building critical mass in markets
- Economies of scale in operations
- Increase purchasing power- e.g. insurance, appliances, trash removal
- Economies of scale in raising capital
- Reduced cost of debt
- Geographical diversification and presence
- Increased liquidity and stability in common stock
- Acquiring development capability from companies taken over
- Scope to deliver additional revenue generating goods and services to residents
- Achieving deeper management experience

Sixty percent of total apartment REIT capitalization is accounted for by the 8 largest REITs

Proportion of Total Apartment REIT Capitalization by REITS of Different Sizes



Financial and real estate analysts generally share the view that the future belongs to large integrated REITs. The pace of growth through acquisitions shows little sign of easing off. However, John Vogel⁵ in the summer of 1997 questioned this "conventional wisdom", and his paper has generated some debate.

He argued that size has never been as advantageous in the real estate industry as in other types of business, and pointed to the recent examples of Trammel Crow, Cadillac Fairview and Olympia and York. On economies of scale, he argues that if large real estate companies can do property management better, then they would get into management rather than owning. On cost of capital, he argues that the current advantage cannot be considered permanent. If Wall Street's opinion about real estate changes REITs may find their equity costs will increase dramatically, i.e. investors will demand a higher return to compensate for the perceived poorer prospects, and the price earnings ratio, and stock prices will fall.

D4. Structuring for Acquisition

The UPREIT

If property were sold directly to a REIT, or exchanged for stock, the existing owner would immediately face tax liability for any built-in gain in the acquisition price. This would clearly be a serious impediment to the formation of REITs, the acquisition of additional properties or to mergers.

In 1992, a new REIT structure was developed which enabled existing owners transferring property to defer this liability. This structure is the Umbrella partnership REIT or UPREIT.

Under the UPREIT structure, the existing owners and the (newly formed) REIT become partners in an umbrella partnership, or operating partnership, with the REIT as the general partner. The existing owners transfer their property to this umbrella partnership in exchange for *partnership units*.

Partnership units are exchangeable for shares of the REIT according to a fixed formula. The exchange of property for partnership units is not a taxable transaction under U.S. tax law. Tax is only due subsequently when the owners exchange any partnership units for shares of the REIT.

Since the partnership units will earn returns equivalent to dividends of the REIT, and since the exchange value of their units will appreciate along with any appreciation in the

⁵ John H. Vogel Jr. "Why the Conventional Wisdom About REITs is Wrong" *Real Estate Finance*, Summer 1997

share value of the REIT, they enjoy all the financial benefits of REIT ownership without incurring the immediate tax liability.

The REIT transfers to the operating partnership cash raised through the public offering. This is normally used to pay down the debts to achieve a debt equity level more acceptable to the market, and to increase the returns

NAREIT reports that 75 percent of the REIT Initial Public Offerings since 1972 have used the UPREIT structure. Of the 32 apartment REITs in place on March 31, 1998, nineteen (19) were structured as UPREITs.

The use of the umbrella partnership has not only been the mechanism through which most REITs have been formed, but has also made possible the rapid pace of acquisitions in recent years. Under these acquisitions, existing owners, including holders of limited partnership units receive operating partnership units in exchange for their property in the same way as the REIT founders did.

The DOWNREIT

A similar structure, which is used for acquisition of properties, is the DOWNREIT. As with the UPREIT, an operating partnership is formed. However, this operating partnership holds the acquired properties separately and apart from other REIT properties. This means that the existing owner can maintain some control and interest in the business. As with the UPREIT, the existing owner(s) transfer their properties to the operating partnership in return for operating partnership units which are exchangeable for stock.

Both UPREIT and DOWNREIT mechanisms enable the transferring owners to defer and spread their tax liability over time, by exchanging operating units for stock only when they require the cash.

D.5. Mergers

Following the burst of initial public offerings in 1993, the general market perception is that there is limited scope for additional REITs. The REIT sector is therefore now growing primarily through acquisition of properties by existing REITs, and by mergers.

MERGERS RECENTLY ANNOUNCED AMONG THE TOP 10 APARTMENT REITS

Equity Residential Properties Trust	Merged with Wellsford (REIT) and Evans Withycombe Residential (1997) Merging with Merry Land and Investment Company (Agreement of July 8, 1998)
Security Capital Pacific Trust	Merging with Security Capital Atlantic (REIT) (announced April 2, 1998)
Apartment Investment and Management Company (AIMCO)	Merging with Insignia- largest U.S. property mgt. company (announced March 17, 1998) Recently merged with Ambassador Apartments (REIT) (approved May 8, 1998)
United Dominion Realty Trust	Merged with ASR (REIT) (closed March 17, 1998). Acquired S.W. Property Trust Dec 1996
Post Properties, Inc.	No mergers
Avalon Properties	Merged with Bay (REIT), Approved June 5, 1998
BRE Properties, Inc.	Acquired Trammel Crowe Residential-West (Nov. 1997). Merged with REIT of California (Dec 1996).
Security Capital Atlantic	Merging with Security Capital Pacific (REIT) (announced April 2, 1998)
Cambden Property Trust	Merged with Oasis (REIT) (approved April 8, 1998). Merged with Paragon (April 1997)
Bay Apartment Communities	Merging with Avalon (REIT), (approved June 5, 1998)

Source: company announcements, filings, news articles

The consensus among market analysts is that the number of REITs will drop sharply through mergers over the next 10 to 20 years perhaps to a third of the present number.

Merger activity has been strong in the last 6 months, as the larger REITs swallow up smaller REITs. Only one of the top ten was not involved in a merger in the last year.

Driving the market towards mergers is the perceived advantages of size. Analysts have been suggesting for years that consolidation is inevitable because less efficient REITs will be unable to attract funds cost-effectively through secondary offerings. As Phillip Scherrer⁶ wrote as far back as 1995.

Cost of funds will be dictated by past and projected returns of the REIT, management effectiveness, competition with alternative investments, perceived property appreciation valuations, funds from operations.... geographic area, of the REIT, individual properties owned by the REIT institutionalization of the market, cost of property acquisition, potential for improved economies of scale and scope..... Only the most successful REITs can issue stock and acquire properties at a cost that will allow capital rate arbitrage to continue... (i.e. for which return exceeds their cost of capital). ... Underperforming REITS become ready targets for more efficient ones.

Since Scherrer wrote, the availability of information, and analysis on individual REITs has mushroomed, enabling the market to readily rank and assess REITs, and enabling REITs to assess other REITs as potential acquisitions.

⁶ Phillip S. Scherrer, "The Consolidation of REITs Through Acquisitions and Mergers", *Real Estate Finance Journal*, Fall 1995

E. The Focus of Apartment REITs

E.1. Market Focus

Many REITs focus on a particular market segment. While the five largest REITs (by number of apartments) either tend not to focus on any particular market segment, or to concentrate in the moderate to middle income range, a large number of medium sized REITs describe themselves as in the upscale or luxury category.

The table below shows the focus of REITs as indicated in their annual reports.

Name	No. of Apts Jan 1, 1998	Upscale/ Luxury	Upper middle	Middle	Moderate
Equity Residential Properties Trust	138,923	"Diversified"			
Apartment Investment and Management Comp.	123,323			3	
United Dominion Realty Trust	62,600			3	3
Security Capital Pacific Trust	59,097				3
Walden Residential Properties, Inc.	42,481	Not stated			
Cambden Property Trust	34,669	3			
Mid America Apartment Communities	30,520	Not stated			
Merry Land and Investment company	29,490	3			
Lexford Residential Trust	28,929	Not stated			
Post Properties, Inc.	25,412	3			
Security Capital Atlantic	21,693				
Avalon Properties	20,700	Not stated			
Charles E. Smith Realty	20,555	3			
Gables Residential Trust	19,888	3			
Associated Estates Realty Corporation	18,920	Not stated			
Home Properties of New York inc.	18,850			3	
Berkshire Realty Co. Inc.	18,773	3	3	3	3
BRE Properties, Inc.	18,569	3	3	3	3
AMLI Residential Properties Trust	17,501	3			
Bay Apartment Communities	17,097	3			
Irvine Apartment Properties	15,136	3			
Summit Properties Inc.	14,462	3			
Ambassador Apartments, Inc.	14,456			3	
Oasis Residential, inc.	14,241	3			
Town and Country Trust	13,631	Not stated			
Cornerstone Realty Income Trust	12,586	Not stated			
Essex Property Trust	10,700		3	3	
National Income Realty Trust	7,987	Not stated			
Grove Property Trust	3,580			3	
Roberts Realty Investors, inc.	1,524	Not stated			

The "higher end" focus of many REITs clearly limits their impact on affordability for those of moderate income. Further, the REIT strategy of upgrading and maximizing rent increases (see page 24), while improving the quality of the stock, can potentially have the effect of reducing the supply of affordable accommodation.

E.2. Strategic Objectives of Apartment REITs

The primary objective of REITs is to provide shareholders with increasing dividends, stock price appreciation, and liquidity. As discussed earlier, they see growth through accretive acquisitions, mergers, and development as prerequisites for high market performance. Other objectives that appear frequently in annual reports are:

Revenue Enhancing Upgrades

REITs seek to increase rent levels by upgrading units. Several REITs have a stated objective to look for under-performing projects and put in around \$2,000- \$5,000 per unit in renovation to enable them to increase rents and improve profitability.

Adding Services to Produce Other Sources of Income

A frequently occurring objective in annual reports is the addition of fee paying services to complement income. These can be leisure services or convenience services e.g. cable, internet, covered parking, exercise facilities. Some REITs have reported significant increases in "other income" from such sources.

Brand Image

Increasingly, apartment REITs are striving to achieve brand recognition. They believe that association of the brand name with high standards not only attracts new residents, but also aids retention of existing residents

Disposing of Non-Apartment Properties

The market has shown a preference for REITs that focus on one category of property. Many apartment REITs are now in the process of selling off office or retail facilities to focus entirely on apartments.

Achieving Operating Efficiencies

REITS look for economies in advertising, personnel, purchasing and other areas of operations. Energy is another area for cost savings frequently mentioned. Utility deregulation is referred to as increasing the scope for utility cost savings through purchasing utilities in bulk and remarketing them to residents.

