RESEARCH REPORT

UNDERSTANDING THE RELATIVE UNDERDEVELOPMENT OF REITS IN CANADA

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Understanding the Relative Underdevelopment of REITs in Canada

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EXECUTIVE SUMMARY

Objective: This report assesses apartment and non-apartment REITs in the Canadian and in the American context. The main objective of this examination is to identify barriers and opportunities impacting apartment REIT growth in Canada.

Methodology: This report develops a framework for understanding the relative underdevelopment of REITs in Canada when compared to the American REIT industry. The framework identifies the factors in the Canadian environment that have contributed to the Canadian industry currently being less developed than its U.S. counterpart. Further, a summary of the drivers of success for both apartment and non-apartment REITs in both Canada and the U.S. is presented, based on the study of the participants in both environments. The overall intent of these examinations is to suggest a list of suggestions that could enable the Canadian REIT industry in general, and the Canadian apartment REIT industry specifically, to eventually mirror the success seen in the U.S.

U.S. Findings: Through discussions with research analysts working in both the U.S. and Canada, as well as discussions with, and research on the individual players in the U.S. REIT industry, a few general features of the U.S. REIT industry become very important in formulating Canadian policy suggestions. The most critical findings include:

1. U.S. REIT holders view REITs as an alternative to equities. For the most part, U.S. REITs have elected to make use of a corporate structure. Hence, U.S. REIT investors are supportive of REIT management undertaking high levels of risk.
2. U.S. legislation is extremely REIT-friendly. As long as certain simple conditions are met, REITs have access to beneficial tax rules.
3. U.S. REITs operate in highly specialized niche market segments; they are large and diversify risk geographically. The geographic and demographic situation in the United States presents a multitude of profitable niche segments in which to specialize.

1\. U.S. REITs have a much larger financial market from which to draw capital.

2. The U.S. financial markets are far more experienced and accepting of REITs as investment vehicles. The retail and institutional investor bases for REITs are approximately equal.

Canadian Findings: Discussions were held with Canadian analysts, institutional investors, and REIT operators. Certain features of Canadian REITs were identified that must be considered when suggesting changes to stimulate REIT growth in Canada.

1. Canadian REIT investors view REITs as an alternative to bonds. Hence, investors in existing REITs are far less willing to permit REIT management to undertake development and other risks in the operation of their business. Indeed, an argument can be made that the Canadian Tax Code precludes REIT development of new properties.
2. Canadian REITs are all business trusts, and not corporations. This means that Canadian REITs carry a risk (believed to be theoretical) of absence of limited liability protection, and cannot use shares as currency for new property acquisition.
3. As a result of their recent introduction into the Canadian securities environment, the Canadian financial market is not entirely familiar or comfortable with REITs.
4. The geography and demographics of Canada make it less likely that Canadian REITs will specialize in a market niche and diversify geographically to the same degree as has been seen in the U.S.

Key Success Factors for Canadian and U.S. REITs:

A number of key success factors were identified for **all REIT categories** in Canada. These include:

1. A statement of clear strategic/asset class focus;
2. Investment in superior quality assets in the relevant asset class;
3. Strong management (preferably internal);
4. Favourable past operating performance;
5. Good projected cash flow growth prospects based on properties currently held;
6. Access to capital on favourable terms;
7. Sustainable distributions; and
8. Attractive pricing.

In addition, a list of key success factors was identified for **all REITs operating in the U.S**. It is important to note that all of these factors are a function of overall size of the REIT, and will not be, by themselves, independent variables determining success. This list includes:

1. Large market capitalization;
2. Experienced and capable management;
3. Geographic dispersion of risk;
4. Access to high barrier to entry markets;
5. Low debt levels;
6. Quality of assets;
7. Ability to use retained cash flow to generate internal growth; and
8. Greater degrees of risk tolerance.

For **apartment REITs**, several additional criteria are necessary for a label of "Best-in-Class". These criteria were largely determined through the examination of the U.S. Apartment REIT industry because of the small sample size (2) in Canada. These include:

1. Ownership of a large number of properties in geographically diverse areas with low vacancy rates;
2. High levels of capital expenditure that justify premium rental rates;
3. Ownership of properties located in areas of high employment;
4. A focus on densely populated areas; and
5. The ability to purchase properties at below replacement cost, OR the ability to develop properties at a cost lower than would be possible using outside contractors.

Suggested Changes: A list of suggested changes was identified and ranked. These options seek to address the limitations currently facing Canadian REITs, while simultaneously attempting to ensure the ability of Canadian REITs to satisfy the key success factors necessary for a designation of "Best-in-Class". The changes were identified, assessed and ranked individually in order of their potential ability to address the objectives set forth at the beginning of this summary. The individual changes are:

1. Permitting REITs to adopt a corporate structure;
2. Granting REITs limited liability protection;
3. Permitting REITs to purchase properties in exchange for tax-deferred units;
4. Changing the tax provisions;
5. Clarifying that the term "Improvement" extends to development;
6. Permitting REITs greater freedom in charging for additional services;
7. Allowing Canadian REITs to have a larger share of foreign investment;
8. Permitting joint ventures between U.S. REITs and Canadian REITs;
9. Permitting joint ventures between U.S. REITs and Canadian institutional investors;
10. Allowing U.S. REITs to operate independently in Canada;

11. Providing an educational campaign for individual investors in regard to REITs;
12. Creating a standard declaration of trust;
13. Encouraging formation of a national body to promote the interests of REITs;
14. Offering venture capital and mezzanine financing for new REITs;
15. Providing guarantees for Canadian banks and other financial institutions for loans to REITs at more attractive lending rates;
16. Creating a system of revenue guarantees for new construction; and
17. Creating a system of rental subsidies.

In viewing the above policy suggestions, it is important to realize that some render others redundant. For example, granting REITs the right to organize as corporations eliminates the need to grant limited liability protection.

In considering these options, it is important to note certain limitations of REITs. In particular, although it is possible to implement options that will likely be successful in spurring growth in the Canadian apartment REIT industry, it must be remembered that REITs will have little incentive to offer housing that is affordable to lower-income Canadians unless options 16 and 17 are adopted.

SOMMAIRE

Objectif : Ce rapport porte sur les sociétés de placement immobilier (SPI) qui investissent dans des immeubles d'appartements (SPIA) et autres que d'appartements (SPIAA) au Canada et aux États-Unis. Son principal objectif consiste à déterminer les éléments favorables et défavorables à la croissance des SPIA au Canada.

Méthodologie : Le présent rapport élabore un cadre en vue d'expliquer le sous-développement relatif des SPI au Canada comparativement à celles aux États-Unis. Ce cadre présente les facteurs de l'environnement canadien qui expliquent pourquoi l'industrie canadienne est actuellement moins développée que son homologue américaine. En outre, le rapport comprend un sommaire des facteurs de succès pour les SPIA et les SPIAA au Canada et aux États-Unis, en fonction des participants à l'étude dans ces deux environnements. L'examen vise globalement à proposer des changements qui permettraient au secteur canadien des SPI en général, et au secteur canadien des SPIA en particulier, de remporter autant de succès que les sociétés américaines.

Résultats des recherches effectuées aux États-Unis : Dans le cadre de discussions avec des analystes travaillant aux États-Unis et au Canada et avec des participants du secteur américain des SPI et de recherches visant ces derniers, quelques caractéristiques du secteur américain des SPI ont été jugées très importantes pour proposer des changements concernant le secteur canadien. Les résultats les plus concluants sont présentés ci-dessous

3. Les porteurs de parts américains considèrent celles-ci comme un substitut aux actions. En général, les SPI américaines ont adopté la forme juridique des sociétés. Ainsi, les investisseurs dans les SPI américaines sont prêts à soutenir les gestionnaires de SPI qui assument des risques plus grands.
4. La législation américaine est très favorable aux SPI. En autant que certaines conditions simples sont remplies, les SPI profitent de règles fiscales avantageuses.
5. Les SPI américaines exploitent des créneaux de marché très spécialisés. Elles sont de grande taille et misent sur une diversification géographique des risques. Les caractéristiques géographiques et démographiques aux États-Unis leur offrent une diversité de créneaux rentables aux fins de spécialisation.
6. Les SPI américaines ont accès à un marché des capitaux beaucoup plus important.
7. Les marchés financiers américains sont beaucoup plus expérimentés et réceptifs aux SPI en tant que véhicules de placement. Les particuliers et les institutions investissant dans les SPI constituent des clientèles ayant à peu près la même taille.

Résultats des recherches effectuées au Canada : Des discussions ont été tenues avec des analystes, des investisseurs institutionnels et des exploitants de SPI au Canada. Certaines caractéristiques des SPI canadiennes doivent être prises en considération pour proposer des changements visant à stimuler la croissance des SPI au Canada.

5. Les porteurs de parts canadiens considèrent celles-ci comme un substitut aux obligations. Ainsi, les investisseurs sont beaucoup moins disposés à permettre aux gestionnaires de SPI d'assumer des risques de développement et autres dans le cadre des activités exercées. En fait, on peut prétendre que le régime fiscal canadien empêche l'aménagement de nouvelles propriétés par les SPI.
6. Les SPI canadiennes sont toutes des fiducies et non des sociétés, de sorte qu'elles ne profitent pas de la protection de la responsabilité limitée et qu'elles ne peuvent faire d'acquisitions payées en actions.
7. En raison de leur lancement relativement récent au Canada, le marché canadien des capitaux n'est pas totalement familier ni à l'aise avec les SPI.
8. En raison des caractéristiques géographiques et démographiques du Canada, il est moins probable que les SPI canadiennes puissent exploiter des créneaux de marché aussi spécialisés et miser sur une diversification géographique aussi grande qu'aux États-Unis.

Facteurs de succès clés pour les SPI au Canada et aux États-Unis

Certains facteurs de succès clés ont été relevés à l'égard de toutes les catégories de SPI au Canada, notamment les suivantes :

9. énoncé précis sur la stratégie et la classe d'actifs visées;
10. investissements dans les actifs de qualité supérieure selon la classe pertinente;
11. direction chevronnée (préférablement interne);
12. résultats d'exploitation antérieurs favorables;
13. bonnes perspectives de croissance des flux de trésorerie pour les propriétés détenues;
14. accès au capital à des conditions favorables;
15. distributions soutenables;
16. prix attrayants.

En outre, une liste de facteurs de succès clés a été préparée pour **toutes les catégories de SPI aux États-Unis**. Il importe de noter que ces facteurs dépendent de la taille de la SPI et qu'aucun d'entre eux n'est une variable indépendante et explicative du succès. La liste est la suivante :

9. forte capitalisation boursière;
10. direction expérimentée et compétente;

11. diversification géographique des risques;
12. accès aux marchés dont les barrières à l'entrée sont importantes;
13. faible niveau d'endettement;
14. actifs de qualité;
15. capacité de conserver les flux de trésorerie pour soutenir la croissance interne;
16. plus grande tolérance aux risques.

Dans le cas des **SPIA**, plusieurs critères additionnels doivent être satisfaits pour qu'une société soit l'une des meilleures de sa catégorie. Ces critères ont été établis en se fondant surtout sur le secteur américain des SPIA, en raison de la petite taille de l'échantillon (2) au Canada, et comprennent les suivants :

6. nombre élevé de propriétés situées dans des régions géographiquement dispersées et dont les taux d'inoccupation sont faibles;
7. niveau élevé de dépenses en immobilisations justifiant des loyers supérieurs;
8. propriétés situées dans des régions à taux d'emploi élevés;
9. accent mis sur les zones densément peuplées;
10. capacité d'acheter des propriétés à des prix inférieurs au coût de remplacement OU d'aménager des propriétés à des coûts inférieurs à ceux qui seraient exigés par des entrepreneurs externes.

Changements proposés : Des changements ont été proposés et classés en vue de trouver des solutions aux restrictions touchant actuellement les SPI canadiennes, tout en essayant simultanément de soutenir la capacité des SPI canadiennes à se conformer aux facteurs de succès clés des meilleures entreprises. Les changements ont été définis, évalués puis classés individuellement en fonction de leur utilité pour répondre aux objectifs énoncés au début du sommaire. Voici la liste des changements :

18. permettre aux SPI d'adopter la forme juridique d'une société;
19. accorder aux SPI la protection de la responsabilité limitée;
20. permettre aux SPI d'acheter des propriétés en contrepartie de parts à imposition reportée;
21. modifier les dispositions fiscales;
22. préciser que le terme « amélioration » inclut l'aménagement;
23. accorder plus de latitude aux SPI concernant l'imposition de frais pour des services supplémentaires;
24. permettre aux SPI canadiennes d'accroître la part des investissements étrangers;
25. permettre à des SPI canadiennes et américaines d'établir des coentreprises;
26. permettre à des SPI américaines et à des investisseurs institutionnels canadiens d'établir des coentreprises;

27. permettre aux SPI américaines d’exercer des activités autonomes au Canada;
28. organiser une campagne de sensibilisation à l’intention des investisseurs particuliers sur les SPI;
29. préparer un acte de fiducie normalisé;
30. encourager la création d’un organisme national chargé de promouvoir les SPI;
31. offrir du capital de risque et du financement secondaire aux nouvelles SPI;
32. donner des garanties aux banques et aux autres institutions financières canadiennes afin que des prêts soient consentis aux SPI à des taux plus intéressants;
33. établir un régime de revenus garantis pour les nouveaux immeubles;
34. lancer un programme de subventions pour logement locatif.

À la lumière des changements proposés ci-dessus, il importe de se rendre compte que l’adoption de certains changements rendrait d’autres inutiles. Par exemple, la décision de permettre aux SPI canadiennes de se constituer en sociétés élimine le besoin d’accorder la protection de la responsabilité limitée.

En étudiant ces options, il est important de prendre note de certaines restrictions visant les SPI. En particulier, malgré qu’il soit possible de mettre en oeuvre des options qui réussiront probablement à favoriser l’essor du secteur canadien des SPIA, il faut se souvenir que les SPI auront peu de motivations à offrir des logements abordables aux Canadiens touchant un faible revenu à moins que ne soient adoptées les options 16 et 17.

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GENERAL OVERVIEW OF REITS

REITS Defined

A Real Estate Investment Trust is a security consisting of a managed pool of capital, units of which are traded on stock exchanges. Investors, also called “unit holders”, have an undivided beneficial interest in the properties owned by the REIT.[1] Investors purchase “units” and receive a right to a proportional income stream resulting from the properties owned by the REIT. At regular intervals, usually monthly, investors receive “distributions”. These distributions are the rents collected by the REIT, passed along to the investor. At the time when the investor sells his or her units, if the value of the units has increased in the market, the investor also receives a capital gain equal to the value between the sale price and the original purchase price of the units. REITs should not be confused with debt instruments.

The benefit of these vehicles to Canadian investors is that any income earned on the properties that is distributed to unit holders is deducted from the REIT-level tax bill. Instead of receiving its tax revenue on the rental income from the REIT directly, the government receives tax on the distribution from the unit holder who is taxed on the taxable portion of the distributions at his or her personal marginal rate.[2] In addition, the unit holder is able to shield portions of the distribution from tax because the capital cost allowance claimed at the REIT level reduces taxable income, but not cash flow for the unit holder.

An appeal of a REIT instrument to investors is the regular income it provides. When allocating investment dollars to fixed-income securities, the ability to shelter a portion of the income produced from the ownership of these instruments, coupled with any additional deductions allowable by the applicable tax code, is a major reason REITs have become attractive to investors. Alternative fixed income investments (e.g. dividends, bonds, mutual funds) do not allow the investor to shield income from taxation unless the investments are held within Registered Savings Plans. Coupled with traditionally higher yields than enjoyed by bonds, REITs have become an attractive alternative for investors in the fixed income market. Given that the availability of dollars for investment is limited, encouraging investment in REITs will require dollars being attracted from alternative investments.

It is important to note that some of the tax benefits associated with REITs are immaterial to certain investors. Owning properties directly allows the investor access to the Capital Cost Allowance (CCA) flow through benefits in Canada or depreciation benefits in the United States, without the need for a REIT structure. Furthermore, assets held within a pension fund are already tax-deferred, so the tax treatment of REIT distributions would

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[1] Brooks, S.M., “Canadian Real Estate Investment Trusts: An Assessment of Risk”, <u>North American Real Estate Review</u>, February 1996.
[2] Torkin, M., “Real Estate Investment in the 1990’s: An Analysis of REITs”, <u>Banking and Finance Law Review</u>, [13 B.F.L.R.], 1997.

provide no incremental benefits to these investors. Nevertheless, there is a tax benefit for tax-exempt or tax-deferred entities electing to invest in REITs over real estate corporations, since the latter do pay tax at the corporate level.

Among the benefits of REIT ownership, the tax implications are a major attraction. The following section explores the taxation of REITs using Canadian tax laws. Although the U.S. Tax Code uses different terms and labels from the Canadian Code, the U.S. taxation of REITs is similar to the Canadian taxation of REITs. One key difference will be discussed later in: The United States Context.

A Primer in the Taxation of REITs in Canada:

REITs appeal to investors largely as a result of the tax-reducing benefits they provide. In order to understand the benefits of REIT-unit ownership, it is necessary to understand the fundamental operation of the Canadian tax system as it relates to the taxation of REITs. Using the tax rules in place in Canada, a numerical example will serve as a rudimentary explanation of the tax treatment of REITs.

Taxation of the REIT: In Canada, a REIT holding is considered to be an *inter vivos* trust for income tax purposes. This means that the trust was established by a specific act by living persons, for the benefit of identified beneficiaries. As a result, it is subject to income tax at the top marginal tax rate for an individual on any taxable income that it earns. Consistent with the calculation of taxable income for real estate operations, and other business operations, a REIT is entitled to claim Capital Cost Allowance[3] (CCA) each year. While CCA reduces taxable income, it is, like accounting depreciation, a non-cash expense. As a result, the cash flow of a REIT is generally higher than the REIT's taxable income. To the extent that the building is adequately maintained, the tax deduction afforded by the CCA is not related to any decline in value of the property. In fact, it is common for the real estate property to actually increase in economic value when at the same time the property is being slowly written off for income tax purposes.

