Real Estate Series #5 - Introduction to Canadian REITs

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Overview of REITs in Canada

- REITs present an opportunity for investors to access the real estate market without needing to take on significant debts and make large upfront payments
    - REITs pool capital together to invest in real estate properties such as retail, office, multi-family, industrial, etc.
    - Investor’s exposure to risk with respect to their investments in REIT is limited to the capital they have invested
    - Income generated from investments in REITs include distributions/dividends and capital appreciation

- All REITs - public or private - are considered as mutual fund trusts, which means:
    - It is a resident of Canada, as in the operations of the REIT and its control reside in Canada
    - It has at least 150 unitholders (i.e. investors)

Overview of REITs in Canada

Qualification Criteria for Canadian Public REITs

At least 90% of the revenue has to be from real properties (e.g. rent income, interest income, dividends, capital gain)

75% of the gross revenue has to be derived from real properties (i.e. royalties and dividends are not included here)

At least 90% of the fair market value of non-portfolio properties must be qualified non-portfolio REIT properties (i.e. REITs or securities that own Canadian real estates)

Aggregate fair market value of certain assets (e.g. real properties, cash, banker's acceptance) can't be less than 85% of its equity

Overview of REITs in Canada

- If public REITs fail to meet one or more of the asset or the revenue tests, it can be exposed to the SIFT rule, which results in double taxation
    - Qualifying as a public REIT also allows for some tax planning - for example, REITs have significant capital cost allowance deduction in its early years
        - This will allow REITs to treat its distributions as return of capital (ROC) distribution, which is not taxable
        - ROC distributions lower the adjusted cost base of the investment in REIT and will become taxable as capital gain upon sale of investment

- Investing in public REITs will expose investors to volatility in the market in which the investment in a given REIT is being traded
    - REITs have a lot of compliance-related costs such as issuer costs and audit fees
    - As an investor of a REIT, you have no control over its portfolio

Different Types of REITs

- REITs vary depending on the class of real estate properties they invest in
  - Examples;Z REsidential REITs, multi-family REITs, retail or grocery store-centered REITs, healthcare REITs, and industrial REITs

- Investments in public REITs are publicly traded while private REITs can only be invested by “accredited investors”, as in:
  - The investor who earns $200,000 a year or has a combined income with their spouse of $300,000
  - The investor with net assets of $5 million or more
  - The investor who is a qualified financial advisor

- Investors of private REITs can request redemptions, but it’s not guaranteed
  - Because private REITs are not exposed to the volatility of a public market, the net asset value of private REITs generally represent the value of its properties
  - Also, private REITs provide more niche exposure e.g. higher quality student housing

Operational Structure and Accounting Challenges for REITs

Common Operating Structures of REITs

Standalone REITs
(direct investment in properties)

Tiered REITs
(Invested in other REITs or it enters into joint ventures or other relationships)

Operational Structure and Accounting Challenges for REITs

Accounting Challenges for REITs

Acquisition Transactions

Is it an acquisition of assets or a business? (IFRS 3)

Accounting for goodwill

Disposal Transactions

Determining recapture from tax perspective

Refinancing

IFRS 9 considerations on loan modifications

Accounting for debt issuance costs

Property Valuations

Properties are typically valued on an annual basis by qualified appraisers

IAS 40 considerations for properties

This slide deck is a supplemental tool for the **Real Estate Series #5 - Introduction to Canadian REITs** podcast episode available exclusively on the LumiQ platform.

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Operational Structure and Accounting Challenges for REITs

Financial Reporting Considerations for REITs

- For the issued securities of REITs, need to work with auditors on whether they are to be classified as equity or liability in accordance with IAS 32

- In terms of recordkeeping of shareholding, REITs use third party administrators
  - The finance or accounting function within a REIT should have controls over monitoring of the recordkeeping done by third party administrators
  - This is important as the continuity schedule for shareholding in dollars or number of units need to be disclosed in the audited financial statements

- In addition to audited financial statements, public REITs also issue MD&A
  - Metrics disclosed in the MD&A include property metrics, debt metrics, and funds from operations metrics that are defined by REALPAC

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"... Most people are not able to buy an entire shopping plaza or an office building, and this is a great way for you to have a piece of that action and benefit from the distributions, dividends, and the capital appreciation that real estate provides and not take on the leverage."

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