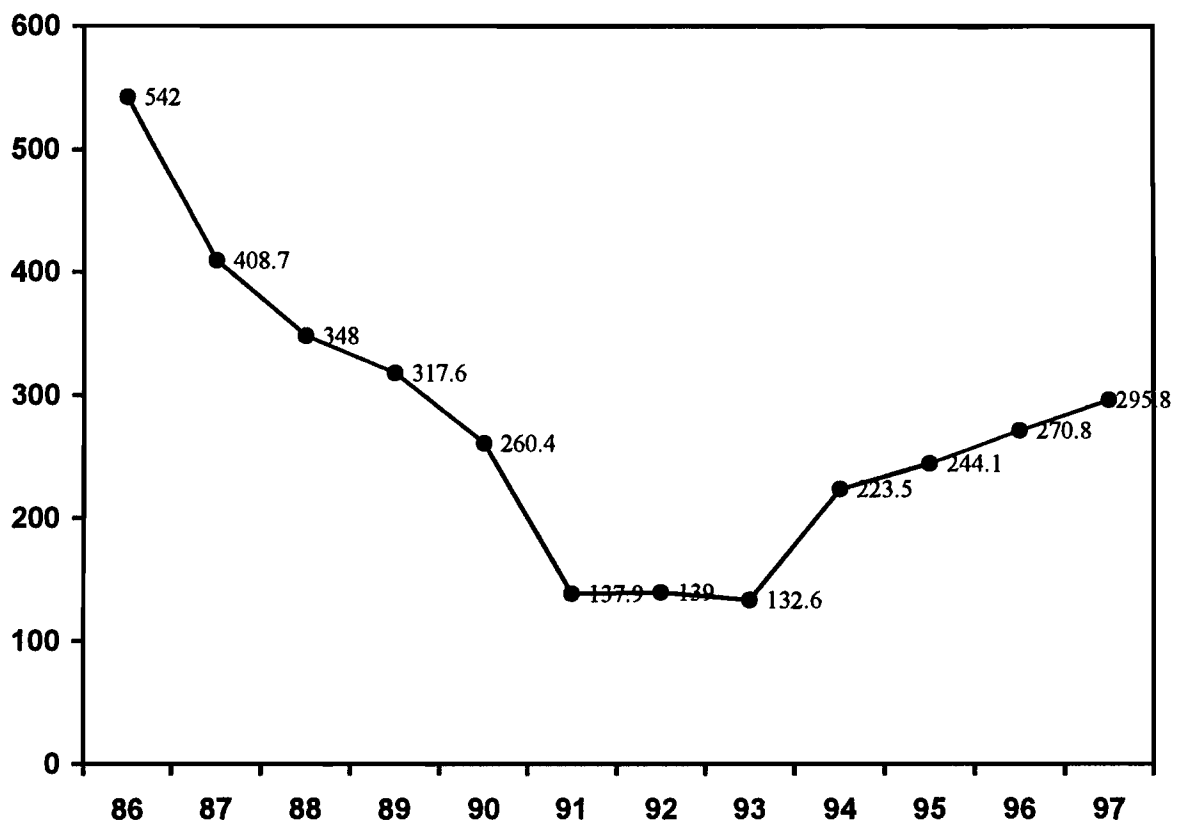
Increasing Financial Flexibility

REITs strive to increase their financial flexibility by making use of a wide range of financing choices (equity, secured and unsecured debt). A stated objective among many REITs has been to achieve investment grade rating on their unsecured debt, reducing its cost below that of mortgage debt.

E. 3. REITS and New Construction Investment

The chart below is designed to show the construction context in which REITs have been operating in recent years. Substantial overbuilding in the late eighties contributed to the cyclical downswing in privately owned multi-family starts which dropped from 542,000 in 1986 to 132,600 by 1993. Of the 295,800 multi-family starts in 1997, REITs contributed approximately 10%. There appears to be no research on the *incremental* impact of REIT formation on multi-family starts, and no speculation as to future market effects as REITs become significant players in construction.

Multi-family Housing Starts 5 units and above ('000s)



Source of data: U.S. Department of Commerce.

The generally accepted view among industry analysts is that REITs will increasingly place more emphasis on new construction. Reasons given are:

- declining supply of suitable properties for acquisition
- rising prices for existing properties
- improving real estate markets, the strong economy
- the desire to be fully integrated companies

The augmented supply of rental accommodation will assist in moderating rent levels.

Some financial analysts however anticipate that the evaluations of Wall Street will play a moderating role in constraining REITs from high levels of speculative development. To the extent that stock market investors look more favorably on REITs with more limited construction activity this will temper REIT development activities.

Recent company statements, and other information from annual reports confirm that apartment REITs are giving more attention to development.

Company Statements/Other Information on REITs Construction Activity/Intentions

Name	Yr. End units under construction	Company statements/information
Equity Residential Properties Trust		Entered into a joint venture with Lincoln Property Company to develop multifamily properties in Dec 1997. The joint venture expects to develop \$1 billion of multifamily properties over the next three years.
Security Capital Pacific Trust	5,323	Investment in new construction up 18% in 1997.
Apartment Invest't and Mgt Co. AIMCO)		No development focus
United Dominion Realty Trust	1,475	"Due to rise in prices for existing apartment investments, we are increasing our commitment to development"
Post Properties, Inc.	5,554	Major developer. Given NAHB Best Multi-Family Development Award in April 1998
Avalon Properties	2,422	
BRE Properties, Inc.		"The TCR-West acquisition has provided the catalyst necessary for BRE to become one of the nation's premier development companies"
Security Capital Atlantic	5,847	Investment in communities under construction up 30% in 1997
Cambden Property Trust	2,343	
Bay Apartment Communities	n.a	
Merry Land and Investment company	2,408	Began development program in 1994.
Irvine Apartment Properties	979	"Competitive advantage has shifted from property acquisition to development expertise"
Gables Residential Trust	2,515	
Essex Property Trust	345	
Charles E. Smith Realty	2,000	Development at record volume in 1997
Summit Properties Inc.	2,716	"New community development continues to be the primary driver of our external growth"
Mid America Apartment Communities	234	
Walden Residential Properties, Inc.		No development focus
Cornerstone Realty Income Trust		No development focus
Berkshire Realty Co. Inc.	740	Planning to build 500 to 1,500 units per year
AMLI Residential Properties Trust	3944	Plan to increase apartment starts by 78% to 4,160 in 1998
Oasis Residential, inc.	1,897	
Associated Estates Realty Corporation	0	
Home Properties of New York inc.	40,742	"The company expects to expand its development activities in neighbouring states"

F. The Origins of Apartment REITs

REITS are generally established through:

- Conversion of privately held companies,
- Conversion of limited partnerships,
- Election of public companies to be taxed as REITs.

ORIGINS OF SOME RECENTLY FORMED APARTMENT REITS

NAME	IPO	ORIGIN
Equity Residential Properties Trust	1993	Continue and expand operations of existing company
Avalon Properties	1993	Continue and expand operations of existing company
Merry Land and Investment company	1981	Public company-chose to file as REIT
Irvine Apartment Properties	1993	Previously apartment Division of Irvine
Gables Residential Trust	1994	Continue and expand operations of existing company
Essex Property Trust	1994	Continue and expand operations of existing company
Charles E. Smith Realty	1994	Previously limited partnership
Summit Properties Inc.	1994	Continue and expand operations of existing company
Walden Residential Properties, Inc.	1994	Continue and expand operations of existing company
AMLI Residential Properties Trust	1994	Continue and expand operations of existing company
Associated Estates Realty Corporation	1993	Continue and expand operations of existing company
Home Properties of New York inc.	1994	Continue and expand operations of existing company
Town and Country Trust	1993	Previously limited partnerships

Initial Public Offerings are expensive. REIT underwriters take about 7% of the offerings proceeds as their fee. An offering must reach a minimum size before underwriters are interested, the venture is worthwhile to the company, and the market will evaluate it favorably. The recent consolidation in REITS and the market acceptance of the merits of size will make it increasingly difficult to initiate "small cap" type REIT IPOs (less than \$150 million).

For property owners just wishing to sell off properties, the costs of going public are prohibitive. A more appropriate route is to sell the portfolio to an existing REIT which operates through an UPREIT or DOWNREIT structure, in exchange for operating partnership units which are convertible to stock.

G. Cost of Capital

REITs raise funds primarily by:

- Long term debt offerings
- Line of credit arrangements
- Equity offerings

G.1. Debt Financing

Unsecured debt, both through line of credit facilities and long term debt offerings is becoming increasingly important. Armed with an investment grade credit rating, a REIT can borrow more cheaply through the issue of unsecured debt than through mortgage financing.

For many REITs over the last few years, it has been a stated objective to achieve an "investment grade" credit rating (BBB- or above from Standard and Poor, or equivalent from other rating services).

The ability to obtain unsecured debt gives the REIT a distinct advantage in cost of capital over the private company for whom this option is typically not available.

Long term debt

In 1997 Existing REITs raised \$11 billion through unsecured debt issues, (compared with \$26 billion through Secondary Equity Offerings). To mid 1998, they had raised close to \$10 billion through unsecured debt issues compared to \$14 billion in secondary equity.

According to the Wall Street Journal and Financial Times financial guides/companions, a company that can obtain a BBB rating has historically been able to borrow at 83-88 basis points cheaper than a company with a BB rating (just below investment grade).

REITs can obtain unsecured financing at 75 to 125 points above the comparable Bond rate. REITs contacted indicated that multi-family mortgage loans would be 100 points higher than their cost for unsecured financing.

Short term debt

To take advantage of acquisition opportunities REITs need the ability to access funds without having to wait for a public debt or equity offering. This flexibility is attained through substantial lines of credit. These are being increasingly used by REITs. For these too, the cost of financing is highly dependent on the credit rating.

Line of credit interest rates are generally quoted in terms of the spread over LIBOR (London Interbank Offered Rates, i.e. the rate at which money changes hands between

major banks). Often, the terms for a line of credit provide for scaled reductions in the spread over LIBOR if credit ratings for the company are upgraded⁷.

Typically, these financing agreement contain covenants to meet certain financial ratios.

G.2. Equity Capital

The cost of equity is the expected rate of return necessary to induce investors to invest in the companies' common stock. This is made up of the expected dividend plus the expected appreciation in the stock price.

REITs, generally consider their cost of equity to be 12-14 percent. This is made up of 7-8% dividend yield, plus 5-6 percent for the expected stock price appreciation. (The average total return for REITs over the last 5 years has been 14%⁸).

REITs' cost of equity is thus considerably higher than that of debt. However, increasing their leverage would not only be both counter to their stated charters, but would also (i) push up the price of equity (investors would demand a higher return- depressing the stock price to compensate for the risk), and (ii) increase their cost of debt through adversely affecting their credit rating.

G.3. Offerings of Securities by REITs

Offerings of securities by REITs (all REITs) reached a record \$45 billion in 1997 according to NAREIT statistics. 1998 issues at mid year were close to \$28 billion.