A critical difference in the computation of taxable income for a REIT compared to other structures for owning and operating real estate is that a REIT is permitted to deduct any income and capital gains that it distributes to the unit holders. As a result, REITs generally do not pay income tax because they transfer all of their taxable income to unit holders.

If the unit holder is a taxable entity, the distribution of income must be included in the unit holder's computation of taxable income. As a result, tax will be paid based on the marginal tax rate of the unit holder. Non-profit organizations, such as universities, etc., are non-taxable entities, and they would not pay any tax on these distributions. As a

[3] Capital cost allowance is the tax equivalent of accounting depreciation. Under current rules buildings, including apartments, can be written off at four per cent declining balance. In the year of acquisition, the only one-half of the CCA may be claimed.

result, REITs have a potential tax advantage compared to corporations holding the same assets as the REIT, but have no notable advantage over non-profit organizations, pension funds and registered savings plans. If a corporation held the same assets that the REIT owns, it would be subject to tax at the corporate level on any income it earned. Therefore, any distribution of the corporation's after-tax flows to a non-taxable entity would have been subject to tax. This is because tax would have been deducted from the corporation's income before any distribution is made to the non-taxable entity. Stated another way, a corporation pays a dividend to its shareholders out of after-tax income. REITs do not have any tax deducted prior to distributing to the investor so these distributions do not face a direct or indirect tax burden.

As a general rule, REITs distribute to unit holders more cash than the taxable income earned by the REITs. As noted above, this is possible because depreciation (CCA) is a non-cash expense such that the REIT's cash flow from operations exceeds its taxable income. This distribution in excess of the REITs taxable income is not taxable to the unit holder at the time it is received. Instead, it reduces the adjusted cost base of the unit, which only becomes relevant in the computation of the capital gain at the time the unit is disposed of. To the extent this non-taxed receipt is not associated with a decline in the economic value of the REIT's assets, the REIT offers a significant advantage compared with other investments.

It is important to note that these trusts **must** produce positive earnings to be useful to investors, as losses cannot flow through to the unit holders.

An Example: Suppose an investor purchases a REIT unit on January 1, 2001 for $20. Further, suppose that between January 1, 2001 and December 31, 2001 the investor receives cash distributions from the REIT totalling $2.00, of which $1.20 represents taxable income. An amount of $.80 is the proportion of the CCA expense, claimed by the REIT, that has been passed on to the investor. Finally, assume the investor sells his or her unit on December 31, 2002 for $21.00. We will now consider effects of taxation on the individual investor. Because, the REIT distributes all of its income, it does not face an income tax liability.

Taxation of the Investor: The investor would report $1.20 as taxable income. If the investor pays tax at the maximum Ontario tax rate for individuals of approximately 47%, the tax paid on this portion is 56 cents, for an effective tax rate on the $2.00 distribution of 28.0%. The adjusted cost base of the REIT unit has been reduced by $0.80 per unit, because of the tax-free distribution. When the unit is sold on December 31, 2001, the investor must recognize a capital gain for the difference between the sale price of $21.00 and the adjusted cost base of $19.20 ($20.00 - $0.80). Because only one-half of the capital gain is subject to tax the investor pays $0.42 of tax on the $1.80 capital gain. On total earnings of $3.00 (one dollar capital appreciation plus two dollars in distributions), the investor in the top income tax bracket pays only approximately 33% in tax, instead of the 47% the investor would pay on many alternate types of earnings.

Additional Taxation Issue—Recapture: There is one caveat that must be considered when calculating the tax implications of REIT ownership. This is the issue of recapture that is faced by the REIT when it sells a property. Assume the sale price of a building is $10 million. Further, assume that the building originally cost the REIT $8 million and that the remaining tax-cost of the building has been reduced to $2 million as a result of claiming capital cost allowance (CCA). The result will be that the REIT faces a capital gain of $2 million ($10 - $8), half of which is taxable. There will also be recapture on the $6 million difference between original cost and tax value at time of sale. Because recaptured CCA is fully taxable, the unit holders for that year will face a substantial tax cost when the taxable income is distributed to them. This introduces some inequity among unit holders. Those unit holders that have sold their units will have enjoyed the benefit of the C.C.A. allowances, but will never face the cost of recapture. New unit holders will not have enjoyed the benefit of the CCA allowance on the buildings on which they are now forced to bear the cost of recapture. In an efficient market, the potential impact of recapture should be factored into the REIT's unit price.

Supply/Demand for REIT Offerings:

Given that there is limited capital available to be invested in the multitude of security offerings, increased demand for one security logically results in a corresponding decrease in demand for some or all other securities. The REIT industry is no exception to this dynamic. If REITs suddenly become less attractive relative to other investment offerings, the REIT industry is unlikely to continue to expand. Assuming that all relevant information is built into the yields (both from cash distributions and capital appreciation) earned on REIT offerings, it is possible to forecast future trends in REIT performance based on forecasts of pertinent information. For that reason, it is important to consider the factors that influence a REIT’s performance (relative to other security offerings).

REITs, like bonds, have traditionally provided a nice hedge against declining equity markets. While the relationship is not exact, when equity markets decline, REITs tend to perform well. Hence, forecasts for equities will become extremely important for forecasting REIT capital appreciation (assuming distribution yields remain constant). As an economy enters a recession, equities become less attractive to investors, and the stock market tends to under-perform. On the other hand, as interest rates fall in a recession, traditional bonds, with a fixed return, become more attractive. REIT returns are locked in under lease contracts. When interest rates fall, this constant stream of REIT income becomes more attractive to investors.

However, one of the most positive aspects of a REIT is that although there is a tendency to perform well in equity market downturns, they also tend to fare well in equity market upturns. REITs do have the ability to adjust to increases in inflation by increasing rents over time. Compared to a bond with a fixed coupon, REITs are very attractive because their income stream is able to increase in an expansionary period. Because increasing inflation has the effect of increasing interest rates, REIT distributions adjust to take into account higher inflation and interest rates, while bonds and mortgage backed securities (being long-term contracts) cannot adapt nearly as quickly. In heated interest rate environments, eventually growth in the equity markets tends to decline. REITs once again, become more attractive to investors. The only additional explanation for the spread of REITs yields over mortgage backed securities, appears to be a return for management-related risks and the possibility of loss of principal due to lack of asset maintenance.

Because of the REIT's ability to lock in returns, while retaining the flexibility necessary to increase income, regardless of the trend in the bond and equity markets, REITs tend to provide a stable source of return for investors.

Apartment and Non-Apartment REITs Compared, The U.S. Experience

Each specialized REIT category (hotel, office, retail, apartment, etc.) has its own specific risk profile. For instance, hotel REITs tend to prosper in times of economic growth and tend to face adversity in times of recession. Hotel REITs are extremely flexible in times of rising inflation because they are the most nimble class in their ability to adjust room rates, but are extremely vulnerable to decreases in individual disposable income. Office REITs fare well initially during downturns because they have the ability to lock-in rental rates over the long term. However, they are least able to adjust to periods of rising inflation.[4] Retail and Office REITs tend to be rather illiquid because their properties are more difficult to sell, relative to other property types. Apartment buildings tend to be rather liquid and are easily bought and sold.[5]

The U.S. apartment REIT has shown itself to be a particularly promising form of REIT specialization. These REITs tend to fare better than other REITs over the whole spectrum of economic conditions for a number of reasons.[6] Apartment buildings tend to be far easier to sell than other property types. The cost of acquiring new tenants is lower for apartments than for other property types. Leasehold improvements are less costly for

[4] Mattson-Teig, B., "Resurgent REITs", National Real Estate Investor; Atlanta; Nov 2000.
[5]" Apartment REITs Have Debt Capacity", National Mortgage News; New York, Oct 11, 1999
[6] "Equity REITs Perform Well in 3rd Quarter", Multi-Housing News. San Francisco, January 2001.

apartment tenants than for offices or retail complexes accommodating new tenants.[7] Nevertheless, there exists some research that indicates apartment REITs in the U.S. tend to overpay for their properties, thereby reducing the return on investment to their unit holders. Multi-year examinations of the prices paid for given classifications of real estate have identified that REITs pay a statistically significant premium over real estate operating companies for real estate of objectively equal value.[8]

The other major way in which apartment REITs tend to have an advantage over other REIT types is their ability to weather the business cycle comparatively unscathed. Apartment REITs tend to fare well in both economic downturns and expansions. During a downturn, many people who might have purchased a single-family home, owing to uncertainty in personal finances, instead opt to continue renting their residences. Interest rates also tend to fall during these periods, thereby reducing the debt-service cost to the REIT. During downturns, the higher yield of REITs, relative to bonds, attracts capital to the vehicles. REITs, in general, and apartment REITs, specifically, tend to provide a nice hedge against the equity market. When the Nasdaq fell over 20%, apartment REITs experienced an average yield (dividend and capital gains) of over 20%. [9] Although lower interest rates may encourage certain individuals to purchase homes, it does not appear as though this tendency outweighs the benefit of lowered debt-service costs to apartment REITs.[10]

During times of economic expansion, apartment REITs, with their relatively short lease terms, are able to factor accelerated inflation rates into their rental rates more rapidly than other REIT categories. Rising interest rates, have not proven problematic for apartment REITs. The higher rates tend to discourage home purchasing on the part of tenants and may even bid up rental rates. [11] Legislative and trust-declaration limits on the proportion of leverage a REIT may operate with, tend to keep debt-service requirements at a manageable level, even with rising interest rates.

Lending institutions tend to view apartment REITs more favourably than other REITs seeking debt financing.[12] Because the value of the properties held by apartment REITs tends to stay high, reflecting their ability to generate consistent cash flow, these REITs have greater access to funding at better rates. It would appear as though apartment REITs have less difficulty meeting debt service requirements than other REITs, providing greater certainty of distributions for investors. Banks have little worry about apartment REITs being able to service their loans because the loss of an individual tenant does not have the same negative cash flow impact for an apartment REIT as for an Office REIT. Indeed, there has been some research indicating that apartment REITs have a tendency to

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[7]Avidon, E., "For Apartment REITs, Another Solid Year", National Mortgage News; March 1999.
[8] Hardin, W.G., and M.L. Wolverton, "Equity REIT Property Acquisitions: Do Apartment REITs Pay a Premium?", The Journal of Real Estate Research; Sacramento; 1999.
[9] Braham, L., "REITs Still Offer a Solid Defense", Business Week; New York; December 25, 2000.
[10] Foong, K., "Apartment REITs Count Among Top Performers in Investment Returns", Multi-Housing News; San Francisco, October 2000.
[11] Ibid.
[12]Supra, Note 21.

carry higher levels of leverage (approximately 8% more) than other REITs. This may allow a REIT more flexibility when attractive purchase opportunities arise.

Apartment REITs have begun to specialize along geographic or demographic lines.[13] This allows the investor to further delineate his or her risk when making portfolio decisions. Many apartment REITs have chosen to concentrate on developing in areas of high growth and favourable demographics. The aging of the baby boomer generation promises to fuel further growth in apartment REITs as the burdens of home ownership encourage a shift towards apartment dwelling.

Apartment REITs have a number of positive aspects that make them an attractive investment for both those looking for fixed income alternatives, as well as for those seeking a hedge against negative economic impacts. Their superior funding opportunities (relative to those available to other REITs), coupled with their ability to weather downturns in the business cycle, while also faring extremely well during upturns, make them an attractive investment choice for the investor.

THE UNITED STATES CONTEXT

The Current State of the U.S. REIT Industry

In August 2001, the market capitalization of all REITs in the United States was US$138.715 billion. This was down from the peak in 1997 of US$140.533 billion.[14]

Although created by statute in the 1960's, it was not until the late 1990's that REITs experienced phenomenal growth in their market capitalization. During a one-year period from 1996 to 1997, market capitalization of REITs grew by 58.3%. This compares to the five-year period from 1971-1976 when an overall decline in market capitalization of 12.5% occurred. [15]

American REITs have a number of structural options from which to choose. They can be corporations, business trusts, partnerships, or other similar structures. So long as all taxable income is paid out to unit holders in the form of distributions, the REIT is not subject to tax at the corporate level.

Because one of the objectives of this paper is to suggest methods of increasing the popularity of Canadian REITs, it is useful, at this point, to juxtapose the U.S. environment with the Canadian context and to identify the main taxation difference between the two nations. The difference between the Canadian and American REITs appears at the point in which distributions are taxed in unit holder's hands. In Canada, the unit holder is able to reduce his or her taxable income from the REIT's distribution as a result of the REIT taking a depreciation expense that is passed on to the unit holder.

[13] Rudnitsky, H, "Renter's Market", Institutional Investor. New York: December 1999.
[14] N.A.R.E.I.T., August 12, 2001
[15] Ibid.

Investors hope that the depreciation expense taken by the REIT will be adequate to shield the entire distribution from taxation. However, it may be that the depreciation deduction does not cover the entire distribution and the unit holder will be liable for tax on the uncovered portion. In the United States, where distributions are categorized as dividends, so long as a number of specific criteria set out in the Internal Revenue Code are met, the REIT qualifies for tax-free status at the corporate level and the unit holder is able to declare the income at the preferential rate at which dividends are taxed.[16]

Returning to the examination of the U.S. REIT industry, the main provisions contained within the Internal Revenue Code for qualification as a REIT are as follows:

- The REIT must be structured as a corporation, business trust, or similar association. (Note: some material differences exist between the structures);
- The REIT must be managed by a board of directors or trustees;
- Shares must be fully transferable;
- There must be a minimum of 100 shareholders;
- The REIT must invest at least 75% of total assets in Real Estate;
- The REIT must derive at least 75% of gross income from rents from real property, or interest on mortgages on real property;
- The REIT must pay distributions of at least 90% of the REIT's taxable income;
- No more than 50% of the shares can be held by five or fewer individuals during the last half of each taxable year;
- No more than 30% of gross income can come from the sale of real property held for fewer than four years.

History of U.S. REITs

American REITs have traditionally been of two forms: The Mortgage REIT and the Equity REIT. The REIT of today is, for the most part, extremely different from the REITs created during the early 1970's; there has been a shift from Mortgage REITs to Equity REITs. Although there are a small number of combinations of the two types, these hybrid-REITs account for less than two percent of the total market capitalization of REITs.[17]

Equity REITs hold either freehold or leasehold interests in real property. Although some U.S. REITs do use management agreements with third parties, the objective of the REIT is to manage the properties to produce income for distribution to the unit holders. For example, an equity REIT may own shopping centers, or hotels, and earn rents for allowing others the use of those properties. Those rents, after expenses have been covered, are passed along to unit holders as distributions.

[16] Garrigan R., and Parsons, J., Real Estate Investment Trusts: Structure, Analysis, and Strategy. New York: McGraw-Hill. 1997

[17] N.A.R.E.I.T., August 12, 2001.

Mortgage REITs do not hold properties directly. Instead, these REITs own encumbrances on real properties that are owned in fee simple by other individuals. The mortgage REIT uses the equity contributions of unit holders to make mortgage loans on these properties. As the mortgage income is paid to the REIT, this income is passed along to the REIT unit holders.

In 1971, 63.5% of the market capitalization of all U.S. REITs was of the Mortgage form. As it stands today, only 1.2% of REITs are Mortgage REITs. The vast majority (over 97%) are of the equity form, with the remainder made up of hybrid equity-mortgage REITs. This shift in proportions became apparent during the recession of the early 1980's. As the economy worsened and interest rates became excessively high, mortgage owners found that they were unable to meet their mortgage-payment requirements. The properties fell into the hands of the mortgagers who found themselves becoming unwilling property managers. However, as the economy improved and real estate became more profitable, the mortgage-REITs discovered that direct property management could be quite profitable. The management of these REITs also discovered that over the course of the recession, they had developed significant skills in this new line of business.[18] Hence, today, REITs are almost exclusively of the equity type. Out of 190 publicly traded REITs, 22 (or 11.6% by number) are mortgage REITs, but these only make up 1.2% of the total REIT market capitalization.[19]

The recent development of UPREITs and DOWNREITs in the United States has also increased the popularity of the vehicles in that country.[20] UPREITs and DOWNREITs are REITs that do not own their real estate assets directly. Rather, the REIT establishes an Operating Partnership, wholly owned by the REIT corporation, to hold title of the properties. The benefit of this structure is that the Operating Partnership is able to issue shares as a medium of payment for real estate assets, and allow the owner of the new shares to defer capital gains taxation on the sold properties. If units of the REIT are issued, rather than units of the Operating Partnership, the seller would not be able to defer taxation. These entities allow the REIT to set up Operating Partnerships (OP's) that are owned by the REIT. These operating partnerships hold the title to the REIT's properties. Because the REIT cannot directly issue shares in the REIT to exchange for properties, but the Operating Partnerships can, the use of an operating partnership provides benefits not available to regular REITs. The benefit of this structure is that the REIT can acquire new properties by issuing units in the Operating Partnership that can eventually (generally, tax experts agree this period must be one year or longer) be exchanged for regular units in the REIT. This allows the REIT to acquire further capital without leveraging or creating dilution for existing unit holders by issuing additional units. The benefit to the seller is that he or she can defer capital gains taxes while holding units of the Operating Partnership, and only be subject to partial tax at the time of conversion. The main difference between UPREITs and DOWNREITs relates to when the Operating Partnership was formed; Operating Partnerships created before the acquisition of ANY

[18] Ian Rossa O'Reilly, CIBC-World Markets Toronto.
[19] N.A.R.E.I.T., August 12, 2001.
[20] Supra, Note 2.

properties are UPREITs, while Operating Partnerships created after a REIT's inception, with the properties subsequently transferred, are DOWNREITs.

