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Canadian Retail REITs Come of Age

Now Holding a Major Share of Shopping Center Space, REITs Are Focusing on Redevelopment Opportunities

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Abstract: *The number of retail-focused Real Estate Investment Trusts (REITs) has grown significantly in Canada over the last two decades, with nearly one-third of total shopping centre space now controlled by them. This article examines the factors that contributed to the growth of REITs between 1984 and 2016. In particular, the report analyzes the move towards diversified portfolios, the dominance of a small number of major retail-focused REITs, and the increasing need for REITs to embrace redevelopment and adaptive re-use of properties.*

Characteristics and Specifics

A REIT is a type of mutual fund trust (MFT) in which individuals and organizations either receive or can purchase units of stated value in the property managed by a revenue-producing trust. Though present in Canada since the mid-1980s, REITs have been enshrined in law, as an amendment to the Federal Income Tax Act, only since 1995.[1] All but three (Boardwalk, RioCAN and Canadian REIT) of the 47 currently existing REITs in Canada have been in place since 1995, as seen in Chart 1. Over 90 percent of the REITs are publicly listed on the Toronto Stock Exchange [TSX] with the majority open-ended trusts.

In the U.S., a REIT is required to distribute at least 90% of its net taxable income annually to unit holders, while in Canada this distribution is set individually by each REIT and is usually between 85% and 95% of taxable income. This legal distinction from other kinds of trusts became particularly important in 2006, when REITs were exempted from tax changes affecting other kinds of trusts with respect to the 'flow-through' of profits to unit holders.

As a result, some REITs were exempted from the changes because they were not regarded as 'passive' investment vehicles—i.e., those that exist to hold and mirror aggregate market trends. Instead, REITs' history indicated, according to former Finance Minister Jim Flaherty, that they "actually invest and reinvest in shopping malls and office buildings and various other things, so it's not just a money flow-through to passive investors."[2] The concern about the impact of possible corporate tax avoidance grew in 2013 because of the large number of REITs that were formed in that year.

How Have Canadian REITs Evolved?

Chart 1 indicates that there have been two main steps in the growth in number of REITs from 1984 to 2017: one in the *2002-2007* period, when 19 existing trusts were formed; and another in *2012 and 2013*, when 18 existing trusts were established. What accounts for these growth spurts? Two explanations are:

Lessons Learned

- Over the last two decades, retail real estate in Canada has been increasingly held by REITs, which currently control approximately one-third of total shopping centre space.
- Six major retail-focused REITs control over three-quarters of the total REIT-owned retail space.
- A number of REITs with retail properties are focusing investment on key redevelopment opportunities.
- Five key business strategies can be identified:
  1. turn the REIT into a development company;
  2. diversify the asset mix of the REIT;
  3. create a REIT from the assets of an existing major retail conglomerate;
  4. diffuse from the home base, as the REIT evolves from a regional to a multi-regional/national entity; and;
  5. focus REIT activity in the major urban markets.

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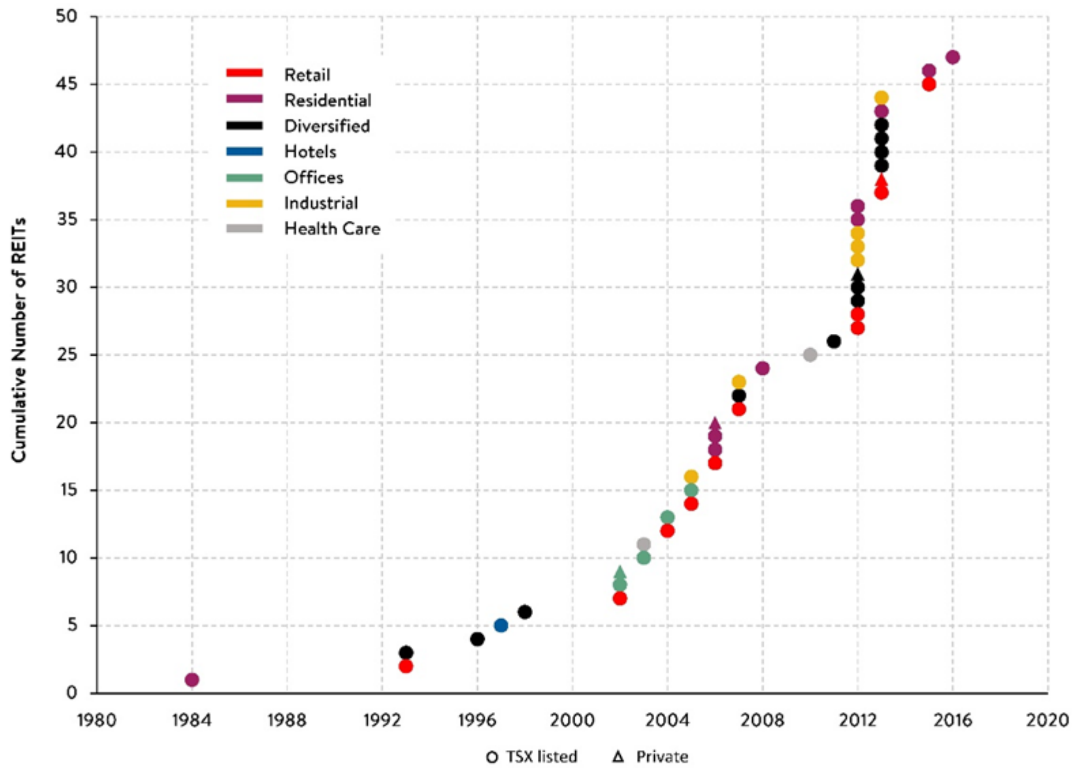
[1] Although this legal amendment simply allowed REITs to qualify as closed-ended (fixed unit) as well as open-ended (non-fixed unit) MFTs under which general procedures they had been operating, it effectively provided them with legal status.