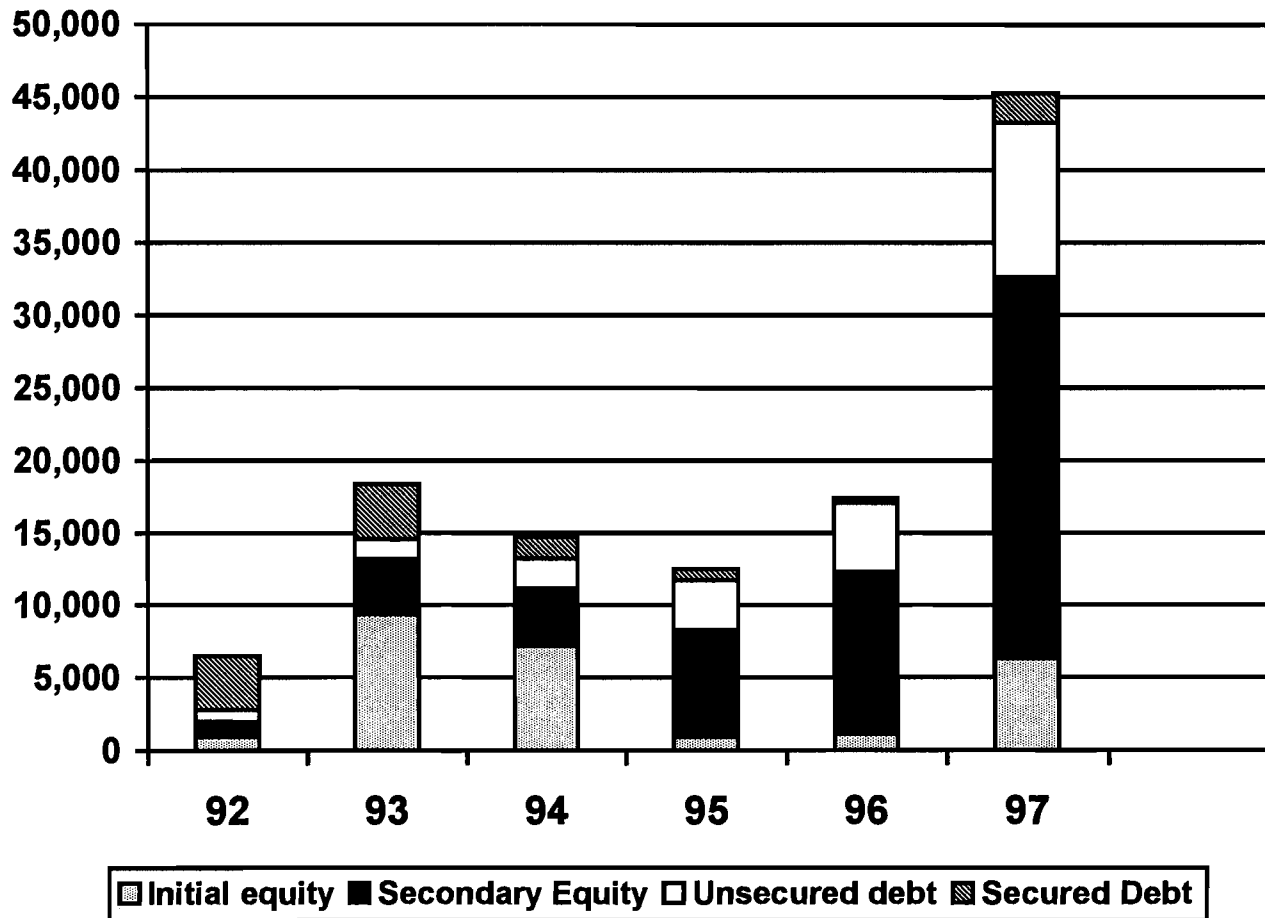
The chart below shows the composition of these offerings from 1992 to 1997. As discussed earlier in the document, initial public offerings peaked in 1993-4, and then dropped off as the market appetite became satiated. Since then the growth in total REIT assets has been funded increasingly through secondary offerings of existing REITs, although initial public offerings regained some momentum in 1997, as the market became more receptive.

Given that REITs must pay out 95% of their income as dividends they cannot use retained earnings for acquisitions. This means that their continued access to new capital is crucial if they are to grow. REITs therefore strive for flexibility in their financing choices.

⁷ Gables Residential Trust, for example, reported being able to reduce their borrowing cost on their \$175 million unsecured revolving credit facility from LIBOR +1.65 in November 1996 to LIBOR + 1.10 in April 1997 on attaining a BBB- rating, and further reduced to LIBOR + 0.80 in August of 1997 as a result of attainment of a BBB+ credit rating, i.e. a total reduction of 85 basis points over nine months. Oasis reported a reduction in their credit facility rate from LIBOR + 1.75 to LIBOR + 1.25. BRE reports having line of credit arrangements at LIBOR + 0.7.

⁸ Average beta statistic (measure of volatility) for the 18 REITs for which I have found estimates is 0.21. This low level of volatility suggests that investors should theoretically willing to accept a somewhat lower rate of return (closer to 10%).

Offerings of securities by REITs (\$m)



G.4. Observations on the Impact of Lower Capital Costs on Housing Affordability and Financial Viability

Lower capital costs for rental owners and developers, to the extent that they are reflected in lower rent levels can contribute to housing affordability.

Further, lower capital costs for new development means that projects (including renovation) that might otherwise be uneconomic can go ahead, increasing the supply of rental accommodation and reducing upward pressure on rent levels.

On the other hand, the tendency of REITs to renovate, upgrade and recapture costs in higher rents can moderate these impacts through diminishing the supply of affordable accommodation.

H. Investor Considerations

H.1. Investment in REIT Stocks

Individuals were the main buyers of the stocks of the earlier generation of REITS. Individuals were attracted to REITs as a hybrid investment, offering stable returns with some tax deferral as well as the prospect of gains in the share price. Institutional investors have become increasingly active in the market for REIT shares in recent years.

REITs are perceived as offering:

- Attractive returns which may be more stable than other stocks because of the high dividend cashflow.
- Portfolio diversification
- Liquidity, which has increased with the expanding stock base of individual REITs
- Professional management
- Continual repricing (which is not available in direct real estate investments)
- Public disclosure

As of the end of 1997, according to the *SNL REIT Weekly*, Institutional investors held 39.3% of outstanding REIT shares

Top 10 Institutional Investors in REITs as of Dec. 31, 1997

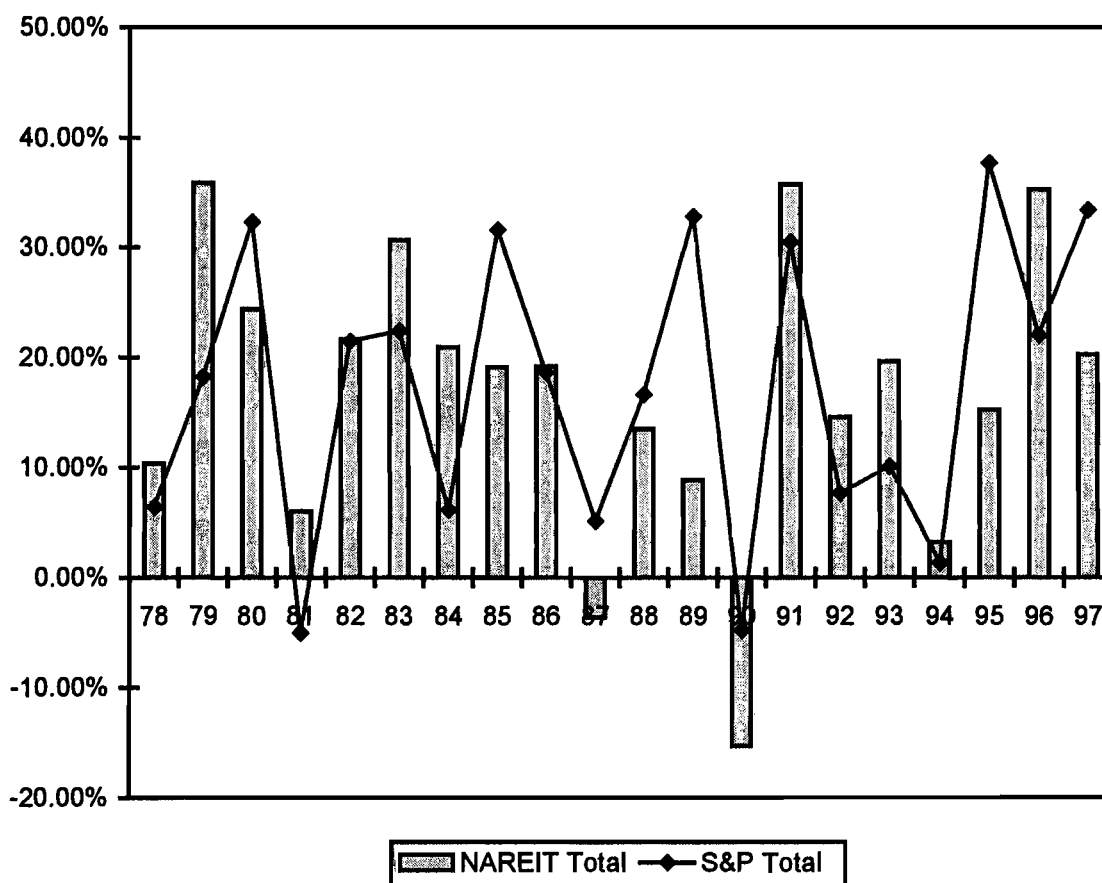
Institutional Investors	# of Positions	Mkt Val. (\$m)	Chg (%)	Shares (millions)	Chg. in # of shares (%)
FMR Corp.	118	4,556.5	39.7	142.3	18.8
Cohen & Steers Capital Management	81	4,447.7	32.9	133.4	11.8
ABKB/LaSalle Securities	59	2,088.5	21.4	69.5	14.5
Franklin Resources Inc.	63	1,821.8	30.8	65.1	29.5
Barclays Bank PLC	149	1,603.9	40.2	59.7	28.1
Morgan Stanley Dean Witter	127	1,344.0	142.0	55.8	144.9
Discover					
Vanguard Group Inc.	138	1,557.4	NA	55.6	NA
Equitable Cos. Inc.	109	1,172.1	79.2	43.3	63.7
European Investors Inc.	45	1,313.6	67.3	43.2	53.8
Fund Asset Management Inc.	24	1,221.7	NA	38.8	NA
(Total Instit. Investment in REIT)		61,981.8	50.8	2,130.0	36.3

Source of table: Vickers Stock Research Group/SNL REIT Weekly, May 26, 1998

The rapid growth in mutual funds (from \$3.71 billion to \$2.16 trillion between 1984 and 1994) has significantly contributed to the demand for REIT stocks. NAREIT lists 40 mutual funds that invest in REITs.

H.2. Performance of REIT Stocks

The total return on equity REITs over the last 20 years, at 14.15% has been close to that of the S&P index as a whole (15.93%). This is in spite of the weakness in REIT stocks in 1998 to date (-19.58% total return compared to -0.38% for the S&P index as at August 31).



Source of data: NAREIT, S&P

The return from investment in REITS is composed of current income in the form of cash dividends, as well as (the potential for) share price appreciation.

Over the last 5 years (as of June 1997), based on the NAREIT Equity Index, 43 percent of the total return from investment in REIT shares has been from current income. By contrast, only 15% of the total S&P return was due to income as opposed to price appreciation. The difference is even more pronounced over the last 20 years, with 69% of REIT return attributable to income, compared to 20% of the S&P return. The higher income component is perceived by investors to give more stability to the total return.