The United States *REIT Modernization Act* came into effect in 2001. Among other things, this act will allow REITs to provide non-rental revenue-producing services to tenants. This new revenue source is expected to substantially increase the earning growth of REITs over the next few decades, as REIT managers discover new services to offer tenant (e.g. telecom services, daycare services, etc.). As well, the technological alliances that this new law will permit between REITs corporations, have the potential to increase earnings and reduce the risks involved in owning these vehicles.[21]

Specialization of U.S. REITs

U.S. REITs are more specialized than Canadian REITs, but it appears that Canadian REITs are moving towards U.S. specialization. It is likely that the vast size of the American marketplace has resulted in conditions that allow a REIT to focus on very narrow segments of the real property market. For example, certain REITs have elected to focus exclusively on grocery stores, while others have seen potential in self-storage facilities. Some of the newer REITs have elected to directly enter into health care services and are, thus, no longer simply property managers. Rather, they manage the health care delivery systems for large health care providers (for example nursing homes, hospitals, and group homes).

The three largest general property sectors that REITs have focused upon are Industrial/Office (with 37 different REITs making up 32.2% of total market capitalization), Retail (with 46 different REITs making up 20.3% of total market capitalization), and Residential (with 25 different REITs making up 21.12% of total market capitalization).[22] However, it is important to note that these labels are becoming largely insignificant as the REITs further specialize. For example, retail is now made up of "Shopping Centers", "Regional Malls", and "Free Standing". Specialization can increase further when geographical and demographical specializations are taken into account.

The "Residential" REIT industry is made up of two components: apartment/multifamily and manufactured housing. Apartments make up twenty out of the twenty-five residential REITs and represent 92.4 percent of the total market capitalization for the residential sector.

The total return to investors varies substantially according to the property sector in which the REIT operates. Total return in 2000 for the REIT Composite Index was 25.89%. Of this total return, dividend yield made up 6.98%, with the remainder being created as a result of capital appreciation. In 2001, total return to investors in the Composite REIT index was 12.55% for the first six months. During 2000, Industrial/Office REITs beat the

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[21] Supra, Note 5.
[22] N.A.R.E.I.T., August 12, 2001.

Composite Index with a total return of 33.38% on a dividend yield of 6.52%. Retail REITs, largely as a result of the economic downturn and the corresponding difficulties encountered by retailers, fell short of the composite index with a total return of 17.97% on a dividend yield of 7.14%. Apartment REITs substantially outperformed the index in 2000, returning a total of 35.49% to investors on a dividend yield of 6.42%. Only Lodging and Resorts, as a category, outperformed apartment REITs, turning in a total return during 2000 of 45.32% on a dividend yield of 9.26%. Terrorist activities in 2001 curtailed the returns available to Lodging and Resort REITs as a result of an unwillingness of consumers to travel amidst the uncertain safety landscape. However, despite their impressive performance seen in 2000, apartment REITs lagged and returned a total yield of only 5.21%, significantly below the 2001 composite REIT index total return of 12.55%.[23]

Individual apartment REITs are large compared to industry standards. The size of the average REIT contained in the Composite REIT index, by market capitalization, is US$736 million. Apartment REITs, by comparison, have an average market capitalization of US$1.4 Billion. In fact, nine out of the twenty publicly traded apartment REITs have a market capitalization of over US$1Billion. In contrast, the second largest average REIT size is found in the Industrial/Office sub-sector with an average market capitalization of just under US$1Billion. Only nine out of a total of forty-six Industrial/Office REITs are over $1Billion in size.

It is important to note that the massive size of U.S. REITs stands in stark contrast to the Canadian environment in which no Canadian REIT has a market capitalization over the US$1 Billion level.[24] Riocan, growing rapidly, however, appears ready to break the US$1 Billion level during 2002.

The Market for U.S. REIT Securities:

The REIT market peaked during 1997, when a total of US$45 billion in capital was raised by the REIT industry. Of that total, there were 26 Initial Public Offerings, raising a total of US$6.2billion. The secondary equity market raised a total of US$20billion in 227 separate offerings. Debt raised in 160 offerings totaled US$16.8 billion, 82% of which was in the form of unsecured funds.[25]

The year 2001 saw a significant reduction in offerings of equity capital. There were no initial public offerings, and only 20 secondary equity offerings, totaling US$1.4 billion. By contrast, the unsecured debt market was relatively strong seeing US$6.9 billion raised in 42 separate offerings.[26] The shift in proportions of equity to debt raised is understandable given the generally depressed equity markets and the relatively low costs

[23] Ibid.
[24] CIBC World Markets.
[25] Standard and Poors, 2001.
[26] Credit Suisse First Boston.

of debt available to borrowers. There is a definite preference for non-secured debt over secured.

Given the low interest rate environment and the high expectation for yields that equity holders possess, it is likely that the REIT industry will favour debt over equity at least until such time as the equity markets recover. To issue equity at this point in time would be the equivalent of giving away large portions of the REIT's properties at bargain prices. Existing unit holders would face significant dilution and management would be faced with substantial unrest in the equity base.

Make-Up of U.S. REIT Investors:

It has been estimated that there is an equal split between institutional and retail REIT equity investors in the United States. When compared to the Canadian experience of 85% retail to 15% institutional, we see the high acceptance level of U.S. REITs by the large pension funds and mutual fund operations.[27] This situation indicates that a great deal of equity capital exists that has not been channeled into Canadian REIT securities. One of the reasons behind this is that Canadian pension funds have been direct investors in real estate and have not needed the REITs in order to participate in the real estate market. In addition, the size of the Canadian REIT industry and the relatively small number of institutional investors in Canada makes it improbable that liquidity could be obtained through REIT investments. Simply put, any sizable investment in a Canadian REIT by a Canadian pension fund would be such a large percentage of the overall equity base in a given REIT that liquidity would be noticeably reduced.

In the United States, large mutual funds companies exist that invest in nothing but REIT securities, and this has raised the institutional share of REITs compared with the situation in Canada. Pension funds have either invested directly in REIT securities or have become part of joint venture operations with REIT corporations. There is a great deal of foreign investment in U.S. REIT securities. In particular, Dutch investors have been extremely receptive to American REIT offerings, largely as a result of favourable Dutch taxation rules for foreign-earned investment income. It is noteworthy that Canadian pension funds have been willing to invest as joint ventures with U.S. REITs to purchase U.S. properties, with the pension fund contributing the major portion of the asset cost, and the U.S. REIT handling the day-to-day management of the property.

U.S. View of REIT Securities:

Investors in U.S. REIT equity and debt securities view the REIT corporations as equity vehicles. Research indicates that REITs are starting to be viewed not as fixed income investments, but rather as equity investments in corporations that happen to pay substantial dividends.[28] This may indicate a new view of the purpose of holding a REIT

[27] Anthony Paolone and Michael Mueller, CIBC World Markets New York.
[28] CIBC World Markets, 2000.

security. Investors are now viewing REITs as an alternate class of equity stock, rather than a bond alternative.

The U.S. view of REITs has had a number of important ramifications. First, in the U.S., the competition for investment dollars is between REITs and other corporations. This has shown itself in the difficulties the U.S. REITs experienced during 1999 and 2000 when technology stocks became the most highly desired investment securities. Price-Earnings ratios for technology stocks became disproportionately high when compared to REIT stocks. Although dividends were high for the REITs, the relatively lower capital appreciation significantly decreased overall yield for these securities.

Second, because REITs are viewed as equity stocks in the United States, the activities investors want management to engage in will approximate those undertaken by managers of equity-issuing corporations. U.S. investors want management to take on risks that will result in their REIT stocks showing growth in share price in a manner that rivals their other equity investments. Hence, REIT corporations have taken on a great deal of development risk and have become extremely skilled as integrated real estate corporations.

BEST-IN-CLASS U.S. REITS

"Best-in-Class" Features for All Types of REITs

The best REITs operating in the United States have been identified in accordance with their total yield to investors. To be able to offer premium returns to investors, U.S. REITs must accomplish a number of aims. First, they must be able to have growth in the distribution yield to investors. Second, they must be able to generate substantial internal growth. This can be measured by the growth in a REIT's "Same Store Net Operating Income" (i.e. not as a result of newly purchased properties or as a result of merger activity). Lastly, REITs must be able to have high projected increases in the previously mentioned measurements.[29]

Although there are specific key success factors for each specialization type, there are a number of important success factors behind the absolute yield and growth in yield for any and all REIT specialization types. Satisfying the requirements for key success factors in the REIT industry will translate into higher yields and stronger growths in yields. However, when the key success factors necessary for superior yields are examined, it would appear that each of these factors can be reduced to a single over-arching key success factor: Size. The larger REITs, as a result of their size, have a natural tendency to satisfy each of the enumerated key success factors required for superior yield performance. Keeping in mind the underlying principle of "size-driving-yield", the most important key success factors will merely be a reflection of the many ways in which size creates benefits that drive yields. The size-influenced key success factors include:

[29] CIBC World Markets, R.E.I.T. report January 2001.

1. Large market capitalization;
2. Experienced and capable management;
3. Geographic dispersion of risk;
4. Access to high barrier to entry markets;
5. Low debt levels;
6. Quality of assets;
7. Ability to use retained cash flow to generate internal growth; and
8. Greater degrees of risk tolerance.

These size-driven advantages will be amplified as a result of their interaction. For example, larger REITs capable of attracting high quality management professionals, will also have the benefit of being viewed as more capable by the debt markets. This will further decrease the costs of debt that were already reduced as a result of the strength created by size. Each size-driven key success factor will be examined independently in the following section:

1. Large Market Capitalization

Because performance of a given REIT will be, at least partially, dependent upon a REIT's ability to keep costs under control, reductions in the costs of borrowing will translate directly into increased earnings when compared to less advantaged REITs. Access to economical financing will depend upon a number of factors and will tend to inter-relate with other key drivers. Size of the REIT, existing debt levels, management experience and ability, and quality of assets will all have an impact on the borrowing costs of a given REIT. For example, the very experienced management team of Equity Office Properties, with a low debt level (relative to industry average) and high quality assets, has traditionally kept borrowing costs to levels that are less than 50 basis points above Treasuries.

The larger REITs have a number of advantages over smaller REITs. First, size can be leveraged to reduce costs as a result of economies of scale. For example, these larger REITs are able to purchase services for capital expenditure and maintenance in bulk at reduced rates. Management software systems are more cost-effective when a fixed cost is spread over a larger number of properties. Hence, these larger firms are better able to track and control costs. Second, as indicated above, larger REITs have access to more economical debt financing as a result of their perceived stability. Third, larger REITs have geographic diversification that will reduce any risks resulting from a downturn in an individual geographic market. This protects the overall earnings of the corporation and enables it to maintain distributions to shareholders. Fourth, larger REITs, for the most part, have larger cash reserves creating the nimbleness necessary to take advantage of market opportunities as they arise. Fifth, the larger REITs are, generally speaking, the REITs that have been in existence the longest. A successful track-record provides assurances for debt-lenders that the REIT will be able to meet its obligations. Hence, borrowing will be accomplished at more attractive rates. Lastly, the larger REITs have access to the best and most experienced management teams. The most skilled professionals are attracted to both the higher potential salaries and the greater power and prestige afforded by working for a larger corporation.

2. Experienced and Capable Management Teams

The REITs with the most experienced management teams have gained the knowledge and skills necessary to outperform other REITs. Traditionally, the more experienced and capable management teams have gravitated towards the larger REITs as a result of a number of factors. First, many of these managers gained their experience as the larger REITs grew from inception to their current size. Since the larger REITs have been in existence longer than smaller competitors, it is only reasonable that their management teams would be more experienced. Second, there appears to be more prestige and opportunity for management skill development in the larger REITs. Third, the larger REITs are under a greater degree of public market scrutiny than smaller, less-widely held REITs. This has meant that a larger REIT must have a better management team in place if it hopes to escape the negative sentiments of public scrutiny. Lastly, the larger REITs are able to pay larger salaries to attract the more skilled managers than would be possible for smaller REITs.

3. Geographic Dispersion of Risk

REITs that are able to operate in a number of geographic markets are not as dependent upon the strength of the economy in any one given market. Because there is less volatility in earnings (and earnings growth), these REITs are able to trade at higher multiples than other REITs. Again, it is the larger REITs that have been able to accomplish greater degrees of geographic dispersion as a result of having more assets to distribute over a greater number of areas.

4. Access to More Expansive Markets

Markets with high barriers to entry will be those markets with few available properties and correspondingly high values for the properties already in existence. REITs that have an existing presence in growing and strong markets have shown the strongest earnings growth. For example, Post Properties (a premium-apartment REIT) has chosen to develop properties in the core business area of large cities. The assumption is that as these cities become more suburban through growth, the core business areas will attract premium rental prices. However, this strategy involves predicting which markets will experience substantial future growth and the foresight to enter those markets before the attractive core-area land becomes prohibitively expensive. By purchasing these properties in advance of the projected urban growth, Post is hoping to be able to earn above market level returns on their initial investment. This should translate into higher total returns for investors.

5. Low Debt Levels

REITs that keep their debt levels at, or below, the industry standard have a number of advantages. First, these REITs will not be viewed by debt-lenders as being overly-leveraged with the risk of default on current borrowings. This has traditionally translated into lowered borrowing costs for additional capital. Second, these REITs have greater flexibility for taking advantage of market opportunities as they arise. In particular, those REITs that have been prudent in their use of bank operating lines will be able to pounce on opportunities immediately, while less nimble REITs will lose the opportunity as they attempt to raise the required capital. This situation will exist for property acquisitions, new business initiatives, as well as for merger activities. Again, because the larger REITs are able to issue equity at less prohibitive costs (owing to market confidence), it is the larger REITs that usually have the lowest debt/equity levels.

6. Quality of Assets

The higher the quality of a REIT's assets, the higher the market rents that can be demanded. Those REITs that are able to maintain their assets in premium condition, or who choose to recycle their assets in order to keep the average age of assets at a low level, will be able to earn returns higher than those REITs with less well-maintained and older assets. REITs are not vehicles that will reduce rents, but rather gain their ability to increase rents as a result of their management activities. Larger REITs, for the most part, have higher quality assets. This is because they recycle assets frequently and have the size to perform capital expenditures at lower cost due to economies of scale. Boston Properties, for example, has been extremely active in selling off assets that have become less desirable, while focusing on developing new, more attractive properties.

7. Ability to use Retained Cash Flow to Generate Internal Growth

Those REITs that are able to retain maximum cash flow and use that cash flow to generate returns will be able to display growth levels in yield and net operating income above other REITs. It has been estimated that by retaining maximum cash flow, a REIT has the potential to increase growth by 25%.[30] However, in order to access this cash flow, the REIT must be able to continue to pay out the required dividend. The only way to increase cash flow, therefore, is through prudent cost control. Those REITs that can borrow at reduced costs and keep operating costs low will have growth potential greatly above the industry average. These growth prospects ought to translate into increases in the total yield to investors.

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[30] CIBC World Markets.

8. Risk Tolerance

Those REITs that undertake more risky activities will, on average, reap greater returns. Therefore, those REITs that take on direct development risks, and are first to implement innovation, will be rewarded by greater performance results. Because U.S. investors view REITs as low-risk equities, there is less of a demand for risk-reduction than has been the case with bond-like offerings. Indeed, it is the most pro-active and aggressive REITs that have shown the highest total yields to investors.

Identification of "Best-in-Class" Non-Apartment REITs

Two of the most successful REITs in the recent past are Equity Office Properties and Boston Properties. These REITs have shown strong growth in earnings, dividends, and same store operating income.

Equity Office Properties (EOP):
Equity Office Properties is the largest real estate corporation in the United States, owning over US$27 Billion in assets. This REIT is also one of the earliest American REITs established. Sam Zell, one of the most reputable names in real estate, founded the REIT in Chicago and still remains the chairman of the board. Owing to the size and reputation of this REIT, it is able to access funding (both debt and equity) at costs lower than available to other REITs. Economies of scale are strongly leveraged. EOP has a well-developed capital recycling program that has resulted in a low average age and a high level of quality for most properties. Management is extremely skilled and has been in place for long periods of time. EOP tends to be ahead of the curve in entering new ventures (for example technology services for tenants and electronic buying networks for property management purposes). This has resulted in higher than median returns. EOP has a below industry average debt level, usually below 40%. This further increases the company's access to low-cost financing and also provides the flexibility necessary to take advantage of market opportunities. Properties are well diversified with representation in over 36 states. Many of the properties are in high barrier to entry markets.

Equity Office Properties' ability to master the key drivers in the industry has resulted in strong stock prices (Price/Funds from Operations (P/FFO) well above the average), high dividend yields, and strong internal growth.

Boston Properties:
This REIT, although smaller than the mammoth Equity Office Properties, is still extremely large by industry standards. This REIT owns and manages premium office properties. The quality of the properties is second-to-none. A great deal of development risk has been accepted and this has been evidenced by the high total returns to investors.

Debt, although relatively cheap owing to the size and track-record of the company, is relatively low. The company recycles its assets frequently to take advantage of market opportunities. It is well diversified geographically and has extremely high barrier to entry locations.

Growth for this REIT is expected to be extremely strong, both in terms of dividend and total yields. Again, this REIT has been able to manipulate the key industry drivers in a way that has translated into superior performance and growth.

"Best-in-Class" U.S. Apartment REITs

In addition to the list of key success factors germane to any REIT, apartment REITs have a number of additional key success factors that will be translated into total yield and internal growth performance. Again, these key success factors are also achieved largely as the result of the size of a given apartment REIT. Although other REIT types may also have similar key success factors, apartment REITs are extremely dependent upon the following key success factors:

1. Offering premium units;
2. Entering into areas with rents below market value;
3. Operating in areas of high projected employment and economic growth;
4. Offering new services;
5. Building at less than replacement value; and
6. Having low tenant turnover/high occupancy.

1. Offering premium units

Given that there is a base level of cost involved in constructing any structure, the comparatively low costs of improving to a premium position are accepted by successful apartment REITs. Additionally, it is believed that tenants residing in high-cost units will be easier to manage than tenants in less expensive surroundings. Whether or not this is true is uncertain, but it is definitely the perception of most property managers, who believe rents will be easier to collect in a premium market, and that the premises will be treated with greater care. As well, the net asset value is usually higher for premium units, making debt financing more readily available at reasonable cost.