[2] Jim Flaherty quoted in Theophilos Argitis, "Casting a Kind Eye on REITs," *Ottawa Citizen*, May 14, 2013.

Chart 1
Canadian REITs by Year of Formation and Type, 1984-2016



Source: Company Reports, CSCA

1. *Legal*: Without the changes to the Income Tax Act in 1995, REITs would not have the wider opportunities that are provided by both closed and open-ended formations. Moreover; their special status was reinforced when they were exempt from changes made in 2006 to curb tax avoidance. These two changes alone place REITs in a strong competitive position in the investment world, and have encouraged them to grow.
2. *Economic cycles*: With a sharp economic slump from 1990 to 1992 leading to an elongated downturn in the property market, low property values were particularly disadvantageous to open-ended REITs. An economic recovery began to occur with the 1995-2001 'dot-com' tech bubble. But high interest rates still discouraged REIT formation. Between 2002 and 2007, REIT growth's second big step occurred in conjunction with an expanding economy and a vibrant property market, which lasted until the 2008-09 Global Financial Crisis (GFC). A dynamic factor in REIT growth during this period was that interest rates were much lower compared with the early 1990s, as the Federal Government, along with the Bank of Canada, sought to maintain an inflation rate average of 1%-3% per annum. In consequence, vehicles other than bonds appealed to those seeking higher returns from relatively safe instruments – and REITs came to the fore. With post-GFC economic growth still sluggish, investors desiring predictable gains have re-focused on REITs offering returns higher than those in the bond market. As a result, there has been a considerable investor appetite for existing and new REIT formation (especially between 2012 and 2014).

How Have REITs Affected the Canadian Retail Landscape?

The Canadian REIT sector embraces six kinds of property services: offices, retail, housing, health care, industrial (including manufacturing), and hotels (including motels). Some REITs focus almost entirely on one kind of service activity, while others either commenced as diversified or have become so since they were first listed. Of the six categories, retail is the most ubiquitous as it includes the kinds of services that can be associated with many types of properties, particularly offices and high-rise housing.

By adopting a simple, share-of-space majority rule, retail-focused REITs can be defined as any REIT with 50% or more of its space in retail. Only those with no particular concentration above this level are defined as 'diversified.' Using this basic definition, most REITs in Canada are diversified (12) while others are primarily in retail (11), residential (10), industrial (6), and offices (4).

REITs vary not only by portfolio type, but also by the (current or book) value of property assets under their control. This is an extremely important value because real property is the basis of a REIT. Using current value, it is estimated that REITs listed on the TSX and those conducted privately total $130 billion in property assets. Although there are more REITs in the diversified category than any other, REITs that have 50% or more of their space in retail contribute the greatest share of property in the REIT market in Canada.

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REIT size, however, varies considerably (e.g., in 2016 values ranged from $10 million for Maplewood International to $12.6 billion for H&R). The largest 25% of the REITs account for 63% of the total valuation, highlighting that the REIT industry in Canada is dominated by a few large trusts. There are five retail REITs with portfolios greater than their group mean (Choice, RioCan, Smart, CT, and Crombie) and six with less.

There are 10 REITs with 50% or more of their Canadian leasable space in retail. Others in the diversified and office categories, however, have some, but less than 50%, space in retail, and 22 REITs hold only 5% or more of their leasable space in retail. The estimated total retail square footage in Canada from all REITs is 207 million, just over one-third of shopping centre space in the country.[3] This level of concentration is increasing as major national retail companies have sought to unlock the value of their property without selling assets.