H.3. Portfolio Considerations

Financial analysts in the nineteen nineties have debated the nature of REIT stocks, specifically devoting attention to two fundamental issues:

- Should REITs be considered an investment in real estate, or as a stock?
- What role do REITs play in an investment portfolio and to what extent do REITs diversify the risk in a mixed asset portfolio?

A majority view has emerged among academics and industry analysts, that while, up until the recent growth in REITs, their market performance was closely correlated with the stock market, this correlation has weakened in recent years. REIT price performance is now reflecting that of the underlying property, and thereby diversifying the risk in a portfolio. The reasons suggested for this are:

- A maturing of the market
- Better information on costs and returns
- Increase in trading volume/improved liquidity)
- Dramatic reduction in risk has enabled more accurate valuation

How do institutional investors view REIT Stocks?

With institutional investors holding large volumes of REIT stocks, the future volatility depends to a great extent on how the role they see them playing in their portfolios. Several papers have been written on this topic.

Of particular importance is whether institutional investors regard REITs as another **industry sector** (such as financial services, healthcare etc.) or whether they consider them as a **distinct asset class**. To the extent that investors view REITS as just another industry sector, they would shift in and out depending on their perceived prospects for the sector, increasing the volatility in the stock price. If they perceive them as a distinct asset class, then they are likely to set a specific allocation for them to diversify the portfolio, which can be expected to bring about more stability in the stock price.

The most comprehensive study of this question was carried out by Daniel McCadden and Peter McNally⁹. In a survey of top executives of large pension funds, they found that 96% viewed them as a separate asset class, and in fact, 85% had a specific allocation target for them. McCadden and McNally also asked what the present , and targeted allocations were. Allocation targets were 50% above present levels (7.76% versus 5.12% on a weighted average basis, suggesting that demand from pension funds will continue to be strong.

⁹ Daniel McCadden and Peter McNally, "U.S. Pension Fund Investments in Real Estate: "Current and Future Investment Strategy", *Real Estate Finance*, Winter 1997

PART 2:
THE CANADIAN EXPERIENCE

A. Origins of the REIT Industry in Canada

The REIT industry in Canada has its origins in 1993. The first three REITs were previously open ended mutual fund trusts which converted to REITs as a consequence of difficulties which the open ended structure gave rise to in the depressed real estate markets of 1992.

The problem with the open ended real estate mutual fund trusts was that the trust is obliged to redeem units on demand although the underlying assets are at times illiquid. At a time of depressed markets such as the early 1990's, the trust, to raise cash for the high level of redemptions, may have to dispose of properties at "fire sale" prices.

The high demand for redemptions in 1992, resulted in three real estate mutual fund trusts suspending redemptions. These trusts subsequently converted to closed end mutual fund trusts REITs in 1993-4, becoming the first Canadian REITs. These REITs are *Realfund*, *Canadian Real Estate Investment Trust (CREIT)* and *Riocan*. None of these three were residential REITs.

The first Canadian residential REITs, Canadian Apartment Properties Real Estate Investment Trust, and Residential Equities Real Estate Investment Trust (RESREIT) were not formed until 1997.

B. The Canadian REIT Industry compared to the U.S.

The REIT industry in Canada is small compared to that in the U.S. Presently (as of the end of October, 1998, there are 15 REITs in Canada. Two of these are apartment REITs (in Canada, more commonly described as *residential* REITs)¹⁰.

The total market capitalization of the Canadian REIT industry as of October 30, 1998 was 3.5 billion¹¹. This compares with \$140 billion in the U.S. at that date. The total capitalization of the two Canadian residential REITs at \$350 million equals only 1.6% of the total capitalization of U.S. apartment REITs (\$22.5 billion), whereas the Canadian rental market is around 11% of the size of the U.S. rental market.

The average number of units held by U.S. residential REITs is 30,000 compared to an average of 5,362 held by the two Canadian REITs.

¹⁰ There are also two diversified REITs that have acquired a small number of residential properties (see later).

¹¹ Wood Gundy Securities statistics used

Comparisons between Canadian and U.S. REITs (end of October, 1998)		
	Canada	U.S.A
Total REIT Capitalization	\$3.5 b	\$140 b
Total number of REITs	15	200
Residential REIT capitalization	\$350 m	\$22.5 b
Residential REIT assets as a % of all REITs	10%	16%
Number of residential REITs	2	30
Total residential units held by residential REITs	10,725	900,000
Average number of residential units per REIT	5,362	30,000

C. Differences in the legislative framework in Canada and the United States

The legislative framework under which REITs operate is very different between Canada and the United States.

United States has specific REIT legislation, inspired by the intent to broaden the ownership of real estate and attract additional capital into the sector. In Canada, the term REIT does not appear in the Canadian Income Tax Act. REITs in Canada are governed by sections of the Act dealing with mutual fund trusts. In the U.S., while REITs issue *shares*, in Canada, a REIT as a mutual fund trust issues *trust units*. These can be listed on an exchange and are fully transferable as are shares however, as discussed later, there are some important differences between shares and trust units.

A comparison of the main aspects of the Canadian and U.S. legislation is shown in the chart on page 37. Two important factors from the point of view of residential REITs relate to tax treatment of acquisitions and the liability of unitholders

Provisions relating to the sale of properties by REITS

As discussed in the summary of the U.S. experience, acquisition by U.S. REITs who have assumed an UPREIT or DOWNREIT structure is facilitated by the ability to transfer property to a REIT without immediate tax liability for the seller. Under this approach, operating partnership units are used as payment. As well as increasing the scope for acquisitions, this mechanism, lessens the need to go to the market to raise capital for acquisitions. U.S. corporations *cannot* generally offer a tax deferred shares-for-property exchange¹². This fact places UPREITs in the U.S. at an advantage in acquisitions compared to regular corporations, and has been an important factor in influencing those considering going public to go the REIT route.

¹² The exceptions are (i) if the entity transferring the property has "control" of the corporation (80% or more ownership) or (ii) the exchange is pursuant to a plan of reorganization and both entities are parties to the plan.

By contrast in Canada, while corporations *can* offer a shares-for-property exchange on a deferred tax basis (i.e., tax deferred until the shares are subsequently sold). Canadian REITs do not have this option. Trust units cannot be exchanged on a tax deferred basis. The option to assume an UPREIT structure is also not available under Canadian tax law. Thus in Canada, a corporation has an advantage over REITs in acquisitions.

This advantage is particularly relevant given the characteristics of owners of rental property in Canada. A large proportion of them have held the property for a long time. As a result of extensive use of capital cost allowance, and property appreciation, their cost base is very low in relation to the selling price (the same applies to the heavily tax depreciated properties in limited partnerships). This means massive capital cost allowance recapture and capital gain on sale. A tax deferred property-for-shares transaction allows the seller to obtain liquidity and only pay taxes on a gradual basis as he sells any shares to meet cash needs.

As discussed later, RESREIT is using a leasehold approach to acquisition which provides revenue in prepaid lease costs to the property owner without triggering the capital gains and recapture.

Unlimited liability

It is widely perceived that a REIT unitholder does not have limited liability (e.g. in an environmental disaster) in the same way as a company shareholder.

The Canadian Institute for Public Real Estate Companies (CIPREC) has suggested that there is some protection in common law. In an extract from their forthcoming REIT handbook they state:

“At common law, it would appear that conditional limited liability exists for beneficiaries of a trust on a basis similar to limited partners in a statutory limited partnership. As long as the beneficiaries are not controlling the day to day activities of the trust, they would appear to have limited liability. Canadian caselaw is relatively scant, although the fundamental principles have been established”¹³.”

Canadian REITs have responded to the issue by undertaking thorough environmental assessments prior to acquiring properties, through insurance policies, and through non-recourse clauses in mortgages to protect unit-holders.

Canadian REITs and New Development

Eligible activities for a REIT are defined in 132(6) of the Canadian Income Tax Act. The key eligible activity is:

“Acquiring, holding, maintaining, *improving*, leasing of any property or interest in real property that is *capital property* of the trust” (my italics).

¹³ Quoted with the permission of CIPREC

“Improving” precludes construction for sale but based on the meaning given to the term by Revenue Canada of late, it should allow REITs to be develop new rental units on capital property of the Trust. Even this however is a gray area, and it is conceivable that future Revenue Canada interpretations could find that extensive involvement in new construction stretches the meaning of the term “improvement”. As discussed below, the Declarations of Trust for the two residential REITs restrict their involvement in construction. Existing (non-residential) REITs are initiating new development through partnerships with developers under which they acquire ownership interests after the developer has completed construction.

Key legislative differences in REIT legislation, Canada and U.S.

Aspect	U.S	Canada
Legislation	Specific REIT acts and legislation	No specific REIT Act or legislation. REITs operate under sections of the Income Tax Act relating to mutual fund trusts.
Assets	75% of its assets in real estate	80% of its assets in shares, bonds, mortgages, marketable securities, cash, real property situated in Canada” (or oil and gas interests)
Income	75% of gross income from real estate assets	95% of income from, or from disposition of the assets described above
Investment type	Shares	Trust units
Dividends	Must pay out at least 95% of net income	No requirement. Most Canadian REITs pay out 85-100% of distributable income.
Tax at REIT level	Neither subject to tax if meet requirements (i.e. no double taxation)	
Tax at Investor level	Taxed at preferential dividend tax rate	Taxed at personal income tax rate
	Tax on the return of capital (depreciation) portion of the dividend is deferred until sale of unit.	
Tax deferred acquisitions	Possible through UPREIT structure	Not possible, although leasehold approach to acquisition is a substitute to some extent.
Liability	limited	Not limited, but declarations of trust & specific contracts provide protection. Also may be protection in common law (see page 36).
Activities	Not specifically defined	Acquiring, holding, maintaining, improving, leasing of any property or interest in real property that is capital property of the trust.

D. The Canadian Residential REITs

There are presently two REITs in Canada focusing on residential properties. They both had their initial public offerings in 1997. Their main characteristics are listed and compared in the chart on page 39.

Their Declarations of Trust both indicate their intention to focus on investment in income producing multi-unit residential.

Both Declarations of Trust restrict their involvement in construction or development: The relevant paragraph (the same wording in each document) reads.

Except for renovation or expansion of existing facilities and development of new facilities on property adjacent to existing facilities as permitted under paragraph (stated paragraph) under the heading "Investment Restrictions", RESREIT shall not engage in construction or development of real property except as necessary to maintain its real properties in good repair or to enhance the income producing ability of capital properties in which RESREIT has an interest.

Canadian Apartment Properties Real Estate Investment Trust (CAP REIT), the first Canadian REIT to focus on residential properties, filed its prospectus in May 1997, raising a net \$76m. Its initial portfolio was 2,900 rental units. In April of 1998, it raised a further (net) \$32.5m through a secondary offering, and has since increased its portfolio to 3,887 rental units. In total, 3,238 suites are located in Ontario and 649 in Nova Scotia.