2. Entering into areas with rents below market value

Theoretically, an apartment REIT has purchased properties at a price equal to the discounted cash flow of the projections for current rent with increases equal to inflation. Should the REIT be able to make some improvements and raise rents above the predicted inflation, premium returns will be available. Those REITs that can identify areas that will see rental increases above the national average, will be able to offer higher total returns to investors.

3. Operating in areas with high projected employment and economic growth

By focusing on areas of high employment and economic growth, it is anticipated that vacancies will be lowered. Revenue will increase, while the costs of releasing will be reduced. As well, because growth attracts more individuals needing shelter, there will be a higher demand (and hopefully higher prices) for the existing units. Single-family homes will become more expensive in high-growth areas. Periods of high interest rates created during periods of economic expansion, further create a larger pool of potential renters.

4. Offering new services

Those REITs that are ahead of the curve in provision of new services valued by tenants will be more attractive to prospective tenants, while simultaneously generating new sources of income. This translates into lower vacancies, less turnover, and lower costs coupled with higher revenues. For example, Equity Residential Properties has wired all of its residential units for high-speed internet access. As soon as this service was available, over 25% of the tenant-base immediately signed up for this added-value service. In addition, waiting lists for these wired properties have begun to form. Hence, although risky, these sorts of new undertakings have created a more loyal customer base and also provided additional cash flow available for internal growth.

5. Building at less than replacement value

As long as higher returns can be earned from development activity (relative to refurbishment of existing stock), development will be attractive. Although this is a risky activity, returns are greatest for those firms that take on direct development risk. However, in many markets, the cost of building new buildings is substantially higher than the cost of purchasing existing stock. In this situation, REITs will simply refurbish existing properties, hoping to reap whatever benefits such slight improvements can generate. However, returns are limited by the market value of such improvements. Those REITs that develop new properties can have higher earnings that will translate into better yield performance and growth.

6. Having low tenant turnover/high occupancy

The cost of securing a new tenant is substantial. It has been estimated that the cost approximates at least a month's rent. If rental inducements are also necessary (for example, by offering a free month's rent), the costs escalate further. Hence, those REITs that can retain existing tenants will fare best over the long-term. However, retaining tenants requires a number of things. First, the properties must be maintained in good repair. Second, the properties must offer those amenities tenants desire. Third, the properties must be located in areas with overall low vacancy rates. If a new apartment is difficult to find, it is less likely tenants will opt to leave their existing residences. By maintaining existing tenants and keeping units filled, REITs safeguard their revenue inflows, while minimizing the costs associated with securing new tenants. This results in higher yields and growth. It must be remembered, however, that maintaining tenants, and freezing rents that are below market level as time passes, will negatively impact the benefits obtained from lowered turnover.

The apartment REITs that have best been able to manipulate both sets of key success factors (those for <u>all</u> REITs and those for <u>apartment</u> REITs) have had substantially better performance than other apartment REITs. The two apartment REITs that can be labeled as U.S. "Best-in-Class" are Equity Residential Properties and Avalon Bay Communities.

<u>Equity Residential Properties(ERP):</u>

ERP is another huge REIT created by Sam Zell. Like EOP, Equity Residential Properties has had outstanding success over the past decade. At present, the REIT owns over 200,000 units, with representation in nearly every state. The costs of both equity and debt financing are quite low. The company has a substantial development pipeline in multiple high barrier to entry, high-growth areas. The economies of scale that this company possesses have resulted in the ability to develop new properties at less than replacement cost. Traditionally occupancy has been over 92%. As previously mentioned, Equity Residential has been at the forefront of tenant-service developments. This strategy will become even more important as REITs are afforded the right to operate taxable REIT subsidiaries as permitted by the "*REIT Modernization Act*". Debt levels are well below sector averages, permitting the REIT to take advantage of merger, acquisition and joint venture opportunities. ERP has successfully leveraged the key success factors for REITs in general, and apartment REITs, in particular, to produce above average growth and total returns.

<u>Avalon Bay:</u>

Avalon Bay offers premium units in some of the best locations in the United States. Avalon Bay has chosen to focus on high barrier to entry markets with high projected economic growth. The REIT is well diversified geographically and is larger than average in size. Asset quality is second-to-none. Rental rates are extremely high relative to market average. Development has been substantial, and in many instances, has come in under budget. The management team is highly skilled, debt levels are low, cost of financing is low, as are vacancy rates. This REIT has been on the forefront of new service offerings to tenants. Overall, this REIT has also been able to leverage the key success factors to generate growth and high total returns to investors.

THE CANADIAN CONTEXT

Development and History of Canadian REITS

Canadian REITs, in contrast to their U.S. counterparts, have not reached the same level of sophistication in terms of size or categories of offerings. This is, in large part, due to their rather recent introduction and the smaller market size.

Canadian REITs, as they exist today, were only granted the tax benefits they currently enjoy in 1994. Technically, these legislative changes enabled these vehicles to qualify as "closed-end mutual funds". Prior to that, there did exist a number of trust-like vehicles, however they were not able to avoid taxes at the trust level, and they also contained a right of redemption.

During the 1970's, many REITs had extremely high leverage levels, requiring high levels of cash flow to service those debts. This reduced the distributions to unit holders, and the value of the units on the market dropped correspondingly to take into account the reduction in discounted cash flow, often to below fair value for the properties owned by the trust. The right to redeeming units at fair value reduced the value of remaining units. In 1994, Canadian legislation was passed that eliminated the unit holder's "Right of Redemption".[31] Today, REIT holders possess no right of redemption. This creates stability and, if one believes in market efficiency, fair market values for the shares.

Features of Canadian REITs

Although, on the surface, it would appear as though REITs operating in the Canadian context simply mirror their U.S. counterparts, there are some essential differences that have significantly limited their growth and specialization.

First, all Canadian REITs are Business Trusts. [32] Unlike in the U.S., REITs are not created by statute, but rather through the use of a Declaration of Trust. This means that although there are rules that must be followed, most of the rules investors must consider before making an investment are contained within the Declaration of Trust of a specific REIT. There is no "standard" REIT in the Canadian environment. Because of this lack of uniformity, a higher level of sophistication and due diligence is required of investors choosing to invest in these vehicles. Although there are benefits of a trust structure, like the imposition of strict fiduciary duty on trustees, and the ability to tailor trust indenture agreements, there are some disadvantages that have likely limited their growth in Canada. First, unit holders are not afforded limited liability protection. This may mean that unit holders are liable for damages in excess of their investment.[33] Despite this concern, this issue has not been tested in court as of yet, and it is the opinion of the legal community

[31] Ibid.
[32] Supra, Note 2.
[33] Supra, Note 2.

that limited liability will be granted to unit holders should it ever become necessary to test the issue in court. Second, the unit holder may or may not have a say in the election of trustees of the REIT. This will depend entirely on the contents of the particular Declaration of Trust. Third, the unit holder does not have the same right as shareholders of a corporation to challenge the actions of the trustees of the REIT (depends of trust indenture). The only option available to unit holders disagreeing with the actions of trustees, is to sell their units on the open market. Fourth, while there is no director's liability imposed upon the trustees of the REIT, trustees must meet an even higher duty of care, that of a fiduciary for the unit holders. Liability of directors has been clarified significantly in recent years, while fiduciary duty standards vary according to circumstances. Lastly, trusts are not permitted to make acquisitions using units as a medium of payment and without tax costs being imposed upon the seller. This limits the REITs ability to grow through acquisitions.

Specialization of Canadian REITs

Canadian REITs have tended not to specialize to the same extent as the U.S. REITs for a number of important reasons (to be discussed in the next section), but tend to specialize more and more. Although, of late, there has been a greater tendency to specialize, many of the Canadian REITs are still of the diversified property type. The inability to delineate risk along specific property type lines may be one of a number of explanations for why Canadian institutional investors have not been as active in the REIT market as their U.S. counterparts have been.[34]

Current State of the Canadian REIT Industry

The U.S. REIT industry has enjoyed a thirty-year head-start over its Canadian counterpart. As a result, the Canadian REIT industry is not as important as a financial instrument, even taking into account population differences. This under-development exists in terms of both market capitalization levels as well as in terms of specialization according to property type (e.g. hotels, office buildings, retail, multi-family). Currently, the Canadian REIT market is made up of approximately 13 players with a market capitalization of approximately Cdn$3 billion.[35] Although there has been some specialization along particular property types (hotels, offices, and retail), other types (apartments, health care) have not been able to support a large number of security offerings for reasons that will be examined. It is also important to note that Canadian legislative differences make it difficult (or impossible) for REITs to operate in certain areas (e.g. Mortgage and Hybrid REITS). This issue will be discussed further in this paper.[36]

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[34] Anonymous Interview, July 2001.
[35] Globe and Mail, January 30, 2001
[36] Supra, Note 2.

The largest players, by market capitalization, in the Canadian context and their building type concentrations as of January 2002 are as follows:

- H&R Real Estate Investment Trust: offices and industrial properties
- Canadian Real Estate Investment Trust (CREIT): diversified
- RioCan Real Estate Investment Trust (RioCan): shopping centres
- Summit Real Estate Investment Trust (Summit): diversified
- Canadian Apartment Real Estate Investment Trust (CAP REIT): apartment
- Residential Equities Real Estate Investment Trust (RESREIT): apartment
- CPL Long Term Care Real Estate Investment Trust (CPL): nursing homes
- Canadian Hotel Income Property REIT (CHIP REIT): hotels
- Morguard REIT: commercial properties
- Legacy Hotels Real Estate Investment Trust (Legacy): hotels
- Royal Host REIT: hotels
- Retirement Residential REIT: nursing homes
- O&Y REIT: Office

Distribution yields have ranged from the 8.5% distributed by Canadian Apartment Properties REIT (CAP-REIT) to the 11.3% of Legacy Hotel REITS.[37] Predictions have been made that these yields will continue to be relatively high, although certain economy-sensitive sectors (e.g. hotels) will suffer disproportionately in an economic downturn, while others will experience higher yields (e.g. apartment and office REITs).[38]

"BEST-IN-CLASS" CANADIAN REITS

Our list of key success factors necessary for superior Canadian REIT performance could differ from the list of key success factors identified in the U.S. REIT industry for three main reasons. First, the Canadian REIT industry is operating in a different national environment and has required different skills and abilities in order to achieve superior returns. Second, during the course of the examinations of the two countries and discussions with two sets of analysts (U.S. and Canadian) different key success factors were identified. Third, the differences attributable to the relative newness of Canadian REITs as compared to U.S. REITs may be remedied in the fullness of time. Nevertheless, in Table 1, we do apply the key success factors for U.S. REITs to existing Canadian REITs to determine the suitability of Canadian REITs for competing in an environment akin to that seen in the U.S. If, as predicted, the Canadian REIT industry becomes more like the U.S. industry as Canadian investors and the REIT industry progress along the experience curve, this table provides insights into which REITs will ultimately be "Best-in-Class" in Canada.

[37] The Globe and Mail, January 30, 2001.
[38] Braham, L., "REITs Still Offer a Solid Defence", Business Week. New York; December 25,2000.

Key Success Factors to be considered in Determining "Best-in-Class" for Canadian REITs in General

Given that all investors have a preference for obtaining maximum return for a set level of risk, those factors that serve to maximize those returns will be the most important for the investor to consider when ranking individual offerings within a security class.

The Canadian REIT analysts at CIBC World Markets—Equity Research have proposed a list of eight criteria that they believe ought to be considered when an investor attempts to rank individual REITs. They propose that the most important indications of future success for <u>any</u> REIT are:

1. A statement of clear strategic/asset class focus;
2. Investment in superior quality of assets in the relevant asset class;
3. Strong management (preferably internal);
4. Favourable past operating performance;
5. Good projected cash flow growth prospects based on properties currently held;
6. Access to capital on favourable terms;
7. Sustainable distributions; and
8. Attractive pricing.

In the opinion of these analysts, these eight considerations will provide the investor with a good idea of the returns that can be expected, along with an assessment of the risk-creating factors that are driving those returns (i.e. the probability that those returns will <u>actually</u> be attained). The following section provides an example of how these eight criteria can be used to evaluate a high-performing (perhaps "Best-in-Class") REIT that a number of analysts have rated a "strong buy."

Canada's "Best-in-Class" Non-Apartment REIT

Applying this list of criteria to the universe (non-apartment AND apartment) of REITs that are currently in existence in Canada, it would appear as though one REIT has shown itself to be "Best-in-Class" for REITs in general. Riocan REIT has been able to meet the criteria for "Best-in-Class" for all Canadian REITs.

<u>Riocan REIT</u>: This shopping-centre/retail REIT can be labeled as "Best-in-Class" in the REIT industry for a number of reasons that indicate high projected returns with a moderate degree of risk. Although it would appear as though the residential REITs have higher returns than Riocan, those returns were significantly affected by a "flight-to-safety" during the economic uncertainty of 2000-2001. Apartment REITs tend to be a safe source of steady income, and given the recent recession, results from fiscal year 2001 significantly inflated the returns for apartment REITs. Long-term prospects for growth and capital appreciation are extremely strong for Riocan. Surveys conducted by Firstcall/Thompson have indicated that more research analysts rate the units of Riocan either a "buy" or a "strong buy" than any other REIT offering in Canada. Some of the reasons behind this are:

- Riocan operates in the "essential services" segment of the retail industry that is not seriously impacted by a decrease in consumer disposable income. Other segments of the retail industry have experienced significant difficulties owing to the recent economic downturn.
- The properties that Riocan owns are of high quality relative to other properties in the same class.
- Riocan has a stated strategy of purchasing strip-shopping centres at prices that are below replacement value and then maintaining, or renovating them through adequate preventative capital expenditure.
- There is a strong, experienced internal management group. The REIT has access to capital at reasonable rates, largely as a result of its close association with the highly experienced U.S. Shopping-Centre REIT, Kimble.
- Riocan operates in markets with high barriers to entry.
- Riocan REIT's past performance (high yields, low price/cash flow multiples) has established the REIT's future earnings ability and relative bargain price when compared to other REITs of similar and differing asset classes.

These criteria, coupled with drivers specific to the shopping-centre industry (e.g. long-term leasing contracts, locations central to large suburban populations, etc.) have created a demand for this REIT that has resulted in significant capital appreciation for the investor, along with healthy distribution yields.

"Best-in-Class" Canadian Apartment REITs

At present, only two apartment REITs exist (CAPREIT and RESREIT). It is difficult to determine "Best-in-Class" for Canadian apartment REITs because, despite subtle differences, the two REITs are largely indistinguishable in terms of price-ratios, operating performance, and risk profile. It is useful to look to the more extensive U.S. market to determine which key success factors, in addition to the general list proposed for all REITs by CIBC World Markets, would be necessary in the apartment REIT industry to justify a "Best-in-Class" label.

Research reports produced by bond rating agencies and investment banks in the United States have provided a generally-agreed-upon list of additional criteria for determining "Best-in-Class" for this particular class of REITs in the U.S. context.[39] It would be reasonable to assume that these criteria would also be important in the determination of

[39] The bond rating agencies include: Dominion Bond Rating Agency, Standard and Poor's, and Moody's Investor's Services. The investment banks include: Solomon Smith Barney, and Deutsche Bank

success of Canadian apartment REITs. The additional criteria for apartment REIT success that all of these U.S. sources appear to agree upon are:

1. Ownership of a large number of properties in geographically diverse areas with low vacancy rates;
2. High levels of capital expenditure that justify premium rental rates;
3. Ownership of properties located in areas of high employment, and high projected growth;
4. A focus on densely populated areas in which home ownership is undesirable;
5. The ability to purchase properties at below replacement cost OR the ability to develop properties at a cost lower than would be possible using outside contractors.

The above factors drive either 1) minimization of risk or 2) maximization of cash flows. Those apartment REITs that are best able to leverage their resources to satisfy both drivers will be able to secure the label "Best-in-Class".

Again, owing to the small size of the Canadian REIT industry and the benefits of the lengthy experience of the U.S. REIT industry, it is most useful to consider the key success factors developed through the examination of the U.S. to project the likelihood of a Canadian apartment REIT achieving "Best-in-Class" status. To recall, these key success factors include:

1. Offering premium units;
2. Entering into areas with rents below market value;
3. Operating in areas of high projected employment and economic growth;
4. Offering new services;
5. Building at less than replacement value; and
6. Having low tenant turnover/high occupancy.

<u>RESREIT</u>: Residential Equities REIT (RESREIT) began trading publicly in February of 1998 with an IPO totaling $196 million and offering investors the option of purchasing units using installment receipts. This REIT's strategy has been to acquire properties in large urban centres with high employment and population growth (78% of its properties are within the Greater Toronto Area). The objective is to purchase properties at below replacement cost and currently renting at below market prices. Renovations are carried out in order to allow the REIT to raise rents and increase returns to investors. This REIT has largely chosen to concentrate on the luxury and upscale multi-unit residential market. The day-to-day management activity is performed by an outside party, LT Greenwin Property Management. The REIT raises additional capital continuously using a dividend reinvestment program for existing unit holders and has recently filed a prospectus for additional equity financing. Net earnings per share have grown by 8.95% over the past fiscal year, while dividend payouts have increased by 13.6%.

CAPREIT: Canadian Apartment Properties REIT has been in existence since 1997's IPO, which raised $76million. Since then, there have been four additional equity-financing offerings of units. This REIT's strategy is to purchase existing properties at below replacement value, to provide adequate renovations necessary to minimize maintenance costs and to increase rents to reflect market value. CAPREIT has chosen to operate in large, growing areas (26% of its properties are in the Greater Toronto Area). It has chosen to offer a more diverse category of residences. This REIT is unique in that it devotes a sizable proportion (25%) of its units to those seeking "affordable" accommodations and 47% to those seeking the "mid-tier" accommodation category. The reason for this choice is the current government trend towards reducing publicly funded and operated social housing support and the corresponding increase in demand for affordable properties as a result of this reduction.

