Canadian Real Estate Companies and REITs

December 2013

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In their continued search for yield, many investors have turned to Real Estate Investment Trusts ("REITs"). These companies pay out a significant percentage of their earnings as dividends; accordingly, they have historically provided a high level of income. However, a high dividend payout ratio leaves little in the way of earnings that can be reinvested in the business, such that the REIT must sell more shares in order to acquire additional income-producing properties. Lately, in order to support continued dividend increases—which are required to support continued share issuance—many REITs have also resorted to reducing their capital expenditures below the levels that will ultimately be required to properly maintain their properties. We have previously touched on these and other risks associated with investing in American REITs and, for the most part, prefer to implement any real estate exposure through owner-operated real estate development and management companies rather than through REITs. Real estate developers frequently have dormant assets, in that undeveloped land generates no cash flow, which makes such developers more difficult to value using standard metrics such as capitalization rates, price to earnings ratios and adjusted funds from operations multiples. Furthermore, their value-creating projects are generally very long-term in nature, which reduces their utility to investors focused on near-term results.

Broadly speaking, Canadian-listed companies trade at a discount to their United States-listed peers, providing an opportunity to invest in high quality North American companies at attractive valuations.

Canadian REITs

The Canadian REITs yield considerably more than the American REITs despite having lower dividend payout ratios and much more conservative balance sheets. Typically, they pay out 80 percent of earnings. Yet, there is no US-listed exchange-traded fund ("ETF") for Canadian REITs, even though there are over three dozen publicly-traded REITs in Canada. The market capitalizations of the Canadian REITs are too small to make such a fund a first-order profit opportunity.

Table 1 lists eight Canadian REITs with market capitalizations over $2 billion Canadian dollars. RioCan has a market capitalization of $7.6 billion; and another, H&R, has a market capitalization of $5.8 billion. The others are between $2 billion and $3.4 billion. The average yield of these eight companies is 5.84%. Their average capitalization is insufficient for the commercial purpose of an ETF, even though the yield is

Table 1: Larger Canadian REITs

	Market Cap. (CAD billions)	Yield
Cominar REIT (CUF-U CN)	$2.30	7.89%
Canadian Apartment Properties REIT (CAR-U CN)	2.30	5.45%
H & R REIT (HR-U CN)	5.79	6.27%
Calloway REIT (CWT-U CN)	3.35	6.07%
Allied Properties (AP-U CN)	2.27	4.23%
Dundee REIT (D-U CN)	3.03	7.88%
Boardwalk REIT (BEI-U CN)	3.12	3.32%
RioCan REIT (REI-U CN)	7.58	5.63%
Average Yield		*5.84%*

Source: Bloomberg as of 11/19/2013

considerably more than US REIT funds (which average less than 5%). To illustrate, the 10th largest holding in the SPDR Dow Jones Wilshire REIT ETF (which is but one such ETF among many, and which has $2 billion of assets under management) is Vornado Realty Trust ("Vornado"). Vornado has a market capitalization of $16 billion.

The Canadian REIT business is not radically different from the U.S. business. Leasing commercial property in Canada is not a different exercise than leasing commercial property in the U.S—the leasing laws may vary, but only slightly. The business practices are what vary, because the Canadian REITs are much less leveraged and have much more conservative dividend policies.

This brings to the fore a new search criterion for value: index raw material insufficiency. Any index that does not have the necessary raw material or any group of companies that collectively does not provide the necessary raw material to constitute an index is not unlikely to be a source of value. One can see this more clearly if one looks at a sample of smaller Canadian REITs with market capitalizations one step below those of the leading ones. The smaller REITs listed in Table 2 have market capitalizations that range from $100 million Canadian to $1.7 billion. These REITs are unlikely to be familiar names.

Table 2: Smaller Canadian REITs

	Market Cap *(CAD millions)*	Yield
Chartwell Retirement Residences REIT (CSH-U CN)	$1,741	5.36%
HealthLease Properties REIT (HLP-U CN)	249	8.83%
NorthWest Healthcare Properties REIT (NWH-U CN)	396	7.81%
Pure Industrial REIT (AAR-U CN)	619	6.84%
Dundee Industrial REIT (DIR-U CN)	488	7.85%
Summit Industrial Income REIT (SMU-U CN)	105	8.46%
InnVest REIT (INN-U CN)	415	9.02%
Average Yield		*7.74%*

Source: Bloomberg as of 11/19/2013

The average yield of these companies is 7.74%, which is much higher than that of the U.S. REITs. The yield is high, but it would be dangerous to arbitrage relative to the U.S. REITs because there is no observable correlation. There is also the Canadian dividend withholding tax to contend with, and there is currency risk. However, the most important matter is insufficiency of size.

