Real Estate Investment Trusts – Can REITS Get Any Better?

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by George Valentini, Rod Davidge and Chris Murray

If the global economy has been in a downturn since 2008, somebody forgot to tell the Canadian real estate market. For the fourth consecutive year, real estate investment trusts (REITs) have consistently outperformed the S&P/TSX composite index. What exactly are these REITs? And where did they come from?

The Canadian REIT

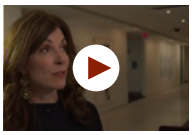
A REIT is an investment vehicle structured as a trust that allows investors to pool their resources to purchase and to derive income from real properties. In its simplest form, investors of REITs indirectly hold a beneficial interest in the properties through a nominee corporation which is entrusted with the legal title. This provides trustees with an advantageous and tax-efficient method of dealing with the real properties, while still reaping the financial rewards. Canadian investors in REITs also enjoy favourable tax treatment over other non-real estate income trusts and corporate dividends.

However, it took over two decades for today's prosperous REIT to evolve from what was once a restricted and inefficient investment vehicle. The most significant changes occurred during the 2000s, after the public market's comfort with REITs grew and investors allowed many restrictions in the declarations of trust governing many of the REITs to be loosened. This created a more flexible REIT, many with internalized management structures. This period of time also witnessed the creation and growth of a wide variety of income trusts with investments in many different businesses and asset classes.

In 2006, with the federal government's concern about losing tax revenues due to the increasing number and size of Canadian income trusts, the federal government announced legislation taxing income trusts. However, in recognition that the government still wanted to encourage investment in real estate, its new legislation excluded REITs from the new tax treatment provided that each REIT derives at least 95% of its revenue from passive real property sources[1]. This effectively ended the tax advantages for non-REIT income trusts and certain REITs which invested in operating businesses such as hotels.

Review of Select 2012 Activity

The recent success of, and the enormous demand for, REITs can be attributed to the near perfect fundamental conditions in the Canadian economic landscape relating to this part of the real estate market: low interest rates, strong occupancy rates, rising rental rates



OSLER REPRESENTED THE FOLLOWING CLIENTS IN 2012:

KingSett Capital and Ontario Pension Board in connection with their $4.4 billion take-over bid to acquire Primaris Retail REIT.

CANMARC REIT in connection with the $900 million take-over bid made by Cominar REIT.

Dundee Industrial REIT on its $155 million initial public offering and listing on the Toronto Stock Exchange together with its purchase of two portfolios of industrial properties across Canada for a purchase price of approximately $575 million and $159 million, respectively.

Dundee REIT and **H&R REIT** on their $1.266 billion acquisition of Scotia Plaza from the Bank of Nova Scotia together with a $650 million first mortgage bond offering and the lease back to The Bank of Nova Scotia of 1.2 million square feet of office and retail space in the Plaza.

Chartwell Seniors Housing REIT in connection with its multi-faceted transaction involving a joint venture purchase with Health Care REIT, Inc. of the United States of 42 seniors facilities throughout Canada for $931 million, and in connection with other acquisitions in Ontario.

Dundee REIT on its $1.4 billion acquisition of Whiterock REIT.

1 There are currently proposed amendments to the ITA that, if enacted, will reduce the 95% threshold to 90%, among other amendments.

and perhaps most importantly, high typically tax advantaged distributions for investors who were receiving very low returns from their interest and bond investments.

The growth of REITs, both individually and generally, has also resulted in their inclusion in indices tracking the performance of the stock exchanges and the creation of indices tracking the performance of Canadian REITs. Inclusion in broader indices, and the creation of Canadian REIT indices, has led to the acquisition of REIT units by index tracking funds.

The REIT sector started the year by continuing its torrid growth from 2011 and has not slowed markedly with a spate of transactions, IPOs and follow-on offerings at year-end. It was a defining year for REITs, as the acquisitions during the year, and in particular those by the large cap REITs such as Dundee REIT, H&R REIT, RioCan REIT and others such as Kingsett Capital, were indicative of the maturation of the REIT sector and demonstrated to the investment community that REITs could legitimately compete with other large investors such as pension funds, institutional investors and sovereign wealth funds.