To facilitate acquisition and access to financing, CAP REIT has a strategic alliance with Gentra a company which finances, purchases, manages and sells properties. Under the agreement, Gentra commits to make "reasonable efforts" to offer properties to, and provide financing to CAP. Gentra is a unit holder and appoints one Trustee.

CAP's management strategy, similar to that of U.S. REITs emphasizes tenant relations, upgrading and low leverage, including as the first items in its "Management Strategy": "*devotion to tenant relations*", "*preventative maintenance and repair programs (capital improvement and upgrading)*", "*attentive and dedicated on-site building staff*", "*sophisticated financial management*", and "*prudent debt management*"

Residential Equities Real Estate Investment Trust (RESREIT), filed its prospectus in November, 1997, raising \$197m. Its initial portfolio is 6,838 rental units in 32 apartment buildings and one townhouse complex. Approximately 85% of the suites are located in the Toronto with the remainder being located in Vancouver, Calgary & Edmonton.

RESREIT's portfolio is a mix of properties in which it has a freehold interest, and properties in which it has a leasehold interest. The leasehold approach to ownership and acquisition responds to the inability to offer a tax deferred transaction to property sellers. Under the arrangements for the initial properties held by leasehold, RESREIT will receive all rental

income for the units, and will be responsible all ongoing expenses. The leases are for 35 years and the RESREITs leasing costs for the period were prepaid on closing. RESREIT has the option to purchase the properties at a fixed price, negotiated up-front, at any time during the last 10 years of the lease.

All of RESREIT's initial properties were previously owned by Greenwin or Lehndorff Tandem. Greenwin is one of Canada's largest multi-unit residential owner/managers with over 25,000 suites under administration. Approximately 25% of the REIT units have been retained by Greenwin and Lehndorff Tandem, who, together, provide the Property Manager and Advisor. Through a strategic alliance with Greenwin and Lehndorff Tandem, RESREIT has "certain rights of first offer" for properties.

RESREITs management strategy emphasizes the experience of its management and that of the strategic ally in all aspects of real estate acquisition and management.

THE TWO CANADIAN RESIDENTIAL REITs		
	CAP REIT	RESREIT
Date of IPO	May, 1997	November, 1997
Moneys raised in IPO (net)	\$76 million	\$186 million
Subsequent Offerings	\$32.5 million (April, 1998)	n.a.
Initial Portfolio	2,900 units	6,838 units
Current Portfolio	3,887 units	6,838 units
Market Capitalization	\$118 million	\$213 million
Geographical Focus of units	83% in <i>Ontario</i> - primarily Toronto, also Nova Scotia	85% in <i>Ontario</i> (Toronto), also Vancouver, Calgary, Edmonton
Market Positioning	"diversified"-Affordable 40%, (mid-tier 35%, luxury: 25%) Rent range (Ont): \$731-1,231 Ave. rent: \$868 (April, 98)	"middle to upper end" Rent range (Ont): \$540- \$1013 Ave. rent: \$752 (at IPO)
Yield	10%	9.3%
Maximum Total Debt/book value by charter	60% of book value (some trustee discretion). Actual at 1997 year end = 59.9%	60% of book value (some trustee discretion). Actual following IPO = 51.37
Maximum loan to value ratio on any property	75% (modified in June 1998 to allow exception for acquisitions where existing financing exceeds 75%.	75%
Other Special Features	Working on <i>Brand loyalty</i> thrust	One third of properties held by leaseholds
Origins	No predecessor company. Properties acquired from arms length vendors.	Initiated by, and with properties of two private realtors (Greenwin Property Management & Lehndorff Tandem Group)
Quantitative goals	20,000 suites within 5 years	Not stated

Market Performance of the Residential REITs.

Having only been created in 1997, the residential REITs have a limited track record and have had unfortunate timing, compared to the U.S. residential REITs, in entering the market just before the stock market tumble in 1998, and the cooling of market sentiment on real estate stocks in both Canada and the U.S. However, since dipping sharply in August, both have staged a substantial recovery and are trading at close to their issue price as of the end of November. Both have managed to meet their dividend payout projections.

E. The diversified REITs that have multi-family assets

The two Canadian diversified REITs have an explicit strategy of diversification geographically and by product type (including residential). Both argue that given Canada's small market base, focus on a single property type significantly limits the potential for growth, and that the diversification reduces risk.

The two are Summit REIT, and the Canadian Real Estate Investment Trust (CREIT). Both have investments in 4 major product classes, i.e., retail, industrial, office and residential. Residential properties represent the smallest of the 4 asset classes for both REITs.

Summit REIT, recently, (September, 1998), announced the structuring of a transaction with Brookfield Homes in which payment for office properties acquired from Brookfield was through assumption of existing mortgages and the issuance of convertible debentures with a term of four years. These are convertible at maturity to units of Summit REIT at a specified rate. Use of this mechanism will reduce Summits need to go to the stock market for funds.

THE TWO CANADIAN DIVERSIFIED REITs					
	CREIT		SUMMIT REIT		
Date of IPO	1993		1995		
Total Market capitalization	\$410m		\$114m		
Current Portfolio of multi-family apartments	160 (approx)		150 (approx)		
Geographical Focus of assets	83% in Ontario- primarily Toronto, also Nova Scotia		Ontario (45.4%) Alberta, N.S. Quebec, Saskatchewan, Manitoba U.S.A. (16.5%)		
Present distribution of assets by asset class	Retail	57%	Retail	59.7%	
	Industrial	24%	Industrial	24.3%	
	Office	17%	Office	8.9%	
	Apartment	2% (planned:5-10%)	Apartment	7.1%	

G. Canadian Public Corporations that are actively acquiring multi-unit residential property.

In order to understand the industry context in which the residential REITs are operating, it is important to look at other public corporations (non-REITs) that are presently active in acquiring multi-family properties (i.e., that are in the same business as the residential REITs and competing for the same kinds of properties).

Boardwalk Equities is the fastest growing property owner. It is the largest multi-family property owner in Western Canada, with properties in Alberta and Saskatchewan. In the 12 months to May 1998, Boardwalk acquired a total of 11,247 units, bringing its total portfolio to over 20,000 units. Boardwalk's strategy matches closely the strategy followed by REITs in the U.S. Boardwalk buys under-performing properties, upgrades them, provides more tenant services, and gradually increases rents to pay for the additional services.

The company spent an average of \$2,100 per unit on property enhancements in fiscal 1998. The extensive acquisitions of Boardwalk in the last year have quite considerably reduced the availability of suitable properties in these markets. Boardwalk estimate that they now own 11.8 percent of the multi-family rental stock in Alberta and Saskatchewan. Boardwalk has a no dividend policy.

Goldlist Properties is a property owner, manager and developer. It went public in April of 1997, being formed out of a privately held company with a history of development. It has interests in over 5000 rental units. It acquired 770 additional units in its last fiscal year. It also owns industrial properties.

Goldlist is presently developing 3 residential condominium projects. Between its own portfolio and third party contracts, Goldlist manages over 8,400 rental units. Like Boardwalk, Goldlist does not pay dividends.

Acanthus Real Estate Corporation was created in August 1997, and went public in January, 1998. The company evolved out of a private firm which had been a general partner in real estate limited partnerships. Acanthus is specializing in acquisition of *limited partnerships*. It began by asking investors in the limited partnerships it had built up whether they wished to roll the property in to the new company.

It has acquired 47 properties to date (all but two on a tax deferred basis). As of October, 1998, it had 3,256 residential units. It also acquires mid sized commercial developments and is presently redeveloping a retail centre in New Brunswick.

PUBLIC COMPANIES ACTIVELY ENGAGED IN ACQUISITION OF RENTAL PROPERTIES			
	Boardwalk	Acanthus	Goldlist
Initial Public Offering	1994 commenced ops	Created August 31, 1997. IPO January 1998	1996 Previously private company
Number of apartment units	20,000 (June, 98)	3,256 (Oct 98)	5,500 (Oct 98)
Number acquired in the last year	11,247	3,055	770
Geographical focus	Alberta, Saskatchewan, but looking at other markets	Mainly Toronto for residential	Toronto
Residential developer	No	No	Yes
Stock type	No dividend policy	Pays dividends	No dividend policy

Principal Differences between the Residential REITs and the Public Multiple Residential Corporations

There are two ways in which these corporations have an edge over the REITs in their expansion. These are:

- *Possibility of offering a tax deferred transaction to sellers of property (not possible for REITs)*

These corporations can offer a tax deferred exchange of company shares for property. (i.e. existing owners can swap property for shares, deferring any tax on disposal of the property until the shares are sold). This flexibility both facilitates acquisitions, and reduces the dependence on going to market to raise capital for acquisitions.

- *Earnings are retained to meet financial requirements*

Whereas REITs, because of their high payout ratio are very dependent on equity and debt markets to raise capital for property improvements, public corporations have an additional source of capital, through retained earnings. Neither Boardwalk nor Goldlist pay dividends. Thus all earnings are retained to meet capital requirements. Acanthus plans to pay dividends (it paid out 50% of after tax cashflow at the end of its first quarter).

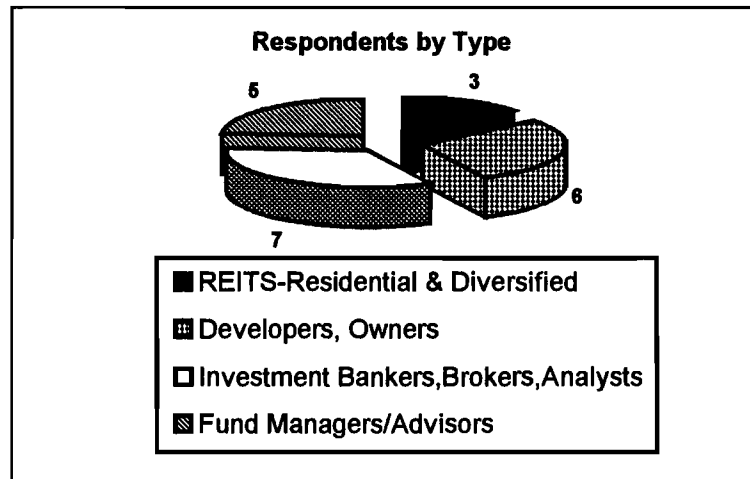
PART 3: SURVEY RESULTS

RESULTS OF THE SURVEY OF CANADIAN PRACTITIONERS AND OTHERS WITH KNOWLEDGE IN THE FIELD

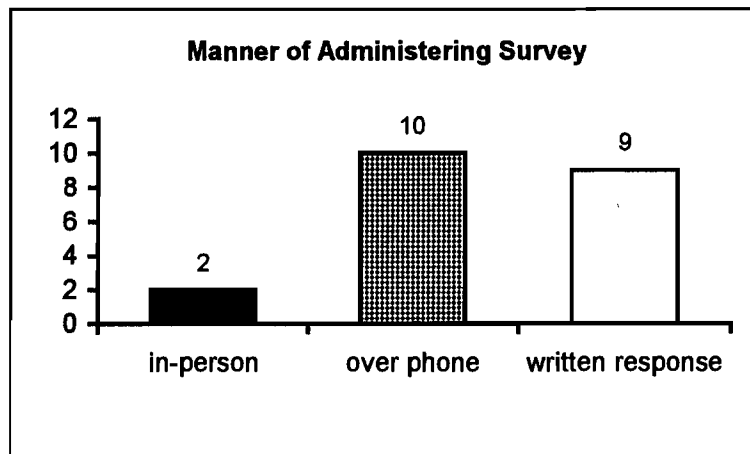
The Sample

The survey was conducted between September and November, 1998. Twelve questions were asked, to seek views on the prospects, impediments and potential impacts of residential REITs (some additional factual information was sought from the REITs themselves). A copy of the general questionnaire is attached as Appendix 2.