A similar discrepancy has been highlighted in previous commentaries: U.S. REITs that are widely held in ETFs ("popular" REITs) compared to "less popular" REITs that are top holdings in only a few ETFs.

Despite the above risks, the Canadian REITs will probably provide a much higher total return than the U.S. REITs. Furthermore, it is worth mentioning that, given the valuation of U.S. REITs and their leveraged balance sheets, the U.S. REITs are not without their own risks. As noted above, our preference is to invest in real estate developers instead.

Canadian Non-REIT Real Estate companies

As in the case for the Canadian REITs, many Canadian real estate developers and managers trade at a discount to their American counterparts.

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Dundee Corp ("Dundee") and DREAM Unlimited Corp ("DREAM") are prime examples of companies that are systematically overlooked/underrepresented relative to their peers for a number of reasons, including their Canadian listings. Other factors include their large insider ownership, small market capitalization, and recent spin-off activity.

Dundee is a diversified company controlled by President and CEO Ned Goodman that is primarily engaged in financial services. Mr. Goodman exemplifies the shareholder-friendly actions of an owner-operator, having directed aggressive share repurchases at Dundee and having recently conducted a spin-off of its real estate assets into what is now DREAM. Dream owns the legacy assets of Dundee Realty (established 1989) that Mr. Goodman believes were not properly valued within the Dundee entity.

The primary assets of DREAM include approximately 9,000 acres of undeveloped land in Saskatchewan, Canada, and over 2,500 condominiums in the greater Toronto area. The Saskatchewan economy and housing market have been notably strong over the past five years, largely due to the strong local labor markets tied to the mining industry. Furthermore, the 9,000 acres will average five house lots per acre. Currently there are approximately 70,000 developed residential lots spread between 7 master planned communities, as well as 6.7 million square feet of commercial space. DREAM also happens to own the largest residential home builder in Saskatchewan and an option to build on the developed lots or sell them to independent home builders. Using basic assumptions for development and construction margins, we believe that the entire market capitalization of the company can be justified by these core assets alone.

More importantly, the company also has a contract to manage approximately $10 billion of real estate assets across three publicly traded REITs (Dundee REIT, Dundee Industrial REIT and Dundee International REIT). DREAM receives management fees of 25 basis points on the assets of the two domestic REITs and 35 basis points for the international REIT. DREAM receives additional fees for acquisitions, financings, capital expenditures, and funds from operations if the REIT meets certain hurdle rates. Needless to say, this is a considerable stream of cash flow tied to a strong permanent capital base. Based on the assumed value of the land and the company's current market capitalization, this cash flow stream is effectively priced at or near zero. Since the capital is permanent, one can view the asset management fees as a type of perpetuity.

Assuming no growth in the asset management fees generated in 2012, and applying a modest discount rate to this "perpetuity", we can almost justify the entire market capitalization of DREAM (this calculation uses gross revenue from asset management, which omits costs related to these activities—it is intended only for illustrative purposes). This begs the question: why, during a year in which such opportunities are increasingly scarce due to market appreciation, does such an opportunity exist?

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Consider that the S&P 500 Index has appreciated approximately 29% this year, while the S&P TSX Composite (the general Canadian equity benchmark) has appreciated slightly close to 8%. Although it defies logic, most investors invest in rising asset classes. This process alone has created inefficiencies in the prices of some Canadian securities. Additionally, DREAM was a May 2013 spin-off, and empirical evidence suggests that most spin-off securities are less efficiently valued than other stocks. Furthermore, Ned Goodman and Dundee collectively own approximately 30% of the DREAM Class A shares, thus limiting the share float, which results in an underweighting or exclusion from float-adjusted indexes or ETFs. In fact, neither Dundee nor DREAM is a top 10 holding in any ETF. Finally, DREAM also receives minimal cash flows from its real estate operations, as these assets are largely undeveloped. Accordingly, the company does not pay a dividend, and therefore, is also overlooked by yield-oriented real estate investors.

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