Total returns to investors since this REIT's IPO have been 72%. At present, the REIT is attempting to reduce distributions from 93% of distributable income to 85%. This will allow the REIT access to internally-generated capital for use in renovation and new acquisitions. At present, the REIT has the debt capacity to purchase another $143 million in properties.

Applying U.S. definitions of "Best-in-Class" to the Universe of Canadian REITs

In order to determine the long-range prospects for particular Canadian REITs, it may be useful to apply U.S. determined "Best-in-Class" key success factors to the universe of existing Canadian REITs. Because the Canadian context is so small, it is difficult to make a meaningful identification of what drives "Best-in-Class". Hence, it becomes logical to look at the more diverse and longer-established U.S. context. By doing so, it becomes possible to determine which Canadian REITs best exemplify the traits of REITs that will ultimately become "Best-in-Class". The following table identifies the existing Canadian REITs, groups them according to their property specializations and then applies the 14 criteria developed for "Best-in-Class" U.S. REITs. The ranking system is determined by a simple "1", "2" or "3" with "1" being outstanding performance in a given success factor, "2" implying average performance in a given success factor, and "3" implying below average performance in a given success factor for the specialization-type.

In examining the results, note the impact of size on the total score and total yield for each REIT. In addition, in examining these results, bear in mind that Royal Host has suffered significant instability reflected in the share price; total yields appear higher recently as a result of management's decision to maintain distributions amidst business uncertainty and difficulties in the property segment performance.

TABLE 1

	Diversified			Industrial	Shopping		Nursing Home		Hotels			Apartment	
	CREIT	Summit	Morguard	H&R	Riocan	Cominar	Retirement REIT	CPL REIT	CHIP	Legacy	Royal Host	Res REIT	CAP REIT
Large Market Capitalization	3	3	3	2	2	3	3	3	3	2	3	3	3
Access to economical financing capitalization	2	2	2	3	2	3	2	3	3	1	3	1	1
Geographic Dispersion of Risk	1	1	2	2	2	3	3	1	2	1	2	3	2
Access to High Barrier to Entry Markets	2	2	2	2	2	3	1	1	2	1	3	1	1
Low Debt Levels	2	3	3	3	2	3	3	3	1	1	2	3**	3**
High-Quality Assets	2	2	1	1	3	2	2	2	2	1	3	2	3
Ability to use Retained Cash-flow for Growth	2	2	2	2	2	3	2	2	2	2	3	2	2
Greater Degree of Risk Tolerance	3	3	3	2	1	3	1	1	2	1	2	3	3
Premium Real Estate Offerings	2	2	1	2	3	2	2	2	2	1	3	2	3
Ability to enter markets at below market rent	3	3	3	2	2	2	2	2	2	2	3	3	3
Operations in areas of high employment or need	2	2	2	1	2	2	1	1	2	1	3	1	1
Ability to offer New Services	2	2	2	1	3	3	1	1	2	1	2	1	1
Ability to Build at less than replacement Cost	3	3	3	1	2	2	1	1	3	3	3	3	3
Low vacancy/tenant turnover	2	2	3	1	1	1	1	1	2	1	3	1	1
Total*	31	32	30	25	29	36	25	24	30	19	38	27	29
Average Annual Yield 1998-2001	9.9%	4.7%	5.5%	13.8%	4.9%	11.6%	10%	(31.2)%	(2.2)%	9.7%	(10.9)%	14.2%	15.8%
Current Yield March, 2002	9.2%	10.1%	11%	8.4%	8.9%	9.1%	8.6%	10.7%	13.2%	9.2%	14%	6.8%	7.4%

* These rankings were based largely on subjective analyses, and so other analysts could come to different rankings.
** Based on author's opinion

A Discussion of the differences between the "Best-in-Class" Canadian Apartment REIT and the "Best-in-Class" Canadian Non-Apartment REIT

There are a number of key differences between the best non-apartment REITs and the best apartment REITs, indicating that investors in each of these REIT specialization categories have fundamentally different objectives. Apartment REITs are so different from non-apartment REITs that they are not offering the same risk return profile, that it is useful to examine both:

1. Investor Preferences and Risk and Return Profiles; and
2. Long Term Demographic Changes in Demand for Apartments.

This examination will underscore the differences between these two sets of investors, and how investors' allocation decisions are reached in a different manner by these two groups of investors.

1. Risk and Return Profiles

As previously stated, renting apartments provides stable cash in-flows that are largely determined by surrounding market conditions. Absent any demographic changes, there is, and will continue to be, a fairly steady demand for apartments that does not appear to be impacted by the business cycle. For the most part, the value of these properties will not increase drastically, or at least not beyond the price increases seen in other residential real estate properties. Although there is <u>some</u> flexibility in the pricing of apartment rents, there is a limit to the improvements that can be made that could justify pricing above that currently being seen in the surrounding market. That said, given recent rent deregulation that has occurred in a number of provinces (most notably Ontario), a number of apartment REITs have opted to seek out properties that are currently renting at below market rates, to make a few capital improvements, and to increase rents significantly.

Although rents have been increasing steadily over the past 5 years, overall apartment rents are set at a market-determined level that does not, absent overall demand shifts, create opportunities for owners to increase cash flows significantly above increases in the general market level. The short duration and constant expiration of leases (usually after one year) also act to reduce the risk of variable real cash flows to the investor because the constant rollover eliminates the risk of inflationary pressures making the contractually agreed upon rents fall below market value. As well, the cost of acquiring a new residential tenant is significantly lower than for other rental types (e.g. office buildings).

Therefore, over the short term, apartment rents are fixed at the market level and the investor in an apartment REIT receives what amounts to a fairly risk-free tax-shielded annuity income. For this reason, the returns achieved by these investors are similar to other securities that offer a similar low-risk annuity stream (for example Bonds, GIC's and CMHC Guaranteed Mortgage Backed Securities). Many of these alternative investments could also be tax-deferred for individual investors through the use of an RRSP, or through legislative exemptions for institutional investors. Coupled with the perception of unlimited liability and a public lack of understanding of the vehicles -- analysts, including Harry Ranala of Raymond James and Rossa O'Reilly of CIBC World Markets -- agree that it is little wonder that apartment REITs have failed to generate the demand for investment securities that has been experienced by non-apartment REITs and Non-REIT residential real estate operating companies.

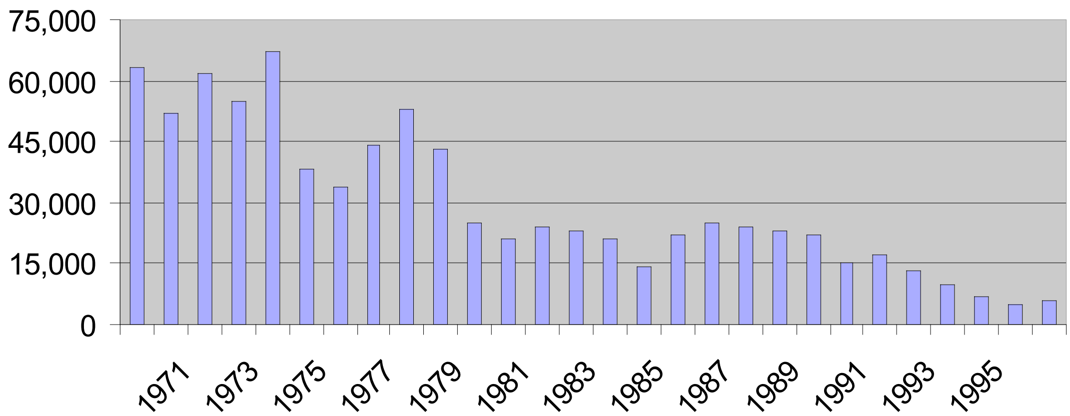
2. Long-Term Demographic Changes in Demand for Apartments

Although, over the short-term, cash flows from a given class of apartments appear to be fixed, it is important to remember that any factor that shifts the overall demand curve for apartments upward may substantially alter the returns that can be achieved by the investor in apartment REITs. David Foot, in his work "Boom, Bust, Echo" has made the point that current demographic changes will result in an older Canadian population that is seeking the lifestyle provided by apartment dwelling. This may significantly increase the demand for apartment buildings, and given the limited supply available in the Canadian market, rents should increase correspondingly. Eventually, it will become impossible to meet the demand for apartment units with the available supply and the higher rents will justify new construction. How this will impact the apartment REIT industry is uncertain, especially given the current restriction in the tax code that limits development activity undertaken by REITs to "improvement" of existing properties.

In addition, the demographically-influenced demand for dependable income-producing securities due to the aging of the baby-boomer generation, amidst a climate of Canadian government retirement of debt-securities, will make the REIT more attractive to investors.[40] Those segments of REITs offering the most dependable income source for this new group of retirees will likely be the most sought after. The apartment REIT meets this criterion quite well and should experience growth as a result. However, as previously mentioned, growth will not be uniform across socio-economically determined apartment segment offerings. In addition, until returns improve, there will be little or no construction in the multi-unit residential sector. And once construction begins, it will likely be in the most lucrative market segments. Recent levels of apartment completions in Canada verify this trend away from new construction.

[40] CIBC World Markets, Canada. Interview with Rossa O'Reilly June 2001.

Exhibit 1 - Private Rental Apartment Completions - Major Urban Centres*, Canada, 1970 - 1997



*** In 26 major urban centres**

Source: Toward a "National Housing Strategy" A Working Paper prepared for the FCM Big City Mayors Caucus, April 2000.

Risk and Return Profile of Non-Apartment REITs:

In comparison, the investor in a non-apartment REIT faces substantially more business and economic risk than that faced by an apartment REIT. The higher baseline yields achieved by these securities are a reflection of this fact.

The tenants of Office REITs and Retail REITs are generally large businesses that are, themselves, subject to business risks that can result in less stable cash flows to the REIT. Because of the size of individual tenants, loss and replacement of a tenant can be difficult and can result in temporary absences of cash flow. Renovations to meet the needs of new tenants can be far more costly than the renovations required for new apartment tenants. Office leases are generally for a longer term, with agreed upon rates of increase, so there is less flexibility for these REITs to adapt to inflationary pressures. This is a significant issue for office and retail REITs that hold properties that can increase significantly in value based on the business cycle and the demand for retail and office rentals. If contracts limit the REIT's ability to increase rents to reflect the new value of the property, yields to investors will not be competitive with the yields of other REITs or Real Estate companies that are able to charge rates corresponding to the value of their properties.

Because there is a substantially greater level of risk for investors in non-apartment REITs, the apartment REIT and non-apartment REIT are not competing for the same investors' dollars. Rather, the investor in the non-apartment REIT is comparing the REIT option with other equity investments in corporations, most likely other real estate corporations. And because of the tax advantages of a REIT, relative to other investments, the non-apartment REIT has historically been very successful at attracting capital. Evidence of this is the fact that REITs are able to trade at only an 8% discount to their net asset value, whereas Real Estate Corporations trade at a 31% discount.[41] Whether or not this trend will continue remains to be seen.

Risk and Return of Apartment and Non-Apartment REITs: Conclusion

The investor in the non-apartment REIT is often considering alternate equity investments, while the investor in the apartment REIT is often considering alternate fixed-income investments, and must be remembered when efforts are made to stimulate the growth of apartment REITs in Canada.

COMPARISON OF U.S. AND CANADIAN REITS

The difference between the success of Canadian and U.S. REITs is the result of two basic categories of factors. First, there are the factors that arise from fundamental differences between the two economies. Second, there are the factors that are specific to the differences in the creation, administration, and regulation of the REIT industries in the two countries. This distinction is important because each type of factor requires a different response. Those arising from specific REIT industry factors can be addressed by simply emulating the system in the United States. However, those factors that arise from fundamental differences between the two economies will require solutions that overcome the disadvantages posed by the particular conditions in Canada, rather than a simple re-creation of the U.S. system. For that reason, the following examination of the factors limiting Canadian REIT growth are separated into the categories of "fundamental factors" and "REIT specific factors."

Limitations of Canadian REIT Growth:

Clearly, U.S. REITs have permeated the securities environment in the United States to a greater extent than Canadian REITs have permeated the Canadian securities environment. There are a number of reasons for this difference and these reasons must be considered prior to making policy suggestions having the objective of stimulating Canadian REITs to approximate the success of U.S. REITs. Unless those differences are addressed and acknowledged, efforts made to increase the popularity of REITs in Canada may be thwarted. The most critical reasons underlying this discrepancy include:

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[41] CIBC-World Markets U.S. Annual Report on REIT Trends, January 2000 and National Post, May 8, 2001

Fundamental Factors

Experience and History of U.S. REITs

The United States has had REITs as part of their security landscape for almost forty years. By comparison, Canadian REITs have really only existed for one decade. Hence, American investors are more familiar with REITs and have a better understanding of the tax implications of holding them. By comparison, Canadian investors are only beginning to become aware of the workings and implications of REIT ownership. These are complicated issues. For example, because REITs are so new in Canada, many investors are not aware of the tax implications of selling their units. Upon sale, the depreciation on the properties will have reduced the cost base of the units, leaving the potential for significant capital gains taxation. Investors who purchased REIT units believing them to be strictly income vehicles are liable for a nasty surprise upon disposition of their units. However, as the tax implications become evident over time, the Canadian market will become more familiar and comfortable with the REIT investment.

In addition, because American REITs are much more entrenched in the U.S. securities environment, public scrutiny has developed to the point where REIT management has had to display great discipline and adopt best management practices. Only a few of the major investment banks in Canada follow Canadian REITs, while almost every major investment bank in the United States has allocated analysts to track and question the REIT industry players. Because of this intense scrutiny, visibility and accountability are much higher in the United States than in Canada. This has produced investor confidence in the management teams in the American REITs, while the management teams in Canadian REITs are less well known and less publicly visible.

Geography/Demographics

Although the United States has a smaller landmass, the population is ten times the size of the Canadian population. The population of Canada is concentrated in specific regions (and specific cities within a region), however, the overall population density is much lower in Canada than in the U.S. The result has been a significantly smaller number of large cities that require multi-family residences. The U.S., in contrast, has a large number of large cities that demand high-density housing. This has allowed U.S. REITs to diversify their risk across geographical locations, resulting in overall increases in REIT returns. This ability to access multiple geographic locations has resulted in U.S. REITs becoming more specialized than their Canadian counterparts. Simply put, there may not be enough properties attractive to Canadian REITs in a specialized asset class to justify a higher degree of specialization. U.S. apartment REITs have been able to find sufficient demand to specialize in very specific niche segments (for example, garden-style premium properties in the suburbs of mid-large cities).

Furthermore, Canadian residential rental real estate still bears the legacy of rent controls. Many rents in the larger cities are significantly below market values, and this creates the potential for REITs to refurbish units and raise rents. However, there is a generalized distrust of Canadian provincial government initiatives that might reintroduce rent control and simultaneously decrease the value of investments.

The combination of Canada possessing fewer cities and the tendency for Canadians to own their own residences, coupled with the legacy of rent controls has resulted in the Canadian REIT industry, in general, being far less developed than its American counterpart.

Financial Market Size

American REITs have access to a significantly larger financial market, and this produces a number of advantages that Canadian REITs have not been able to enjoy. First, because there is a much larger pool of investors, the individual investor in U.S. REITs, for the most part, will be able to eliminate liquidity concerns as a result of the size of that individual investment. This consideration is one of the reasons why U.S. REITs have been more attractive to institutional investors than their Canadian counterparts. Second, scrutiny created by the size of the market has resulted in greater management discipline. This discipline has translated into higher returns, and these higher returns further enhance interest and growth in the U.S. industry. Third, the vast quantity of equity and debt capital has allowed U.S. REITs to achieve substantial size when compared to their Canadian counterparts. These larger entities are able to leverage their size to reduce operating and financing costs, and these cost reductions translate into higher returns for investors. Fourth, because of the size of the U.S. market, there is greater access to economical debt financing. The size of individual REITs has created the corporate strength necessary to access the unsecured borrowing markets. The vast quantities of leverage required by an individual REIT makes it economical for that REIT to issue debt securities rather than seek out mortgage financing.

By contrast, some start-up Canadian REITs are too small to warrant the outlays necessary for bond rating services, and the subsequent costs of investment banking services. The costs of borrowing for the smaller players would be several hundred basis points above the rates at which the larger REITs have been able to borrow. Because of the relatively small size of the debt markets and the small size of each borrowing entity, Canadian REITs have much larger proportions of secured (mostly mortgage) financing. Because this reduces the REIT's flexibility in asset recycling and other operating activities as a result of restrictions imposed by the mortgagers, Canadian REITs have not been as nimble in taking advantage of market opportunities. This has resulted in lowered returns and, ultimately, a less developed Canadian REIT market.

REIT-Specific Factors

Legislation

Although the American REIT legislation appears to be more restrictive than that which exists for Canadian REITs, there are a number of benefits resulting from this specificity. First, investors are certain of the percentage payment of income that they will be receiving in the United States. Canadian investors are uncertain because REITs have complete discretion over the payout ratio. This certainty is built into the price of the American stock, while the Canadian volatility in payouts has resulted in a discount for Canadian REIT units. This is evidenced by the fact that Canadian REITs trade, on average, at an eight percent discount to their Net Asset Value, while U.S. REITs trade, on average, at a one percent discount, with certain sectors trading at a premium.

Because most U.S. REITs are corporations, they are subject to a greater degree of public scrutiny than their Canadian trust counterparts. Although trusts in Canada do have reporting requirements and operating rules that must be adhered to, there is a concern that standardization of reported results does not exist to the same degree as it does in the United States. Because this situation makes it difficult for Canadian investors to gauge the superiority/inferiority of a particular REIT security, investors may have had a tendency to shy away from REIT investments.

The ability of American REITs to organize as corporations has a number of additional benefits that have worked together to contribute to the disparity of growth in REITs between the two countries.