Forty one questionnaires were sent out. Subsequent follow-up focused on ensuring that there was representation from the relevant groups and from key players.



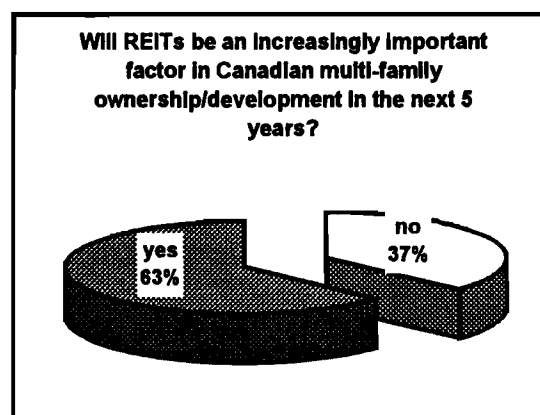
Twenty one responses were obtained. They represent the relevant sectors, i.e. apartment and diversified REITs, other non-REIT developers and owners, investment bankers, brokers and analysts, and institutional investors and pension fund advisors. Some of those responding indicated that they would be willing to have their names listed as having provided input. These names of these are contained in Appendix 1. Some filled in the questionnaire, others were interviewed in person, or over the phone.



Do you feel that REITs will be an increasingly important factor in Canadian *multi-family ownership/development* in the next 5 years?

Of those responding to this question, the majority (63%) felt that REITs would be an increasingly important factor in multi-family ownership (but not development) in the next 5 years. Those that were bullish on the prospects for REITs felt that consolidation in property ownership was inevitable given the capital intensive nature of the business and the structure of ownership. It was felt that the aging of the “mom and pop” property owners who characterized the industry, would result in more properties being available for acquisition.

However, even some who believed that REITs would become increasingly important felt that REIT expansion would be moderated by a lack of suitable product. It was felt that in Ontario, rent controls have created a situation in which the operating mode was one of cost cutting, the stock was deteriorated, and tenants were not prepared to pay for improvements (although the new Tenant Protection Act could improve this). In the West, it was pointed out by several respondents that Boardwalk, a real estate corporation was rapidly absorbing the suitable properties.¹⁴



Those that were less positive on the prospects for REITs felt that REITs suffered significant disadvantages compared to public corporations. The most frequently identified disadvantage was the inability to offer a tax sheltered transaction to sellers of property (this was a common point in response to many questions). In addition, the high payout ratio was cited as a problem. It was felt by some that this would threaten the ability to expand or meet cash requirements when markets were not receptive to REIT secondary offerings. It was also suggested that the availability of CMHC insured mortgages rendered it unnecessary to assume a REIT structure to raise money.

Reasons given for those that said yes:	Reasons given for those that said no:
REIT approach consistent with trend to consolidation which is driven by capital intensive nature of real estate investment.	Corporate structure more conducive to growth because of inability to offer tax deferred transaction to property sellers
Multi-family is the best kind of property for a REIT because of stable income.	High payout ratio impedes expansion
Market dynamics turning in favour of REITs in Toronto because of ending of rent control.	With low cost CMHC insured debt, no-one needs to raise money in a REIT format
	Lack of product will hold back growth

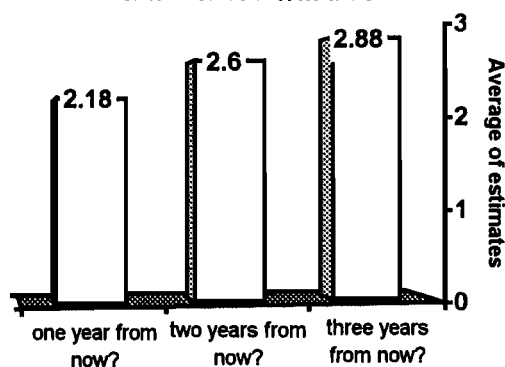
¹⁴ See page 41

How many residential REITs do you think there will be one, two and three years from now?

Average of estimates

The average of the estimates for the number of REITs was around 2 for one year from now, 2.6 for 2 years from now, and 2.88 for 3 years from now. The breakdown of individual responses is discussed below.

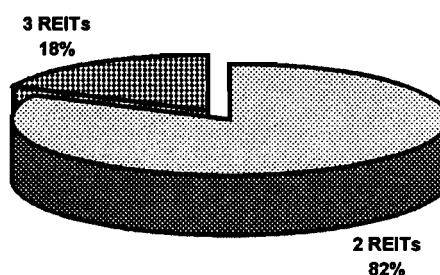
How many residential REITs do you think there will be?



In one year.....

82 % of the respondents felt there would be no change in the number of residential REITs in the next year, with the remainder projecting that there would be 3 REITs one year from now.

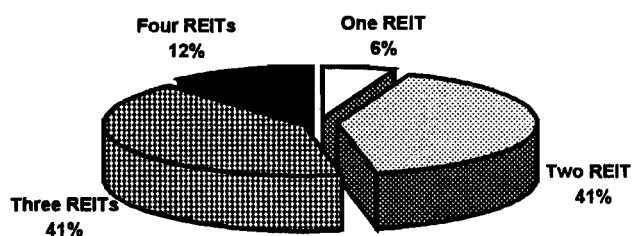
One year from now?



In two years....

In total, 53% of respondents expected an increase in the number of residential REITs in the next two years. 41% expected there to be 3 REITs in two years, and 12% expected a doubling in the number of REITs to 4. There was also a view expressed that the number of residential REITs would decrease through consolidation.

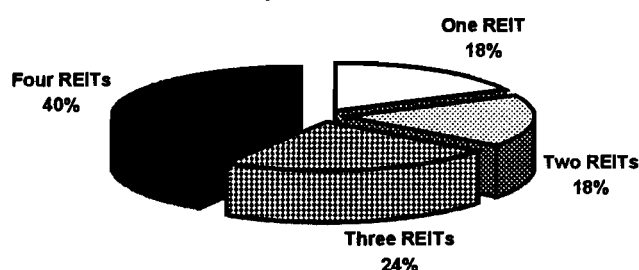
Two years from now?



In three years....

40 percent of respondents expected a doubling in the number of residential REITs to 4 in the next three years. It was suggested that there was room for different REITs with a different focus. A few respondents felt that consolidation would leave only one residential REIT.

Three years from now?



Do you feel that there are legislative and regulatory factors that are serious impediments to growth?

Inability to offer a tax deferred deal when purchasing property

Overwhelmingly, the inability to offer a tax deferred deal (the absence of an UPREIT structure in Canada) when purchasing property was identified as the most serious impediment to the expansion of residential REITs. About 75% of respondents identified this as a problem

Unlimited liability

The perception that REITs cannot offer limited liability to investors who could theoretically be liable in the event of a disaster (e.g. environmental) has often been referred to as an issue. Most respondents who mentioned this, did so more to emphasize that the issue was largely theoretical and was not a serious impediment. However, a few respondents indicated that it was a concern with some institutional investors.

Restrictions on development

The restrictions relating to capital property, which restrict REITs' involvement in condominium development or other development for sale, were viewed as impediments to REITs entering into development in their own right and becoming fully integrated real estate companies (construction for *sale* does not qualify as "improvement of capital property").

What will be the principal sources of asset growth for REITs?

Respondents were asked to rate the importance of various sources of asset growth for REITs. The choices given are shown below in the order in which they were identified as significant. Purchasing from private companies was overwhelmingly considered the most significant source of asset growth. Purchasing from limited companies was the second ranked source.

Importance of various potential sources of growth	
Private companies/private individuals	Rated by close to 60% of those responding as the most significant potential source of asset growth
Private companies and limited companies	Seen as equally (the most) important by close to 15% of respondents
Limited companies	Rated by 25% of those responding as the most significant source of growth
Public companies	Not generally seen as a very significant source of growth
Mergers	Not generally seen as a very significant source of growth
New construction	Seen as not at all significant

How do you feel that the evolution in the residential REIT sector will differ from recent developments in the U.S. What major differences are there in the two markets?

Inability to effect a tax deferred transaction with a property seller:

- Once again, the inability to effect a tax deferred transaction with a property seller was the most frequently mentioned difference. As discussed, Residential Equities REIT has developed a leasehold approach in response to this problem. However, some respondents felt that the complexity of this approach, the uncertainty as to Revenue Canada's continued favorable treatment, and the specialized nature of the transaction limited its potential.

The smaller size of the Canadian market, resulting in:

- Difficulty in achieving market capitalization and liquidity at which the units would be attractive to institutional investors, i.e., so an institution could make a sizeable purchase or sale easily and without major impact on the markets
- Reduced potential to take advantage of economies of scale in operations
- Limited capability to pursue a "brand name" strategy such as is widely practiced by U.S. residential REITs

Impact of rent controls:

- It was suggested that rent controls have both inhibited new construction, and discouraged rehabilitation. The net result is an older, more deteriorated stock than in the U.S., tighter vacancy rates and a rental industry driven by cost cutting rather than tenant service. The tenant population in turn has become used to low rents and not prepared to pay more to receive more. This conflicts with the REIT way of operating in the U.S. , which as discussed in the section on U.S REITs focuses on increasing services and pushing up rents as far as possible.