2012 started with Cominar REIT (Cominar) and Canmarc REIT (Canmarc) in the midst of a battle after Cominar had launched a hostile bid for Canmarc and Canmarc responded by installing a rights plan. After lengthy negotiations, the parties came together in January to announce a friendly takeover, with Cominar increasing its bid 8% to just over $900 million. The acquisition of Canmarc increased Cominar's asset base by almost 50% to over 30 million square feet and solidified its stronghold in Quebec. Osler acted for Canmarc.

2012 is ending with the largest REIT take-over ever commenced, with a consortium led by Kingsett Capital (Kingsett) making an unsolicited $4.4 billion offer for Primaris Retail REIT (Primaris). Osler teams are acting for both Kingsett and a consortium member that has agreed to purchase certain parts of the Primaris portfolio from Kingsett.

Meanwhile, Dundee REIT spent 2012 transforming its portfolio of office and industrial properties into one solely focused on offices, and in particular, strengthening its office-property presence in the Greater Toronto Area.

By the beginning of March, Dundee REIT had acquired Whiterock REIT for approximately $600 million which propelled it to one of Canada's largest REITs. Months later, Dundee, along with its partner H&R REIT, beat out rival bids from pension funds, institutional investors and sovereign wealth funds to acquire Scotia Plaza, a Toronto landmark office complex in the heart of Canada's Financial District for $1.266 billion. Dundee REIT then proceeded in early October to sell over 50% of its interest in its industrial portfolio to a newly created publicly traded industrial REIT and continued to build that REIT with a major acquisition in early December. In just 10 months, Dundee

REIT had become one of the most dominant office REITs in Canada and Dundee Industrial REIT emerged as a dominant industrial property REIT. Osler acted for Dundee in all of these transactions.

In another significant transaction, Chartwell Seniors Housing REIT (Chartwell) teamed up with US-based Health Care REIT (HCN) to purchase 39 properties for $850 million, making Chartwell the largest owner and operator of retirement residences in Canada.

The phenomena of US REITs partnering with Canadian REITs was not limited to the Chartwell/HCN transaction. In 2012, Calloway REIT and Simon Properties Group announced the creation of a new joint venture to develop and operate a premium outlet mall in Quebec and announced the commencement of construction of a premium outlet mall in Ontario that they are developing together.

There was also a steady stream of public offerings of both equity and debt. 2012 to mid-November saw over $5.6 billion of new equity offerings[2] and over $2.5 billion of debt offerings. That represented an extraordinary 14.3% of the total equity capital raised by TSX-listed entities, with Osler acting on 25% of such offerings. And while the overall market for TSX listed IPOs was moribund in 2012, real estate related IPOs represented five of the only eight TSX IPO offerings completed by the end of November (excluding structured products).

Looking Forward into 2013

We expect significant REIT and real property activity to continue in 2013. Despite their high levels of activity in 2012, REITs have generally continued to follow conservative investment practices by maintaining strong balance sheets with low debt leverages. As a result very few REITs have had issues with liquidity or maintaining distributions, even during the very difficult 2008-2009 period. This leaves Canadian REITs in a strong position to react in uncertain economic climates.

If interest rates remain low and the global economic recovery remains uncertain, REITs should remain an attractive option for investors seeking steady yields. Continued high investor demand for greater yields should provide REITs with continued access to low cost of capital, permit additional acquisitions of real properties and foster more M&A activity in the Canadian REIT industry. High trading prices for REITs will also likely attract additional REIT IPO offerings into the market as real estate portfolio owners and managers seek to take advantage of higher valuations. We also expect to see increased use of the Canadian capital markets to finance real estate assets located outside of Canada.

CONTRIBUTORS

George Valentini
Partner, Real Estate
gvalentini@osler.com
416.862.6649

Rod Davidge
Partner, Real Estate
rdavidge@osler.com
416.862.4934

Chris Murray
Partner, Corporate
cmurray@osler.com
416.862.6701

2 "Equity offerings" consists of initial, secondary and convertible debenture issuances, but excludes structured product offerings (though a number of structured product offerings were real estate focused).