First, because corporations have limited liability protection for investors, unit holders in the United States have not had the same concerns about liability beyond their contributed capital as Canadian investors have displayed. Although this concern has been largely dismissed by legal experts and reduced by using various insurance and due-diligence procedures adopted by Canadian REITs, this concern has without a doubt, decreased the attractiveness of REIT units to investors. In particular, institutional investors have had a tendency to shy away from these investments on this basis. This, along with other reasons behind why institutional investors have avoided REITs, has resulted in a substantial investor base that has not been accessible to REITs.

Second, because American REITs are corporations, they have the ability to purchase properties in exchange for tax-deferred shares of the REIT, in the form of exchangeable Operating Partnership units. Canadian REITs do not have this ability, putting them at a disadvantage to Canadian Real Estate Operating Companies. Property holders in the United States can sell their properties to REITs without facing sizable capital gains tax bills if they accept units as a medium of payment. The properties are exchanges for units in an "operating partnership" that can ultimately (usually after a year's time) be exchanged for REIT shares. This structure is usually referred to as an "UPREIT" or a "DOWNREIT". The only difference between the UPREITs and the DOWNREITs is the time at which the operating partnership is formed. UPREITs are formed prior to the acquisition of any properties, while DOWNREITs are formed subsequent to property acquisitions. The result of the ability to purchase properties using Operating Partnership units is that property tends to change hands far more often in the United States. In contrast, in Canada, small property owners will have a tendency to hang onto their properties instead of selling and paying the often prohibitive capital gains tax. The cash flows resulting from renting or leasing the properties may be more attractive than the benefits of liquidating real estate investments. However, this results in properties not being adequately maintained and improved to the degree they would have been had they fallen into the hands of professional managers. In addition, because properties available to Canadian REITs are more expensive owing to the proportionately lower number of properties available for sale, returns on REIT stocks in Canada will be lower than in the United States. This has further contributed to the less desirable perception of Canadian REITs when compared to their U.S. counterparts.

Additional legislative limitations have contributed to the Canadian REIT market being less developed than the U.S. REIT market. The general American equity markets are far more receptive to foreign investment than their Canadian counterparts. Canadian REITs are unable to deduct distributions from the REIT's tax bill if more than 20% of outstanding units are held by foreign investors. In contrast, American REITs are open to foreign investors and have seen significant capital contributed in both the form of equity investments and joint ventures. Even Canadian pension funds have chosen to invest in U.S. REITs using joint ventures, over like investments in Canadian properties. It is speculated that if these restrictions were eliminated, we would see a larger overall market-capitalization for REIT securities in Canada. As well, U.S. REITs have been permitted to make investments in properties in other nations. For a Canadian REIT, ninety percent of real estate must be within the Canadian borders. Furthermore, foreign REITs have not been able to access preferential tax treatment if entering into Canadian ventures with Canadian joint venture partners.

Industry Structure

Another reason for the REIT industry in the United States being more developed than the REIT industry in Canada has to do with the industry itself. In particular, there are two main features of the industry in the United States that have resulted in its growth. First, the structural organization of the industry has advanced the acceptance and enhanced the demand for REIT stocks. Second, the activities that the U.S. industry has chosen to undertake have resulted in returns above those seen in Canada, which further increases the demand for the securities.

Structural Organization

The U.S. REIT industry, although extremely competitive, has organized itself through a central agency, the National Association for Real Estate Investment Trusts (NAREIT). This agency monitors and reports on REIT securities and trends in the industry, as well as lobbies for legislative changes and policies that are in keeping with the industry's needs in order to grow. This extremely powerful organization provides three major benefits. First, it provides the transparency and accountability shareholders require for investment confidence. REIT education is provided through its web site and investor and analyst forums. Because investors are able to access information readily on the REIT industry, and on particular REIT securities, there is greater familiarity and acceptance of REITs than has been seen in Canada. Second, NAREIT lobbies on behalf of the REIT industry, as a whole, for REIT-friendly legislative changes. The organization provides a unified voice for REITs. In Canada, individual REITs would have to access individual lawmakers directly. Particular interests take precedence over industry-wide needs. One example of the power of this U.S. agency is the newly implemented *REIT Modernization Act*, which took effect in 2001. U.S. REITs demanded lower payout ratios and the result was legislation reducing payout requirements from 95% to 90% of taxable income. U.S. REITs demanded the right to offer non-real estate services to tenants, and were granted the right to do so using taxable REIT subsidiaries (TRS).

One of the reasons why lawmakers have been so receptive to the REIT industry in the United States relative to the receptiveness of Canadian lawmakers is the size and power of the REIT industry itself. In the United States, it has been estimated that 15% of all commercial realty (and 30% of all new development) is under the control of REITs.[42] Hence it is reasonable for legislators to be responsive to the needs of the REITs if properties are to be developed optimally. This is not the case in Canada, where a much smaller proportion of real estate is controlled by REITs, and some portion that is controlled by the REITs is of a lower quality. For example, only a few Canadian REIT operating in the office sector own any A-rated properties. Many of A-rated office properties are owned by large real estate operating companies, most notably by those controlled by large institutional investors.[43]

Furthermore, NAREIT provides a degree of REIT organization that can be used to form cost-cutting buying groups, joint ventures, and other forms of REIT alliances. While individual REITs may be unwilling to bear the entire risk and costs of large developments and service-trials, the availability of willing partners results in such undertakings being completed, rather than abandoned in the inception stage. Because REITs complete these developments and reap attractive returns as a result, returns to investors are higher and U.S. REITs become more attractive, resulting in growth in the overall industry.

Activities Undertaken

Because U.S. REITs are competing with other equity offerings, their shareholders demand that management maximize returns. This entails taking on substantially higher levels of risk than has been seen in the Canadian industry. Highly experienced U.S. REIT managers have discovered that maximum returns are only available if REITs

[42] CIBC World Markets, July 2001.
[43] Harry Rannala, Raymond James, July 2001.

undertake higher levels of risk, typically in the form of development activities, while simultaneously becoming highly integrated and specialized corporations.

Canadian REITs, in contrast, appeal to those seeking an alternative to bonds. These unit holders demand that their REIT managers undertake very low levels of risk. This has resulted in a reluctance to undertake any direct development risk and a tendency to off-load risk to third-party developers. Because these third party developers naturally demand a portion of the development returns in exchange for their services, total return to REIT unit holders in Canada is substantially less than has been seen in the United States. The result is a lower demand for REIT securities and a significantly smaller industry, even adjusting for market size.

Limitations of Apartment REIT Growth in Canada

Although apartment REITs, in general, have a number of advantages over other specialized REITs and over diversified REITs, the Canadian environment poses a number of challenges that can provide an explanation for their limited use. Although, there are two apartment REITs operating within Canada (i.e. CAPREIT and RESREIT), and diversified REITs have also increased the number of apartment buildings in their portfolios, this number seems small relative to the number of real estate corporations. This is especially true when the tax benefits of REIT status are considered.

One important issue to note is that any growth in the apartment REIT industry will likely not be spread evenly across the socio-economically segmented apartment markets. For example, discussions with a number of Canadian REIT analysts have revealed that some investors will view building or acquiring low-income housing to be attractive. There is a perception on the part of investors that there is a heightened business risk in dealing in this segment (concerns cited include greater difficulty in collecting rents, more tenant property damage, political difficulty in raising rents, etc.). It is felt by the investment community that these concerns will likely be substantial enough to dissuade investors from making sizable investments that they believe will not earn returns substantial enough to warrant selecting this segment. This reluctance is further increased when it is considered that other, more seemingly attractive segments are available.[44] It is important to note that these perceptions are not those of the authors, but rather have been relayed to the authors by market analysts and REIT managements. Hence these perceptions must be acknowledged and addressed in order to encourage investment in this segment

[44] Anonymous Interviews.

Fundamental Factors

Geography:

The geographic reality of Canada has limited the opportunities for investment in apartment properties.[45] Although vacancy rates in Canada's largest city, Toronto, are extremely low (.5%), causing rental rates to increase, there are a limited number of other communities in Canada that are capable of supporting large numbers of apartment complexes.[46] To be profitable in the rental housing business, it is necessary to have a large, concentrated population. Unfortunately, Canada has few cities that meet this criterion. As well, the abundance of land in Canada makes real estate available to individuals at relatively low prices (relative, say to New York City), encouraging home ownership at the expense of apartment renting.

Size of the Investment Community

As has been the experience of all REIT types, the size of the investment community has also served as an inhibitor of Apartment REIT growth in Canada. The size of the financial markets appears to be a greater inhibitor of apartment REIT growth in Canada than for other types of REITs.

It is useful at this point to recap the issues related to the difference in size of financial markets between the two nations. In the United States, over 70% of investors in REITs are institutional investors.[47] There is a trade-off between the benefits of direct ownership and the benefits of the liquidity created through ownership of REIT units. Institutional investors in the U.S. favour the liquidity of REIT units over traditional property ownership. However, this liquidity is only possible because no one institutional investor is large enough, relative to the size of the overall market, to cause a decrease in price as a result of the sale of its units. This is not the case in the Canadian context. The number of institutional investors is relatively small, with a few large groups overwhelming the market. Ontario Teachers' Pension Plan, Caisse de Depot et Placement, and a few other large players make up the lion's share of the market. Should one of these players take a large position in a REIT, and then wish to sell its units, the flood on the market would substantially reduce the price received for those units. For that reason, many of the large institutional investors have tended to shy away from REITs. In addition, the fact that these institutional investors are not usually subject to immediate taxation makes holding real estate directly just as attractive as owning REIT units. Holding property directly provides the investor with the capital cost allowance flow through without having to pay third party management fees.

Because apartments are extremely capital-intensive operations, and the reality of the limited market size and the limited population size and concentration in the Canadian

[45] Supra, Note 2.
[46] Globe and Mail, January 31st, 2001
[47] Supra, Note 1.

context has resulted in lower growth in the use of theoretically attractive apartment REITs, when compared to the U.S. experience.

REIT Specific Factors

Government Attitude Towards Rent Programs:

One of the main reasons why U.S. REITs, in general, and U.S. apartment REITs, in particular, have had superior growth relative to their Canadian counterparts relates to the rent-determining systems in place in the respective markets.

Returns on Canadian rental properties have suffered from a long legacy of rent controls that have kept rents well below market value. Although these rent controls related directly to residential properties, these policies had a spillover stifling effect on other real estate classes. Understandably, investors who might have purchased apartment buildings have been reluctant to do so as a result of being forced to accept lower than market rents. By contrast, the U.S. has favoured a system of allowing the market to set rent levels. For those unable to access adequate housing at market rates, government has provided subsidies that, when added to the tenant's contribution, have brought the total payment to the property owner up to market level. This is similar to units receiving government rent supplements in Canada.

U.S. REITs, in particular, have been provided with government "rent-top-up"cash disbursements in exchange for making a set portion of their units available to low-income individuals. For example, tenants deemed to require assistance pay a set proportion of their income to the owner of their apartments. The state or federal government also writes cheques to those owners, making the total received equal to market rent. For the most part, the units being offered to subsidized tenants are indistinguishable from other units owned by the REITs. This system benefits both the REIT, which is assured of a return at market level, and the individuals living within the complex. Rather than isolating groups based on socioeconomic status, communities become more integrated and have a more equal sharing of community resources than would likely have been the case if strictly subsidized buildings had been constructed.

Although rent controls are being eliminated in many Canadian provinces, there has been a generalized distrust of government initiatives that may ultimately reintroduce rent controls. Hence, Canadian REITs, despite being able to increase rents are somewhat skeptical of future provincial governments continuing with the trend towards allowing the market to set rental rates.

Alternative Investments Limiting Appeal of REITS

Another reason why REITs, in general, and apartment REITs specifically, have shown slow growth is the existence of alternate real estate investments. These alternatives are welcome, as they satisfy the demand for income securities that has resulted from the reduction in the number of government-produced debt instruments as governments attempt to reduce debt. However, these alternatives pose a certain degree of competition for investor dollars in REITs. Today, investors wanting to add real estate to their portfolios can choose among traditional real estate, equity investments in real estate management corporations, and Mortgage Backed Securities, or Canada Mortgage Bonds. Each of these options introduces different risks and benefits from those inherent with REITs.

Ordinary investment in residential real estate has the disadvantage of limiting diversification opportunities for most investors. It is not possible for the investor to diversify as broadly across building classes and regions as is possible with the use of a REIT, given a specific level of capital invested. This increases the level of risk borne by the investor. The risk is further magnified by the relative lack of real estate management expertise when compared to professionally managed REITs. In addition, it is much more difficult to liquidate real estate than it is to liquidate REIT units. This liquidity is one of the major benefits of owning REITs over owning real estate directly. REITs find it easier to raise capital (and at better rates) than individual investors, decreasing the cost of leverage to the investor. As well, although theoretically REIT holders are subject to liability for their properties, owing to the fact that individual holders exercise little or no control over trustees, liability is unlikely to be found in court.[48] And, lastly, there may be tax disincentives for direct real estate investment. Just one example of these tax disincentives is that the property taxation is not subject to beneficial REIT allotments. For these reasons, traditional real estate does not have the same advantages possible for investors in REITs.

It has also been pointed out that most individual investors are already highly invested in residential real estate as a result of their personal ownership of their home residences. For most investors, since this is the largest component of their investment portfolios, additional investment in residential real estate is undesirable. Once having reaped the benefits of capital appreciation in their home residence, additional holdings are undesirable, given that other investments are available.[49]

Should investors wish to place additional residential real estate holdings in their portfolios, investing in real estate management firms is another option available. While this option provides management skill not available to investors managing their own properties, there are a number of issues that make this choice less desirable than making an investment in a REIT. First, these firms are subject to the two tier taxation issue that the REIT was created to circumvent (i.e. taxation at both the corporate level and at the investor level).[50] Taxation at the corporate level reduces the cash available to be distributed to the investor. Although there are tax incentives for individuals claiming

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[48] Garrigan R., and Parsons, J., Real Estate Investment Trusts: Structure, Analysis, and Strategy. New York: McGraw-Hill. 1997

[49] Wayne Kozon, VP Asset Allocation, Ontario Teachers' Pension Plan.

[50] Mullaney, J., REITS: Building Profits with Real Estate Investment Trusts. New York: John Wiley & Sons, Inc., 1998. p.4.

dividends, these incentives do not adequately compensate for the cost of taxation at the corporate level borne by public corporations. In addition, the distribution of cash to unit holders is much more discretionary for real estate corporations than for REITs. In order to obtain preferential tax status for the majority of the unit holder's investment, Canadian REITs usually find that they are required to pay out between 85 and 95% of operating income to unit holders.[51] Real estate management corporations may pay out all, or none of the operating income. For investors interested in steady income, this is a distinct disadvantage of owning stock in real estate operating companies over REITs.

Second, issues of agency may arise when the interests of the management team are not aligned with those of the investors. REIT trustees have a fiduciary duty to act in the best interests of the unit holders, whereas the management of a real estate firm may have an incentive to maximize their own compensation and stature by increasing the size of the property base, even if this is not in the long-term best interests of equity investors. Lastly, real estate management companies do not face limits on the proportion of leverage used, nor are they limited in their ability to issue equity for access to capital or acquisitions. The increased debt service costs when combined with the possibility of dilution of the earnings base, is a strong disincentive to choosing real estate management equity investments over REITs.

The remaining real estate investment possibilities that pose serious competition to residential REITs are mortgage backed securities. These securities are essentially a package of residential, retail or commercial mortgages put together and sold to investors in packages (or tranches) based on maturities, interest rates, and credit quality.[52] The investor receives his or her payments from the mortgage cash flows. These investments are becoming popular in Canada, and have shown an annual rate of increase of 56% since 1997. [53] Because the investor owns the mortgage, he or she pays tax at the individual level. Yields vary based upon the risk undertaken by the investor. Certain mortgage pools are pre-payable, creating a risk of early payment and the end of the payment stream to the investor.[54] The payment yields on these securities are generally higher than the non-pre-payable types. Canada Mortgage Bonds, on the other hand, are bond-like with no amortization of the principal whatsoever. However, the yields on these securities do not come close to those historically paid by traditional residential REITs.[55]

The question that then becomes relevant, is why these asset-backed securities have experienced such phenomenal growth over the past few years, when compared to the healthy, but less robust growth in the apartment REIT market. One of the major reasons is that Mortgage Backed Securities have almost all the benefits of a REIT, but the investor can also claim fair value for his or her investment. The right to claim fair value means that the issuer is required to redeem units on the demand of investors at a value

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[51] Supra, Note 1.
[52] Thode, S.F., "CMO's, Duration Risk and a New Mortgage", The Journal of Real Estate Research. Sacremento: January-April, 2000.
[53] Fingerhut, M., "Securitization Takes Off in Canada", International Financial Law Review. London: November 2000.
[54] Supra, Note 37.
[55] Globe and Mail, January 31st, 2000., CIBC World Markets Annual REIT report, 2000.

equal to the investor's proportionate share of the fair market value of the properties or mortgages owned by the issuer. Any REIT is an *undivided* interest in a property grouping, and is not exchangeable for fair value.[56] As well, the residential REIT is exposed to management costs and upkeep on properties that the mortgage backed security does not face. Once mortgages are issued, aside from pre-payment and default concerns, economic variables have no effect on the payment stream. There are fewer risks involved in investing in mortgage backed securities than in a similar investment in an apartment REIT. That being said, the liquidity of mortgage backed securities decreases as the tranches become more complicated.[57] This is not the case for REITs, as they are not as individualized as are the newest models of mortgage backed securities. However, this ability to tailor securities to individual needs is a strong incentive for investors to favour mortgage backed securities over apartment REITs.

As indicated in the above analyses, there are a number of reasons why Canadian REITs, in general, and apartment REITs in particular, have not developed to the extent seen in the United States. Some of these reasons relate to the securities themselves, while others relate to realities peculiar to the Canadian financial markets, legislative regulations, historical background, and geography/demographics of the nations themselves. However, one of the most critical reasons why Canadian REITs have not developed to the extent seen with U.S. REITs relates to their newness in the Canadian context. Development of Canadian REITs is at least 20 years behind what has been seen in the United States. The difficulty for those advocating the development of Canadian REITs will be in determining how to "Fast-Forward" the natural progression of the REIT industry in a way that takes but a fraction of the time it would have taken in the normal development process.