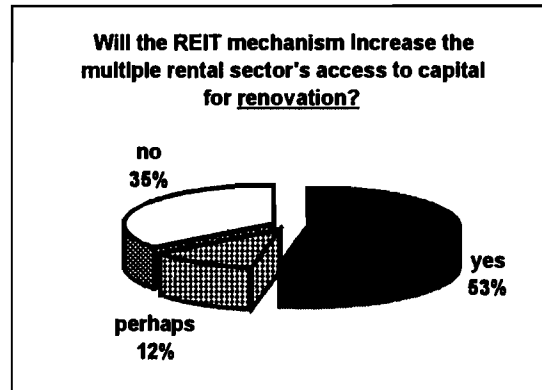
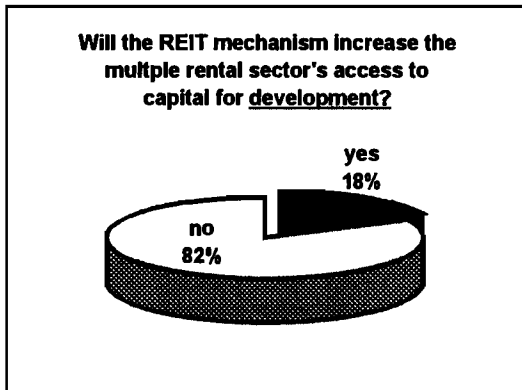
No prior consolidation of properties such as occurred in the U.S.

- It was suggested that Canada did not experience a "mini consolidation" such as occurred in the U.S. as a result of the Savings and Loan Company failures and the subsequent actions of Resolution Trust. This situation in the U.S. created pools of properties which found transitional homes but provided a ready source of buyable assets for REITs.

Will the REIT mechanism increase the multiple rental sector's access to capital?

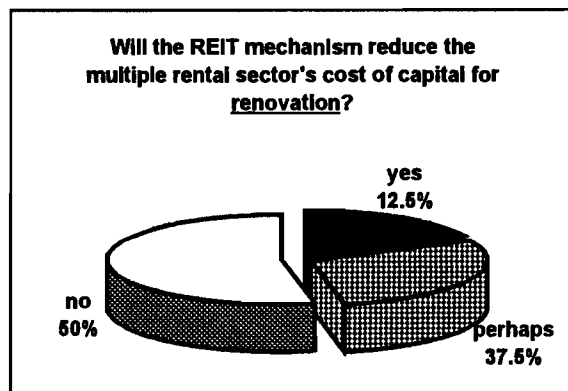
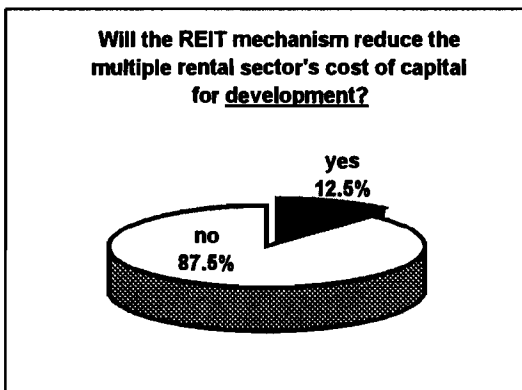
Respondents were asked whether they felt that the REIT mechanism could increase access to capital for development and for renovation.

Less than 20% thought that it would increase access to capital for new development. A much higher percentage (53%) felt that it would increase capital for renovation, and 12% thought that “perhaps” it would. Respondents felt that REITs were not structured for new development.



Will the REIT mechanism reduce the multiple rental sector's cost of capital?

Over 87% did not think that the REIT mechanism would reduce the cost of capital for new development. 50% gave either a “perhaps” or a yes when asked whether it would reduce the cost of capital for renovation (still leaving half that thought it would not).



Do you feel that the market will be receptive to initial/secondary public offerings by residential REITs over the next 5 years?

Respondents were asked whether they felt that the market will be receptive to initial public offerings or secondary offerings of residential REITs in the next 5 years.

Most respondents (close to 70%) felt that while conditions were generally unfavorable at the time of the survey, there would be opportunities for raising capital when general market conditions improved, and that if the offering were right, there would be potential for one or two additional residential REITs. It was suggested by some however that REIT market performance would have to shine before the market was ready.

The 30% that were negative about the long term market reception to offerings of residential REITs referred back to the shortcomings of the REIT concept in Canada that they they had identified in response to earlier questions (size, structure, tax disadvantages).

What do you see as the main source for investors in residential REITs?

All respondents believed that the main source for investors would continue to be individuals. Estimates for the share of institutional investment generally ranged from 10% to 15%.

Factors identified as impeding investment in residential REITs were:

- insufficient liquidity;
- too small for large institutions to invest in;
- the problem of which portfolio manager would be who is responsible for investing in a REIT, (i.e., is it real estate or is it a stock?). REITs presently “fall between the stools”; and
- major education process is required to attract institutional investors.

An investment manager of one large institution indicated that it would not make sense for them to pay someone else to buy and hold property for them (i.e. invest in a REIT), when they were one of the top management companies themselves in owning and administering their own portfolio of properties.

It was suggested that while institutions may continue to be represent a small share of residential REIT investors, the REIT route may continue to be attractive to large institutions as an exit strategy for real estate, and this could be the genesis of future REITs.

What in your opinion are the key success factors for REITs expansion?

Respondents were asked what they felt were the key success factors for REITs continued expansion. The factors identified can be grouped into four main categories. They are listed below.

Acquisition Skills

- How and when to buy. What to buy.
- Finding the right properties where upgrade can be done.
- Ability to buy on accretive basis.

Funding

- Access to capital.
- Ability to go to market when timing is right.
- Lower payout ratios to retain adequate funds.

Management

- Looking after tenants.
- Achieving efficiencies, maximizing rent revenues.
- Business strategy.
- Sticking to the mandate.
- Internalizing management (as opposed to using an external advisor).

Keeping investors happy

- Increasing the cash flow distribution over time.

Are there issues, information gaps regarding the use of REITs for financing multi-family housing that would merit further research?

Generally, it was felt that the residential REIT experience in Canada was too new, and insufficient data was available to allow for more research. The following ideas were however suggested:

- Payout ratios: the extent to which a high payout ratio could threaten the ability to maintain and upgrade stock, and consequently jeopardize the REIT.
- The correlation between residential REIT unit prices and the stock market as a whole to clarify the appropriate role of REITs in an investment portfolio.
- The impact of existing Canadian tax legislation on REITs. Effective tax strategy for REITs.

PART 4: CONCLUSIONS

CONCLUSIONS

Impact on the consumer, and on housing conditions in the U.S.

Consistent with their operating approach of holding for the long term, U.S. residential REITs' strategy is to focus on tenant satisfaction, and property improvement, thereby contributing to the upgrading of the stock in the U.S.

Economies of scale in purchasing, marketing, and general operations, access to lower cost funds, and professional management have enabled REITs to streamline costs while increasing services, thus providing value for money for renters.

Improved access to capital for new construction is enabling greater rental production than otherwise possible, increasing the supply of rental accommodation. This greater supply, through the impact of market forces, should reduce upward pressure on rent levels.

The overall impact on housing affordability will be moderated by the following facts:

- REITs in the U.S. do not typically compete on price, but on service. An important element of the REIT strategy is to find properties in good locations in which there is potential to increase revenue and profits by introducing improvements, increasing occupancy and incrementing rents.
- Most REITs in the U.S. tend to concentrate on lower middle to high end properties, rather than those at the low end. This is largely a "brand image" consideration.

Potential Impacts of REITs in Canada

Canadian residential REITs face a number of impediments compared to their counterparts in the U.S. The major ones are:

- Inability to offer a tax deferred transaction to those from whom they buy property;
- The perception of limited liability for unitholders;
- The smaller size of the Canadian market;
- Unfavorable rental market dynamics;
- Restricted and limited options to engage in new rental production;
- More limited access to capital than U.S. REITs; and
- Less favorable stock market timing than that enjoyed by U.S. REITs.

Inability to offer a tax deferred transaction to sellers of property

The fact that Canadian REITs cannot offer a tax deferred transaction to sellers of property was overwhelmingly identified by respondents to the survey as the major impediment to the development and expansion of residential REITs in Canada.

Generally, corporations in the U.S. do not have the ability to offer a tax deferred exchange of shares for property. REIT creation and expansion in the U.S. owes much to the ability of U.S. REITs (by assuming an “UPREIT” structure) to offer a tax deferred exchange of operating partnership units for property. A tax liability is not triggered until the units are exchanged for shares

While in the U.S., a REIT (that has assumed an UPREIT structure) has an advantage in acquisitions over a real estate corporation, the reverse is true in Canada. A Canadian corporation can offer a tax deferred exchange of shares for property, while the REIT does not have the same option. An exchange of property for REIT units triggers an immediate tax liability (and an UPREIT cannot be created under Canadian tax law).

As discussed, Residential Equities REIT has developed a leasehold approach to acquisition that does not trigger a tax liability, but the mechanism is more limited in its appeal.

The perception of unlimited liability for unitholders

While as discussed, the Canadian Institute for Public Real Estate Companies (CIPREC) has suggested that there is some protection in common law, it is widely perceived that a REIT unitholder does not have limited liability (e.g. in an environmental disaster) in the same way as a company shareholder. Although most investors dismiss this as largely an academic issue, a few respondents to the survey indicated that it has caused reluctance to invest in REITs on the part of several institutional clients.

The smaller size of the Canadian market

Some respondents to the survey argued that the smaller size of the Canadian market makes it difficult for a REIT specializing in residential property to reach the critical mass required to flourish in the same way as U.S. REITs. As discussed in the section on U.S. REITs, the merits of size are argued by most REITs and almost all analysts in the U.S., and have provided the momentum for the spate of mergers over the last few years.

Comparing markets, the Canadian Rental market is approximately one tenth the size of the U.S. market. The total rental stock in the six largest census metropolitan areas in Canada, where one would anticipate most of the REIT property accumulation to take place is approximately equal to the rental stock in Los Angeles.

Specifically, the smaller size of the Canadian market makes it more difficult for residential REITs in Canada to grow to the point where they can enjoy economies of scale in purchasing, marketing, accessing funding, and general management and operations.

The smaller market also makes it difficult to reach the level of stock market capitalization to offer an attractive investment to institutional investors, i.e. offer satisfactory liquidity and the opportunity to move in and out without having a major impact on the unit price.

The size of the Canadian market is in fact cited by Summit and CREIT in their annual reports as a reason for pursuing a diversified strategy with a goal to have investments in all four major asset classes (retail, office, industrial, residential), and in a wide range of markets. They argue that in Canada it is difficult to achieve a high growth rate if focusing on one line of property (or on Canadian properties alone).

Unfavorable rental market dynamics

In markets that have had an extended period of rent controls, particularly in Ontario, restrictions on the ability to recapture renovation costs have created a market in which the operating culture has been to cut costs rather than upgrade. The tight rental market has not necessitated a focus on tenant relations, and it has not encouraged the provision of additional services, since these could not be paid for by increasing the rent. Some respondents argued that tenants in Ontario, unlike counterparts in the U.S., are now not accustomed, or willing to pay more for additional services and improvements.

Vacancy rates in the U.S. are typically more than twice as high as those in Canada. . The average apartment vacancy rate in the U.S. between 1993 and 1997 was 9.6% (structures of 5 units and above). This compares with an average of 4.6% (4 units and above) in Canada over the same period. The greater choice and mobility that this permits has created more of an imperative for owners to focus on tenant relations and the provision of services to retain tenants.