Pay-out, unit value, and the length of time a REIT has been in business are important investment features. Given that the pay-out from Canadian REITs is determined by the operation, it should be consistent with the income-producing capacity of the properties it manages and its stated growth (or reinvestment/redevelopment) objectives. A useful measure of this consistency is provided by the share of *common unit holder distributions* (CUHD or pay-out) of *adjusted funds from operations* (AFFO[4]) over time (% pay-out = CUHD/AFFO).

Six major retail-focused REITs[5] account for 76% of the estimated retail space in REITs in Canada in 2016. For these six REITs, the unweighted average trend suggests that the AFFO-based ratio has decreased from almost 95% in 2012 to 86% in 2016.This implies that *during this five-year period, the major REITs in the retail sector have become relatively more interested in new investments than in disbursements.* They are seeking to sustain and grow the income-producing capacity of their property base, which requires new investments.

What Strategies Are Being Adopted by Canadian Retail-Oriented REITs?

The concentration on new investments by retail-oriented REITS may be toward different types of retail, or even non-retail. Some strategies that such existing REITs have adopted may offer previews of the future:

1. *Turn the REIT into a development company.* This, as exemplified by SmartREIT, involves a REIT merging with a large real estate company which has property assets that may not be fully occupied for the envisioned purpose (in this case, power centres). For example, a big-box-based project can be turned into a coherent, community-oriented multipurpose development, with REIT income generated from a variety of uses.
2. *Metamorphose the retail REIT into one more diversified.* This strategy, followed by Crombie REIT, is invariably achieved by incrementally selling lower-rent properties in retail and buying those that generate greater levels of income per square foot from other uses (such as offices and restaurant services). In essence, this is a mechanism for a retail business to eventually become a real estate rental company.
3. *Create a REIT from the assets of an existing major retailer to serve as the property development arm (or 'pillar') of the 'conveyor' or parent company* (e.g., Canadian Tire Co. with CT REIT and Westons with Choice REIT). These REITs are based on a principal tenant which provides virtually all the income for the REIT. Thus, in theory, if the income from the principal tenant decreases, the REIT can metamorphose into a more diversified trust, and from that become less a retailer and more a real estate landlord.
4. *Diffuse from the home base.* Plaza REIT is an example in retail of a number of REITs that are regionally based. If the region underperforms the country as a whole, then a REIT formed from regionally based properties can provide capital for investment elsewhere. REITs can, therefore, be a useful method that can be employed by retail companies which own, or have interests in, an extensive portfolio of properties and wish to reinvest or shift to other kinds of business operations.
5. *Focus investment activities on the major urban markets.* An alternative geographic strategy for REITs is to focus on the VETCOM[6] markets and concentrate investment within the dominant population hubs across Canada. The VECTOM markets are home to the bulk of the Canada population and are typically the go-to markets for new retail entries and shopping centre development/redevelopment.

Conclusion

REITs are now an established element of Canada's retail real estate landscape. The estimated amount of retail space held by REITs in Canada is quite large–approximately one-third of space held in shopping centres. Given changes in consumer behaviour and waves of retail disruption, there is significant debate as to the future level of demand for additional retail space. This is of no small consequence for REITs that are solely serving retail or have a considerable share of their income-generating properties in retail. But a focus on new investments shows how Canadian REITs may transfer and adapt retail-related capital to more productive uses.

[3] At year-end 2016, shopping centres of 40,000 square feet and over totaled 611.1 million square feet of GLA. Sources: CSCA, IvanhoeCambridge and ICSC Research. See ICSC, "QuickStats."

[4] The AFFO is the funds from operations (FFO), which takes into account depreciation less other items associated with the REITs operation not included in FFO. Unfortunately, there is no standard industry definition of AFFO. There is, however, a REALpac definition of FFO on which AFFO is based. In consequence, some REITs present their distributions as a percent of FFO which would generally be lower than if AFFO were used. Nevertheless, many larger REITs calculate an AFFO and provide statements of the deductions from FFO that are included. Thus, while on the face of it a unit-holder might like to see the largest pay-out possible, both theoretically and practically a REIT with distributions equal to or greater than its AFFO cannot remain solvent for long as it is not investing for the future.

[5] Defined as those with more than 50% of their total income-producing space and more than five million square feet of gross leasable area (GLA) in retail.

[6] VETCOMs refer to the six major urban markets, namely: Vancouver, Edmonton, Toronto, Calgary, Ottawa and Edmonton.

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