[56] Supra, Note 2.

[57] "CMBS Players Voice Cautious Optimism for 2001", Commercial Mortgage Alert. Newark: January 8, 2001.

CONCLUSIONS AND SUGGESTIONS

This section focuses on suggestions for expansion of Canadian owned apartment REITs. In determining whether to adopt any or all of these suggestions, it will be important for CMHC and the government of Canada to be aware of the following realities:

1. Suggestions designed to expand Canadian owned apartment REITs may to some degree simply shift ownership of apartments from real estate corporations, institutional investors, and individual investors to REITs. This may result in an expansion of apartment REITs without there being construction of new apartments.

2. The business plans of REITs include the ability to raise rents. For some REITs, there is a focus on renovation of purchased units, but such renovation is based upon an analysis of potential rent increases that will yield an acceptably high rate of return on renovation costs. This focus on the ability to raise rents is a crucial element of a REIT business plan since it can result in increases in the value of REIT units as a result of increases in the capitalized value of future rents. Although REITs are not unique in their desire to raise rents on properties they own (other developers have similar objectives), apartment REITs have been very vocal and clear about their intention to do so *(for reference see www.resreit.com and www.capreit.com)*.

3. Canadian owned REITs can and do invest in US properties, although this is limited to 20% of capital; while U.S. owned REITs can and do invest in Canadian properties. Consequently, suggestions to expand Canadian owned REITs are not directly targeted at the mission of increasing the construction of new apartments in Canada. There is a potential "leakage" across the Canada/ U.S. border.

4. For many years, Canadian institutional investors have owned apartment buildings directly, and have created managerial structures geared to this ownership. For such institutional investors to sell their apartments to REITs could involve restructuring management within the institutional investor. Consequently, there will be a time delay, and perhaps even a barrier to the investment in REITs by institutional investors.

5. A central feature underlying the attractiveness of REITs is the flow through to REIT unit holders of CCA related to the properties within REITs. However, this flow through of CCA is of no extra benefit to an institutional investor that has been involved in the practice of direct ownership of properties, since direct ownership already provides for full enjoyment of CCA.

6. A major portion of Canada's institutional investor base is made up of pension funds. Since pension funds already defer tax, the CCA flow through benefits of REITs are of no consequence to such investors.

7. In the past two decades, a major portion of Canadian savings has accumulated in the form of RRSPs. Since RRSPs defer taxes, the CCA flow through benefits of REITs are of no consequence to such investors.

As a result of the above realities, expansion of Canadian apartment REITs may involve leakages to securities and activities other than the construction of new apartment REITs. Furthermore, while one might seek evidence of REITs success in statistics indicating a growth in REIT unit values, it is important to note that such growth may simply reflect increases in rents per unit.

Keeping in mind the concerns identified in the above comments, if it is determined that increasing investment in apartment REITs is desirable, there are a number of changes that have the potential to accomplish that aim. Each of these changes differs in terms of ease of implementation, cost, and effectiveness. In this section, seventeen possible changes and the rationale behind those changes will be discussed.

The examination of the U.S. REIT industry has suggested a number of changes that may have the potential to allow the Canadian apartment REIT industry to achieve higher levels of growth. It must be remembered however, that although each of these changes may have some impact on the industry, the structural differences between the two nations may result in the changes not being as effective as they would have been had they been implemented in the U.S. context.

Objectives of Suggestions

These suggestions each attempt to eliminate one of the difficulties currently existing with Canadian REITs. To recap, those difficulties include:

- Size of investor pool being smaller due to the size of Canadian financial markets;
- Smaller number of geographic locations available to diversify risk;
- Reluctance of Canadian investors to view REITs as equity investments;
- Reluctance of institutional investors to invest in REITs;
- REIT disadvantage relative to corporations (e.g. inability to purchase properties using shares, lack of limited liability protection, etc.).

Listing of Suggestions

Given the aforementioned objectives, the changes that have some potential to meet at least one of the objectives include:

1. Permitting REITs to adopt a corporate structure
2. Granting REITs limited liability protection
3. Permitting REITs to purchase properties in exchange for tax-deferred units
4. Changing the tax provisions;
5. Clarifying that the term "Improvement" extends to development
6. Permitting REITs greater freedom in charging for additional services
7. Allowing Canadian REITs to have a larger share of foreign investment
8. Permitting joint ventures between U.S. REITs and Canadian REITs
9. Permitting joint ventures between U.S. REITs and Canadian institutional investors
10. Allowing U.S. REITs to operate independently in Canada.
11. Providing an educational campaign for individual investors in regard to REITs;
12. Creating a standard declaration of trust.
13. Encouraging formation of a national body to promote the interests of REITs.
14. Offering venture capital and mezzanine financing for new REITs
15. Providing guarantees for Canadian banks and other financial institutions for loans to REITs at more attractive lending rates
16. Creating a system of revenue guarantees for new construction
17. Creating a system of rental subsidies

Pros and Cons of Changes:

None of these changes will be able to single-handedly stimulate the growth of the Canadian apartment REIT industry. Rather, a skilfully-implemented combination of changes will be required.

<u>Suggestions Requiring Government Intervention</u>

1. Permitting Canadian REITs to adopt a corporate structure:

Arising from the examination of the U.S. industry, this change has the potential to overcome a number of the negatives involved with a REIT investment. First, the use of a corporate structure provides limited liability protection to equity holders. Given that real property has a long tail in terms of liability in tort and statute, REIT unit holders reasonably fear liability that could significantly exceed their initial contributions. Although this is likely not a concern for small investors (legal opinions have dismissed this as a non-possibility, and REITs undertake mechanisms to limit liability such as insurance policies, etc.), one of the reasons why large institutional investors have avoided investing in REITs relates to these liability concerns. As well, although small investors are unlikely to face actual liability, there is a perception held by this group that they may have to bear responsibility for any liability that may result from ownership of REITs.

Second, use of corporate structures would make REITs more competitive with Real Estate Operating Companies. Because Real Estate Operating Companies can purchase properties using tax-deferred stock as a means of payment, while REITs cannot, REITs are at a clear disadvantage in their ability to pay for new properties. This has greatly limited growth. Allowing REITs to become corporations would grant them the same benefits as currently afforded to Real Estate Operating Companies.

Third, if REITs were able to become corporations, there is the potential that Canadian investors would view these securities as being in competition with other equities, rather than bonds. This would change the investor pool to a group that would be more accepting of development risk, which ultimately ought to translate into new apartment developments being built.

Lastly, corporate status may stimulate a greater degree of public and analyst scrutiny that would result in greater discipline. This greater discipline would hopefully translate into use of the best management practices that would create higher returns and more interest in the REIT industry.

Although this change certainly has an overwhelming number of benefits, it is not without a few drawbacks. First, other corporations may balk at REITs, with their tax advantages, being able to access the same benefits as those who do not possess tax advantages. Second, it would be unlikely that the apartment REIT industry would grow at a rate above non-apartment REITs. In fact, it may be that granting corporate status may appeal more to industrial and office REITs. However, an overall growth in the REIT industry ought to have at least some benefit for the apartment REIT industry.

2. Granting REITs limited liability protection

This change originates from the examination of the U.S. REIT industry. As stated in the previous section, liability concerns have stifled both private and institutional investment. Elimination of this concern should have at least some impact on the number of investors willing to access the REIT market. Although there are other benefits of allowing REITs to organize as corporations, if this is not possible for some reason, granting limited liability to REIT investors ought to be seriously considered.

A drawback of this concern is that it may be difficult to determine who ought to bear certain costs such as environmental damage created as a result of the REITs' management of their properties. Simply put, not being able access the personal capital of investors means less capital is available to cover these costs, absent government initiatives and funding. In addition, because this change does not allow REITs to purchase properties using shares in a tax-advantaged manner, this change is inferior to allowing REITs limited liability as a result of being organized as a corporation.

3. Permitting REITs to purchase properties in exchange for tax-deferred units

Originating from the examination of the U.S. REIT industry, this change would allow the REIT to make acquisitions using units, rather than cash. Because the current owners of the properties sought by the REIT will likely face substantial capital gains tax and recapture on the sale of their properties, this change allows the REIT to provide securities that can ultimately be exchanged for units. This approach is used extensively in the United States and has a number of advantages. First, it may allow the REIT to purchase properties in a way that is competitive with what real estate corporations are able to pay for the same property. Because the original owner is able to defer taxation until the time of conversion (usually at least a year following the initial sale), the REIT is able to provide value to the investor in lieu of a lower price. Secondly, the REIT is able to maintain financial flexibility. Because additional debt has not been assumed to finance these acquisitions, the REIT is able to own significantly more property than would have been possible had debt financing been used. There is an issue of dilution for existing REIT unit holder; however, assuming that the value of the units issued corresponds to the value of the addition to net assets, this effect should be largely irrelevant.

4. Changing the tax provisions:

This change arises from the lack of availability of Canadian residential housing for purchase by REITs, due to the tax consequences of a sale for the current owners. Although beyond the scope of this project, changes in the Tax Act have the potential to address some of the disadvantages of Canadian REITs. Failure to mention this change would provide an incomplete array of the changes available to the legislators of Canada.

Under Canada's former "Multiple Unit Residential Building" (MURB) program, the accelerated CCA offered to apartment investors reduced the tax value of their residential units at a faster rate than was usually allowed by ordinary real estate corporations. The reduction in tax value increased the spread between the tax value and resale value, which has had the effect of increasing the recapture produced by the asset upon disposition. The Federal Government's elimination of its individual, fixed ceiling, capital gains tax exemption, combined with a higher than usual recapture on disposition for previously designated MURB properties, has created a situation where many investors are unwilling or unable to shoulder the tax burden that would be triggered by the resale of their property. In extreme cases, the taxes owing can be larger than the net amount of the selling price minus short-term and long-term liabilities. Investors who do not have the financial resources available to cover the shortfall would not be in a position to sell their property. The potential negative cash flows associated with selling an interest in an apartment may result in an unwillingness to dispose of the interest. Consider Exhibit 2.

It is assumed that the rental property was originally acquired 22 years ago at a cost of $650,000 (land $150,000, building $500,000) and could be sold today for $750,000.

Exhibit 2

	Land	**Building**	**Total**
Selling price	$200,000	$550,000	$750,000
Initial cost	$150,000	$500,000	$650,000
Undepreciated capital cost		$175,000	$175,000
Mortgage			$525,000
Marginal tax rate			48%

A standard cash sale of the land and building for $750,000 would result in a $100,000 capital gain (1/2 taxable) and $325,000 of recaptured CCA. At a 48 per cent tax rate, the individual would be required to pay $180,000 in tax. After paying off the $525,000 mortgage and the $180,000 income tax, the individual would be left with only $45,000 and this ignores all transaction costs. Clearly there would be little if any incentive for the individual to sell the property today, providing it was generating a positive cash flow.

Another means to implement a sale is for the individual to transfer the building to a corporation in exchange for shares and jointly elect with the corporation to a subsection 85(1) rollover. Assuming the corporation and the individual are dealing at arms length, the two parties will only complete the transaction at a value consistent with the fair value of the items being exchanged. As a result, the corporation will issue shares with a market value of approximately $750,000, the fair value of the building; the corporation will acquire land with a fair value of $200,000 and a building with a market value of $550,000.

For income tax purposes, subsection 85(1) of the Income Tax Act permits taxpayers to effectively transfer the $325,000 tax basis they currently have in the property into the shares they receive. Effectively, the tax law assumes that a sale of the building takes place at $175,000 and the land is sold for $150,000. Therefore, the shares will have a tax value of $325,000 and given their $750,000 market value, there is a built-in capital gain.

The corporation is considered to have acquired the building at a cost of $175,000, and the land for $150,000. Future CCA on the building will be based on the $175,000 tax value rather than the $550,000 market value of the building. The present value of the $375,000 of forfeited CCA tax shield is only $45,000 assuming a 10 per cent cost of capital and a 44 per cent corporate tax rate[58]. In other words, the fact that the corporation is considered to acquire the building at a lower value for the purposes of claiming CCA is of limited relevance in negotiating the transaction. Any future sale of the building for more than $175,000 will result in the corporation being liable for income tax. In the case of the

[58] The formula for determining the present value of the tax shield from CCA is I * t*[CCA/(CCA + r)] * [(2 + r)/2*(1 +r)], where I is the amount of the investment, CCA is the rate of write-off for tax purposes and r is the discount rate.

land, there is no tax impact of a lower tax value until the land is disposed of by the acquiring corporation. If it is assumed that the corporation will not dispose of the land and building for an extended period of time, the present value of the accrued tax liability is negligible. The transaction has not eliminated the tax on the appreciated value. Rather the tax has been deferred until the taxpayer disposes of the shares and the corporation disposes of the property.

There are several advantages of the second alternative for the individual. First, he or she no longer has managerial responsibilities associated with operating the apartment building. While these activities could have been transferred to an agent, the transfer to the corporation eliminates all need for involvement. Second, the transfer permits the individual to rapidly diversify their economic exposure as it is likely that the corporation has several other apartment buildings, may own commercial real estate and may have properties in several cities. Third, the corporation, because of greater size, is probably capable of more efficiency in management and maintenance. Fourth, the corporation has the advantage of a longer investment horizon, particularly for income tax purposes. While an individual must eventually dispose of the apartment building because death gives rise to a disposition, a corporation could continue to own the property long after the death of the individual. This ultimately leads to a longer tax deferral and therefore a great value for the building. Fifth, if the transfer is to a public corporation, the individual has greater liquidity through share ownership than through direct ownership of the apartment building.

The negative aspect of the transfer to the corporation is that the recapture and capital gain would be taxed twice. First, the corporation has a tax value of the building of only $175,000 and $150,000 for the land. As a result, it will be subject to tax on any value received on disposing of the land and building in excess of this amount. In addition, the individual will be taxed at the time they dispose of the shares. As the shares will have a tax value of only $325,000, the remaining tax value of the apartment building when transferred to the corporation, the full amount of the gain will be taxed as a capital gain in the hands of the individuals[59].

The assumed justification for permitting a taxpayer to use a rollover is that the taxpayer has not received any cash or debt in excess of the tax value of the apartment building transferred. If the taxpayer does receive more, then he or she is subject to tax on this excess. We suggest that the government consider the implementation of new tax policies so that more investors can take advantage of deferral possibilities.

Implications of Accelerated Depreciation

In attempting to deal with the problems associated with the country's lack of affordable rental housing, politicians must deal with two separate issues. First, they must find a way to provide the owners of the country's aging rental stock with an incentive to properly

[59] The taxpayer could generate cash without paying tax if they used the shares as collateral for a loan. Because posting shares as collateral is not considered a disposition, there is no need to pay tax.

maintain their buildings or to provide a transfer of ownership mechanism that is financially justifiable from the prospective vendor's point of view. Second, politicians will have to deal with the current as well as the impending shortage of affordable rental housing that is likely to occur as a result of the first wave of the baby boomer's children leaving home. This "echo" generation will increase the pressure on an already limited stock of affordable rental housing. In the absence of rent control, the increased demand for rental housing will bid up the price of rents to the point where the potential returns will financially justify the development of new rental housing units. Though solving the short-term rental housing supply problem, increased housing rents will increase the financial pressures experienced by those individuals that struggle paying current rents. In developing a forward-looking affordable housing policy, the government will face the dilemma of initiating a strategy aimed at increasing the stock of affordable housing without exacerbating the plight of low-income Canadians.

One of the important distinguishing factors between REITs is the proportion of the distribution that can be shielded from tax. In Canada, the proportion of distributions shielded from tax ranges from 40-100%. If apartment REITs are given an advantage by increasing the amount of depreciation that can be claimed against individual tax bills, it may be that investors would justify shifting from non-apartment REITs to apartment REITs. However, since the risk profile for investors in apartment REITs differs substantially from that of investors in non-apartment REITs, the increase in yield would have to be substantial enough to narrow the spread between the existing yields. In addition, many REIT units are already held in tax-advantaged portfolios (e.g. individual RRSP's, or large tax-exempt pension funds) and are therefore, indifferent to tax-policy treatments.

Another major concern that is raised should this change be implemented is the issue of CCA recapture that investors face when selling their units. The investor is required to reduce the book value of his or her units each year to reflect the decrease in the value of the properties held by the trust as a result of depreciation. If the shares have not decreased in value correspondingly, there will be a large capital gains tax bill faced by the investor in the year of sale. Because the investor is seeking both distribution-yield and capital appreciation, this effect will be counter to his or her objectives and may deter investment, especially when other alternatives are possible.

The last concern that this change raises is the issue of capital expenditure and maintenance of the buildings. The trust is able to capture all the benefits of the depreciation exemption in the early years. Capital improvements may have the effect of increasing the capital cost base, but if the percentage permitted to be deducted from tax decreases as time passes, subsequent investment will not provide the same tax shield as would have been possible in early years. Once the property depreciates to a certain level, there is no longer an incentive to invest in that particular property, especially when the value of the tax shield for that investment is compared with the value implicit with a new building offering maximum percentage deductions. For that reason, buildings may fall into disrepair and the small depreciation that may exist may even justify abandonment, when compared to the tax consequences of a sale and existing mortgages on the properties.

5. Clarifying that the term “Improvement” extends to development

This change originates from discussions with analysts and REIT management in the Canadian REIT industry. Although there are risk-tolerance reasons behind why REITs have avoided development activities, another reason for the lack of new development is that the Canadian Income Tax Act mentions only improvement activity, while remaining silent on development. Certain legal opinions have indicated that this omission was the government’s method of deliberately prohibiting the more risky development activities that REITs may wish to undertake. Some REITs (most notable H&R) have used alternate mechanisms to allow them to develop new properties. These mechanisms include joint ventures, first option to purchase, mezzanine financing, etc. However, each of these mechanisms imposes a cost that directly reduces the available returns to REIT investors. If other reasons to avoid development activities could be eliminated, clarifying the tax code will be essential to lead REITs to stimulate development.