The U.S. rental housing environment with its relative absence of rent controls and a norm of rental property improvement creates a more favorable environment for the REIT strategy of maximizing revenues through increasing services and increasing rents.

The replacement of rent controls in Ontario with the Tenant Protection Act with its greater facility to recover the cost of renovations should stimulate upgrade of the rental stock in Ontario, and improve the environment for REITs. Several respondents believed that the new legislation had already begun to have an impact on actions of rental owners.

Less favorable stock market timing than that enjoyed by U.S. REITs

In the U.S., the perception was widely held that REITs were insulated from the downturns of the market by virtue of the fact that a high proportion of the total return came from dividends. The dip in the market in 1998 has demonstrated (both in Canada and the U.S. that REITs are vulnerable to stock market conditions. In fact REITs were hit harder than the market as a whole. Thus REITs have to some extent to prove themselves through a stock market cycle.

Capital market access and mechanisms.

With REITs distributing a high proportion of their income in distributions, continued access to capital is crucial since the stock markets are not always receptive to public offerings. In addition, as well as being expensive to float, public offerings also take time to complete, and are sometimes uncertain in outcome.

REITs must insure their access to capital by using a whole range of options and developing relationships with a range of financial institutions, including investment banks, pension funds, insurance companies, mutual fund managers and investment advisors. These relationships facilitate direct placement of debt and equity issues, obtaining secured and unsecured debt and revolving lines of credit as well facilitating the take up of public offerings. In the U.S., through the use of interest rate swaps and other mechanisms to protect themselves against interest rate risk, REITs open up the possibility of a wide range of financing choices enabling them to minimize their borrowing costs.

As the Canadian residential REITs grow, prove themselves, and develop a institutional and individual following, more financing options will be open to them. However, the breadth of alternatives may not be as wide as that available in the U.S.

Some respondents to the survey also argued that whereas in the U.S., an established REIT can achieve a competitive advantage in securing lowest cost capital, in Canada the universal availability of CMHC insured low cost mortgage debt precludes this. It was felt that CMHC insured debt was generally available to most borrowers, and at a price unrelated to financial strength or credit rating.

Restricted options to engage in new construction

Residential REITs in the U.S. have become fully integrated companies, increasingly involved in new development. Their low debt to equity ratio, experienced management, and the expected stability of income from holdings of existing property, presents them as a good risk to lenders who remain reluctant to lend to developers following the memory of the real estate crash in the U.S. in the late 1980's.

The option for Canadian residential REITs to get extensively involved in new multi-family development and become fully integrated companies is impeded by the tax rules, their own Declarations of Trust, and by market conditions. In practice, those (non-residential) REITs that have got involved in new development have done it through partnership arrangements with a developer.

In terms of market conditions, rents in many markets in Canada, particularly Toronto, are still well below levels at which new construction is viable. New rental completions in Canada in 1997 were one fortieth of the level in the U.S. in spite of the fact that the number of rental households is only nine times as high.

Potential Contribution of REITs to affordability and financial viability in Canada

Benefits as realized in the United States

Use of the REIT structure in the U.S. has enabled real estate operators and developers to achieve greater access to capital, and lower cost financing for acquisition, construction and renovation. The resulting ability to grow has also enabled them to achieve economies of scale in purchasing, marketing and operations.

The lower costs and greater availability of capital has reduced cost pressure on rents for existing owners, and enabled projects (including renovation) that would not otherwise have taken place, to go ahead, thereby increasing supply and further moderating pressure on market rents.

The impact on affordability in the U.S. has, however, to some extent been limited by (i) the fact that many apartment REITs focus on more “upscale” property (although this has not been the case to date with Canadian REITs), and (ii) the REIT market strategy of upgrading units and increasing rents (which can have the effect of reducing the supply of affordable rental accommodation).

Limitations to realizing the same benefits in Canada

As discussed, the expansion of REITs in Canada is impeded by legislative and regulatory factors, most particularly the inability to effect a tax deferred exchange of trust units for property, and impediments to becoming fully fledged developers. In addition, a number of market and economic factors are not as conducive to REITs obtaining the competitive advantage that they enjoy in the U.S.

Specific merits of the expansion of REITs given Canadian market conditions:

The further expansion of REITs at this time in Canada could assist in addressing problems specific to the Canadian residential rental sector and contribute to increasing rental availability and affordability and to the improvement of the rental stock. These benefits would be fostered as described below:

Drawing additional players and investors into the Canadian rental sector

The last 30 years has seen the rental sector supported at various times by tax shelter programs, market supply programs and social housing programs.

The ending in turn of each of these means of support has been followed by the ending of an the extended inflationary period in which real estate and ownership of a rental property was viewed as the ideal way to save for retirement for many Canadians.

Thus, there is presently a vacuum in terms of investors in rental markets. Individuals who might in the past have invested their savings in rental property now look to the stock

market. Baby boomers reaching retirement age seek a nest egg more liquid than real estate. Residential REITs, through providing an investment choice which has clearly struck the right chord in the U.S., could help to fill this vacuum. With increased size, and a record of dividend growth, they would become increasingly attractive to institutions and could potentially have a place in the growing portfolios of Canadian pension funds, other institutions, and mutual funds.

Improvement of the Stock

Rent controls have left markets in some parts of Canada with a stock which has not been adequately maintained. In Ontario, in particular, with the replacement of rent controls by the new Tenant Protection Act, REITs, with their focus on maintenance, improvement and tenant services could play an important role in upgrading the stock.

Bringing Stability to the Real Estate Sector

The rental sector is traditionally cyclical. High leverage in real estate contributes to periodic high defaults and mass failures of real estate operators and the institutions that provide funding to them. With economic uncertainty likely to be with us in the foreseeable future, REITs, with their low debt to equity ratio could reduce the risk exposure of financial institutions and mortgage insurers in Canada.

APPENDICES

APPENDIX 1

Partial List of those that Provided Input

Thanks are due to all those who provided input and made this paper possible.

Some of the those that responded to the survey chose not to be named because of company policy or other reasons. The following is therefore only a partial list of those who provided input

Name	Title	Company
Daniel Argiros	President and CEO	Acanthus Real Estate Corporation
Yasdi Bharucha	Chief Financial Officer	Canadian Apartment Properties Real Estate Investment Trust (CAP REIT)
Michael Brookes	Executive Director	Canadian Institute of Public Real Estate Companies (CIPREC)
Greg Christenson	President	Christenson Development
Paul Finkbeiner	Senior VP and Portfolio Manager	GWL Realty Advisers
Louis Forbes	Investment Analyst	Midland Walwyn
Sam Kolas	President	Boardwalk Equities
Anne MacLean	Investment Counsel	Goodman & Company
Lou Maroun	Vice President	Summit REIT
Dick Miller	President	Clayton Developments
John Scott	President and CEO	Residential Equities Real Estate Investment Trust (RESREIT)
Stephen Sender	Investment Banker	Scotia McLeod
Craig Shannon	Senior V.P. and Director	Levesque Beaubien Geoffrion
Ted Welter	Vice President, Real Estate & Mortgage Investments	Greystone Capital Management

Thanks are also due to the individuals at U.S. REITs that answered specific questions, including people at Walden, United Dominion, Gables, AMLI, Merry Land and BRE.

APPENDIX 2

QUESTIONNAIRE ON PROSPECTS FOR RESIDENTIAL REITS IN CANADA

Please fax completed form to:
 Tony Wellman at 613-722-6433
 Or mail to:
 236 Royal Avenue, Ottawa
 Ontario K2A 1T7

If you prefer me to call and discuss on a more informal basis,
 then please contact me.
 Tel: 613-722-5944
 Email: wellman@magma.ca

Thank you

Name:

Company type

Position:

Company:

Address

Phone:

Fax:

Email (if applicable)

Do you feel that REITs will play an increasingly important role in Canadian multi-family ownership/development in the next 5 years?

Reasons:

2. How many residential (multi family apartment) REITs do you think there will be in Canada in:
 1 year? 2 years? 5 years? What do you think might be the limiting number given the
 size/configuration of the Canadian market?

3. Do you feel that there are legislative/regulatory factors that are serious impediments to growth of residential REITs? If so, please indicate what they are.

4. How important do you feel will be the following sources of asset growth for residential REITs?

Acquisition of property from limited partnerships?	very <input type="checkbox"/>	somewhat <input type="checkbox"/>	not very <input type="checkbox"/>	not at all <input type="checkbox"/>	don't know <input type="checkbox"/>
Acquisition of property from private companies?	very <input type="checkbox"/>	somewhat <input type="checkbox"/>	not very <input type="checkbox"/>	not at all <input type="checkbox"/>	don't know <input type="checkbox"/>
Mergers?	very <input type="checkbox"/>	somewhat <input type="checkbox"/>	not very <input type="checkbox"/>	not at all <input type="checkbox"/>	don't know <input type="checkbox"/>
Acquisition of properties from public companies?	very <input type="checkbox"/>	somewhat <input type="checkbox"/>	not very <input type="checkbox"/>	not at all <input type="checkbox"/>	don't know <input type="checkbox"/>
New construction?	very <input type="checkbox"/>	somewhat <input type="checkbox"/>	not very <input type="checkbox"/>	not at all <input type="checkbox"/>	don't know <input type="checkbox"/>

Comments?

5. How do you feel that the evolution in the residential REIT sector in Canada will differ from recent developments in the U.S. ? What major differences are there in the two markets (financial system/industry configuration/economic factors/legislation/geography etc.) that would result in different receptiveness and utilization?

6. Do you feel that the REIT mechanism will increase the multiple rental sector's *access* to capital for :

a) development of new rental properties?	yes <input type="checkbox"/>	no <input type="checkbox"/>	possibly <input type="checkbox"/>	don't know <input type="checkbox"/>
b) renovation/upgrade of existing rental properties?	yes <input type="checkbox"/>	no <input type="checkbox"/>	possibly <input type="checkbox"/>	don't know <input type="checkbox"/>

Comments:

7. Do you feel that the REIT mechanism will enable *lower cost of financing* for:

a) development of new rental properties?	yes <input type="checkbox"/>	no <input type="checkbox"/>	possibly <input type="checkbox"/>	don't know <input type="checkbox"/>
b) renovation/upgrade of existing rental properties?	yes <input type="checkbox"/>	no <input type="checkbox"/>	possibly <input type="checkbox"/>	don't know <input type="checkbox"/>

Comments:

8. Do you feel that the market will be receptive to initial/secondary public equity offerings by residential REITs over the next 5 years?

Comments:

9. What do you see as the main source for investors in residential REIT units

Institutional investors (specify types)

Private individuals

Comments:

10. What in your opinion will be the key success factors for residential REITs' increased expansion (size) in Canada?

11. Are there issues, information gaps regarding the use of REITs for financing multi-family residential projects that would merit further research?

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