Again, it is unlikely that apartment REITs will reap the sole benefit of this clarification. It is likely that other REIT categories, owing to business and market fundamentals, will benefit to a greater degree than apartment REITs. However, it is again speculated that apartment REITs will reap some benefit from this change. As well, unless the existing investor base comes to view apartment REITs as equity offerings, or the holders of these securities change, permitting development will have no effect. The current unit holders want risk minimized and will not tolerate risky development activities. Of course, this translates into lower returns, but since this group is comparing returns with bonds and not equities, these returns seem to be quite attractive.

6. Permitting REITs greater freedom in charging for additional services

This change originates from new developments in the U.S. REIT industry as a result of the U.S. *REIT Modernization Act*. At present, Canadian REITs may not earn income from non-real estate related services and still qualify as a closed-end mutual fund trust. U.S. REITs have had this restriction prior to this year, when the REIT Modernization Act granted the right for these REITs to organize Taxable REIT Subsidiaries. This legislation allows REITs to offer services such as internet, cleaning, furniture rental and others to tenants in exchange for additional payment over and above the rental rates. Previously, these REITs had been operating these extra services, but they did so using partnerships in which REITs were the major shareholders. Use of these off-balance-sheet subsidiaries resulted in a lack of transparency that concerned investors. The *REIT Modernization Act* corrected this problem. Canadian REITs have never had the freedom to manage as freely as U.S. REITs. Income earned has had to come directly from rents. Organization of taxable REIT subsidiaries has not been option.

The benefit of permitting the REITs to develop these new subsidiaries is that it creates the opportunity to earn sufficient additional returns to make investing in apartments attractive. As well, it fosters innovation in the residential market that improves the standard of living for all Canadians. For example, if landlords had been restricted to their existing operations as they were in the late 1800's and early 1900's, electricity might not have become an accepted standard for housing as quickly as it did. Not permitting this sort of innovation stifles the standard of living of Canadians at the level of the status quo. As well, this change could potentially be granted solely to apartment REITs, however, there might be a substantial outcry from other REIT sub-sectors.

One negative of this change is that permitting untried and untested services introduces a new degree of risk to which the unit holders may object. Unless Canadian REITs become viewed more as equities than bond alternatives, it is unlikely that this option will lead REITs to undertake new development.

7. Allowing Canadian REITs to have a larger share of foreign Investment

This change arises from discussions with U.S. REIT analysts about what would be necessary for greater investment in Canadian REITs. These analysts stated that U.S. investors have capital available that could be invested in Canadian REITs.[60]

Canadian REITs are limited to having less than 50% of their total number of units held by foreign investors. Given that the Canadian population and market is so small, and given that Canadian institutional investors have not been receptive to REIT securities, it would appear as though this restriction has greatly reduced the pool of capital available for Canadian REITs. Permitting a greater portion of foreign ownership would likely allow Canadian REITs the access to capital necessary for substantial growth and development activities.

Although there is a great deal of capital available in the U.S., it might be that American investors view Canadian securities as being inferior to what is offered in the American market. For example, Canadian REITs are much smaller, have lower market capitalizations, rely more on secured debt, and have higher levels of debt. All things being equal, Canadian REITs are more risky than American REITs and even changes in the permitted portion of foreign investment may not be enough to entice American and other foreign investment into Canadian REITs. As well, it might be impossible to grant this right to apartment REITs, while excluding other REIT sub-sectors.

8. Permitting joint ventures between U.S. REITs and Canadian REITs

Like the previous change, this change originated during discussions with U.S. analysts who follow the U.S. REIT industry.[61]

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[60] Anthony Paolone, CIBC-World Markets, New York, July 2001
George Skoufis, Standard and Poors, New York, July 2001.

Given that the U.S.REIT industry has a number of advantages over Canadian REITs, it may be possible for access to those benefits to be obtained by permitting U.S./Canadian REIT joint ventures. This option has a number of benefits. First, it would allow the Canadian REITs access to the vast pool of capital available in the United States, and might even reduce the costs of borrowing within Canada. Second, Canadian REITs could permit management activities to be carried out by the U.S. REITs. This would eliminate the unit holder's concerns about limiting risk because the development and management risk would be borne by the joint venture partner. U.S. REITs have traditionally preferred development activity and would likely wish to undertake new development activities for their Canadian investments. Third, the strength of the Joint Venture partner may provide the Canadian REITs with management skills they have not yet developed. The financial strength of the partner could provide the nimbleness Canadian REITs do not currently possess.

However, there are negatives that could make this scenario unworkable. First, it may be difficult to convince a Canadian REIT, lacking limited-liability protection, that it ought to form an alliance with an entity that does have limited-liability protection. The concern would be that in the event of large liability costs, the Canadian partner's unit holders would bear the brunt of the costs using personal assets, while the American partner's shareholders merely forfeit their investments. However, in combination with other changes (granting corporate status or limited liability), this problem is eliminated. Second, it may be difficult to convince a U.S.REIT that Canada, with its legacy of rent controls, is an attractive market in which to invest when other American investment possibilities exist.

9. Permitting joint ventures between U.S. REITs and Canadian institutional investors

This change originated from an examination of investments made in the U.S. REIT industry by Canadian institutional investors.

The reality is that Canadian institutional investors are already forming joint venture partnerships with U.S.REITs to purchase U.S. properties. For example, the Caisse de Depot et de Placement recently put up the majority stake in the purchase of an office building in New York in conjunction with Boston Properties. Boston will be paid to handle the development and management, while the Caisse de depot et de placement will collect its portion of the rental income with little or no risk involved. Canadian institutional investors may be convinced to purchase Canadian development properties if joint venture partners have the strength and reputation, along with the limited liability, possessed by the U.S. REITs. However, this change is only appealing if there are not other reasons behind why Canadian institutional investors are electing to invest outside of Canada. Given that they already have substantial direct real estate holdings in Canada, it

[61] Supra.

may be that nothing would entice this group to put additional dollars into this country's apartments.

10. Allowing U.S. REITs to operate independently in Canada

This change originated from an examination of the portfolio of properties held by U.S. REITs. At present, only one U.S.REIT (Rousse Properties, holding only one property) has any holdings in Canada. Although there is no direct prohibition against foreign REITs operating in Canada, anecdotally, several U.S.REIT analysts remarked that the tax benefits available to U.S.REITs become less attractive when the property is held in Canada. In addition, since cash flows would be denominated in Canadian dollars, there is the introduction of currency risk. However, if the returns were sufficient to justify the investment, it is likely that the U.S.REITs would be interested in dealing with the pent-up and anticipated demand for Canadian apartments.

11. Providing an educational campaign for individual investors in regard to REITs

This change originates from the apparent generalized misunderstanding of REIT vehicles on the part of Canadian investors. There has been some concern that individual investors do not understand REITs and the benefits involved with owning such investments. In addition, those that are familiar with REITs appear to have some misconception about the negative aspects of such an investment. For example, a great deal of concern has centered about the issue of limited liability. As well, there appears to be a belief among some that REITs managers may be involved in activity that seeks to bilk the investor of their resources. These beliefs may be a result of a couple of factors. First, REITs are relatively new in Canada and investors have little experience with their benefits. Secondly, there were a series of problems involving REITs during the early 1980's. REITs, in both Canada and the U.S., became highly levered, and interest rate increases and property value decreases put a number of these trusts into distress. Coupled with the Canadian "right of redemption" afforded to closed-end mutual funds, this resulted in a number of these trusts being forced into insolvency. The U.S. REITs did not have the same problem with this issue because they were predominantly structured as corporations. Canadian legislative changes removed the right of redemption and this danger no longer exists. However, the perceptions of instability and excessively high risk still exist. One relatively low-cost option is to launch an educational campaign to correct investor misconceptions. If the campaign is paid for by the REIT industry, this change will be a no-cost option for the government. However, coordination of the REIT industry may be difficult and enforcement of payment for the campaign complex.

Regardless of who bears the cost of such an initiative, admittedly, it is difficult to change perceptions, but the publicity being provided to the REIT industry may spur additional investment. Again, it is likely that any increase in investment would benefit the entire

REIT industry and not specifically provide an advantage for apartment REITs over non-apartment REITs.

12. Creating a standard declaration of trust

This change originates from an examination of the current regime for Canadian REITs and concerns that have been raised as a result from various investors, particularly institutional investors.

As it stands today, each REIT is responsible for creating its own declaration of trust. So long as the relatively few (when compared to the U.S.) regulations stated in the tax code are adhered to, there is a great deal of flexibility in how a REIT chooses to operate. For example, some declarations of trust state that a conservative level of debt will be maintained, while others permit more risky debt-structures. As well, each states the degree to which investor opinion will be considered and the degree of liability investors face. Hence, an investor must perform substantial due diligence before committing his or her dollars. The time and cost involved in performing such activities may deter investment. Because REITs are not standardized, the investor's perception of REIT unreliability may be heightened. Creation of either a standard declaration of trust or the creation of more stringent requirements for REIT status may create the investor confidence necessary to justify increased investment.

There is a benefit and a disadvantage of standardizing REIT declarations or legislation. The benefit would be greater certainty for the investor arising from greater predictability of cash distributions. The disadvantage would be REITs would face significantly higher degrees of business constraints that might result in reductions of earnings.

However, again, any benefit or disadvantage to apartment REITs (in percentage terms) will likely be similar to the benefit to non-apartment REITs.

13. Encouraging formation of a national body to promote the interests of REITs

This change originates from an examination of the numerous benefits provided to the REIT industry in the United States by the National Association of Real Estate Investment Trusts (N.A.R.E.I.T.)

The creating of a body, similar to the U.S. National Association of REITs (NAREIT) has a number of advantages. First, the body would be able to perform an education function that has the potential to popularize REIT ownership and dispel a number of myths that currently exist. Second, the sharing of data on individual REITs in an easy-to-access medium would create the scrutiny necessary to force REITs to operate using best business practices. Third, coordination would provide greater lobbying power for the overall industry to convince government to be more responsive to REIT needs. Lastly, it would allow small REITs to use their collective bargaining power to reduce the costs involved in purchasing supplies and undertaking new ventures.

Although this change appears to be relatively easy to implement and has a number of clear benefits, it is not without drawbacks or difficulties. First, it would be difficult to convince such a small number of players that the expense and management time required to create a national body is justified. Second, government initiatives to encourage such a group may be viewed with mistrust. Third, the lion share of the benefit would accrue to the larger, industrial or office REITs, rather than being limited strictly to apartment REITs.

Suggestions Requiring Government Financing

14. Offering venture capital and mezzanine financing for new REITs

This change originates from an examination of the Canadian REIT industry and the barriers to entrepreneurs considering creating new REITs.

Before a REIT can purchase property, it must first raise funds. Without an initial public offering, the REIT is not able to access equity financing and without equity financing, it is unlikely that debt financing will be available. Without properties and an established track record, it becomes extremely difficult to sell trust units to investors. This scenario has resulted in most new REITs being created as a result of a spin-off of ordinary real estate corporations. Because there is a limit on the number of corporations that are capable of such spin-offs, the number of new possible REITs (apartment or otherwise) is likewise limited. Providing seed financing for purchase of an initial property portfolio and to set up a REIT trust structure may bridge this otherwise difficult situation. Should the federal or provincial government provide funding to apartment REITs at reasonable rates, potential entrepreneurs may be enticed into creating new apartment REITs.

Funding for these ventures may take the form of “venture capital” where an investor provides funds for a venture in exchange for an ownership stake in the venture. The hope is that the value of the investment will increase substantially and the venture will eventually perform an IPO, wherein the venture capital firm recoups both the initial investment, along with a significant return for use of its capital. Mezzanine financing would be another alternative. In this situation, funding is provided to a company attempting to begin or expand operations. In this case, the investor hopes the value of the company will increase and the mezzanine company will recoup its investment by selling to others interested in the company, or back to the company itself.

15. Providing guarantees for Canadian banks and other financial institutions for loans to REITs at more attractive lending rates

This change originates from an examination of the cost of debt for Canadian REITs and the cost of debt for U.S. REITs. An examination of changes would not be complete without this suggestion because it addresses a number of the causes stifling the Canadian REIT industry.

The size of the Canadian REIT industry prohibits many of the debt vehicles available to U.S. REITs. This change would reduce the interest costs borne by apartment REITs, thereby increasing the distributable cash available to unit holders. Given that levels of leverage are limited by declarations of trust, decreasing the interest costs of that leverage would not enable a given trust to purchase additional properties without securing additional equity capital. However, the increase in yield as a result of the reduction in interest costs may make it possible for apartment REITs to expand by issuing additional units. The question that remains is whether or not the government wants to take on the risk of default.

16. Creating a system of revenue guarantees for new construction

This change originates from an examination of the U.S. low-income rental subsidies and an examination of the Canadian nursing home REIT industry. This change is perhaps not within the scope of government action, but it provides a reasonable method of increasing the housing stock in Canada.

Not unlike what the Province of Ontario has done for Nursing Home REITs, the government could guarantee revenue returns for REITs who elect to build new apartment units. For the most part, the private market would pay the rent on these new units. However, the government would eliminate the risk in development (cost-over-runs, leasing-ramp-ups, etc.) by guaranteeing returns. In addition, the government could make some sort of arrangement to compensate developers, who faced cost over-runs and budget deficits through no fault of their own.

This change has the potential to induce investment in new properties because it eliminates the risks to which REIT unit holders object. It also benefits only the apartment REIT industry, to the exclusion of other categories of REITs. However, there may be some substantial costs imposed that the government may deem to be unacceptable. As well, the returns to those engaging in construction must be substantial enough to justify diverting capital from other purposes. And given the skepticism of the longevity of governmental programs, it may be that even these inducements may not be sufficient to generate interest.

17. Creating a system of rental subsidies

This change originates from an examination of the government-funded rental-subsidy programs available to U.S. apartment REIT, where it has had great success.

Given that it is unlikely that apartment REITs will elect to operate in the affordable housing sector, if the apartment REIT industry does grow, all levels of government must ask how they intend to make these new units affordable. It could be that the very addition of new supply will drive down the prices of older properties to an affordable level. However, since this impact is at best uncertain, it may be possible to induce apartment REITs to accept lower-income tenants if the REITs' revenue remains constant. Since low-income tenants are unlikely to be able to afford market rent, subsidies could be provided to "top-up" the tenant's contribution to market level. Restrictions could be placed upon the REITs that include ensuring the subsidized units are integrated geographically into their overall portfolio and maintained to similar levels. The REITs would have to be convinced that the costs of renting to subsidized tenants would not be higher than to other tenant groups. There is a perception (rightly or wrongly) held by property managers that low-income tenants will require greater rent collection efforts, and may not treat the properties with the same degree of respect. It is hoped that integration into existing communities will create community pride that will eliminate these concerns.

This policy has been used successfully in the United States. Rather than asking the market to accept rent controls, property owners in the United States are able to earn market returns, and housing is being willingly provided as a result. This compares to the Canadian experience where rent controls and fear of rent controls have made many builders unwilling to enter the apartment market.

Considerations in Ranking of the Available Suggestions

As discussed in the above comments, each of the changes outlined has a number of positive aspects, along with a number of drawbacks. However, despite the imperfection of each change, a few of these changes stand out as having the best potential to accomplish the objectives of increasing the apartment REIT industry in Canada. In addition, those changes that can be accomplished without significant cash outlay or taxation foregone would perhaps be more attractive.

Rationale Behind Ranking of Suggestions:

In order for the REIT industry to accelerate the growth trend it is currently experiencing, three things must be accomplished if investor confidence in these securities is to increase. First, distributions must be maintained. The investor must be able to predict income cash flows. This will become increasingly important as demographic shifts render REITs the security of choice for retirement income. Second, the REIT must ensure that nothing is done to undermine the perception of limited liability for investors. Declarations of trust must carefully state limits on liability, and structures must be created that safeguard the investor's protection. Third, any changes that eliminate the disadvantages in choosing to invest in a REIT over a corporate structure must be considered. The changes that best permit these three aims to be accomplished will be the most attractive.

Ranking of Available Suggestions:

The changes suggested will not operate in isolation; there will be interaction among them. For example, increasing the percentage of foreign ownership, while helpful, will not be as effective if implementation of limited liability protection for U.S. shareholders is not simultaneously guaranteed. As well, certain changes will render other changes unnecessary. For example, granting Canadian REITs the right to organize as corporations immediately confers upon an investor limited liability protection, and grants the right to purchase properties in exchange for tax-deferred units. Hence, additional legislation granting limited liability protection and the right to purchase properties using units becomes redundant.

Ranking of Individual Suggestions

1. Granting REITs the right to organize as corporations
2. Granting REITs limited liability protection
3. Granting REITs the right to purchase properties using tax-deferred units as a medium of payment.
4. Clarifying the "improvement" extends to development activities
5. Providing an educational campaign for individual investors in regard to REITs
6. Increasing the percentage of foreign investment permitted for Canadian REITs (however, the Canadian REIT industry believes that this is not that important)
7. Creating subsidies for developers of apartment properties that "top-up" tenant rent contributions to market levels
8. Creating licenses for revenue guarantees for developers of new apartments
9. Permitting Canadian REITs to form joint ventures with U.S.REITs in order to purchase Canadian properties (however, the Canadian REIT industry believes that this is not that important)
10. Permitting Canadian institutional investors to form joint ventures with U.S.REITs in order to purchase Canadian properties
11. Permitting and encouraging U.S.REITs to operate independently in Canada
12. Encouraging the formation of a national body to promote REIT interests and educate potential REIT investors

13. Providing guarantees for Canadian banks and other financial institutions for loans to REITs at more attractive lending rates. (however, the Canadian REIT industry believes that this is insignificant)
14. Creating a standard declaration of trust
15. Offering accelerated depreciation for new apartment buildings (however, the Canadian REIT industry believes that this is more important)
16. Offering venture capital and mezzanine financing for new REITs
17. Permitting REITs greater flexibility in charging for additional services

In conclusion, it would be optimal to implement the entire list of changes, excluding those that would become redundant once a higher ranked change would render them redundant.

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