Update Edition

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REITS CONTINUE COMEBACK

By Gordon Pape, Editor and Publisher

Real estate investment trusts should be taking a beating right now. They're interest-sensitive securities, which means when rates rise, they should fall in value.

In fact, they followed that rule early in the year, as the S&P/TSX Capped REIT Index dropped to below 156 in March. But since then the sector has been on a roll, with the index closing on July 6 at just over 172. That's a gain of about 10% at a time when we would normally expect to see a loss.

Why the turnaround? Interest rates are still moving up, after all. There appear to be two main factors driving this recovery, and both relate to the expanding global trade war. The first is that REITs are relatively immune to trade battles (although not to the economic fallout if the end result is recession). The second is that investors appear to be increasingly concerned that the impact on global trade may result in reduced GDP growth and slow, if not reverse, the interest rate trend.

Whatever the reason, the net result is that REIT investors are experiencing a much better year than originally anticipated. Most of our REIT recommendations are showing positive year to date results, with some outpacing the overall sector by a considerable margin.

One of these is Dream Global REIT (TSX: DRG.UN), which invests in commercial properties in Europe, mainly in Germany and the Netherlands. It continues to expand its operations, having recently announced the acquisition of 135 office and light industrial properties in the Netherlands for a price of $903 million. Management says the deal will immediately add 10% to the REIT's funds from operations.

About a year ago at this time, Dream Global was trading at $10.16 per unit. It closed on July 6 at $14.45, for a gain of 42% over that period. It pays a monthly distribution of $0.0666 per unit to yield (about $0.80 per year) to yield 5.5%.

We also saw a nice gain from Northview Apartment REIT (TSX: NVU.UN). It was trading below $21 at this time last year; it closed on July 6 at $26.70. The REIT pays $0.1358 per month (about $1.63 per year) to yield 6.1%.

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Most REITs have not raised their payouts this year but there are a few exceptions. One is Allied Properties REIT (TSX: AP.UN), which implemented a 2% increase at the end of 2017 to bring the monthly distribution to $0.13 a unit ($1.56 per year). It currently trades at $42.04 to yield 3.7%.

Several of our REIT picks have been taken over or merged in recent years including Milestone Apartments REIT, Pure Industrial REIT, and Canadian Real Estate Investment Trust. We also advised selling RioCan REIT in July 2016 at $28.88, which turned out to be a good call as it is now trading in the $24.70 range.

As a result of all this activity, our REIT list has become somewhat depleted so today we are adding a new entry. See below for details.

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TOP PICKS

Here is our Top Pick for this month. Prices are as of the close of trading on July 6.

Summit Industrial Income REIT (TSX: SMU.UN, OTC: SMMCF)

Type: Real estate investment trust
Trading symbol: SMU.UN, SMMCF
Exchange: TSX, Over-the-counter
Current price: C$8.84, US$6.76
Entry level: Current price
Annual payout: $0.516
Yield: 5.8%
Risk Rating: Moderate risk
Recommended by: Gordon Pape
Website: www.summitIIreit.com

The business: This REIT invests in a portfolio of light industrial properties. It has a few assets in the West and one in the Maritimes, but the prime focus is on Ontario and Quebec. As of the end of March, the REIT owned 84 income producing properties totaling 8.9 million square feet of gross leasable area.

The security: Technically, a REIT is an open ended mutual fund trust. Monthly payments are in the form of distributions, not dividends, so are subject to a different tax treatment (more on this below).

Why we like it: The REIT has been on a steady upward trend for the past 18 months. Payouts are steady, with an occasional bonus thrown in, and the 5.8% yield is attractive

Financial highlights: First-quarter results showed strong growth, due mainly to acquisitions and high occupancy rates. Funds from operations (FFO), the primary measure of financial health for REITs, increased 75.7% to $9.7 million compared to $5.5 million for the same period in 2017. On a per unit basis that worked out to $0.145 compared to $0.138 a year ago. The average number of units outstanding increased to 67.2 million from 40 million as the REIT issued new shares to raise money to fund acquisitions.

Net operating income (NOI), another key measure of a REIT's performance. Summit's improved to $14.8 million ($0.395 per unit) from $8.5 million ($0.155 per unit) last year.

The company has been actively acquiring new properties. The latest deal, announced in June, was for five warehouse and logistics properties located in Markham, Burlington, and Calgary, at a total cost of $127 million. Together, these properties total 798,673 square feet of gross leasable area.

"Our record portfolio growth in 2017 generated a significant and accretive increase in our key financial and operating benchmarks compared to last year's first quarter," commented CEO Paul Dykeman. "Looking ahead, the contribution from our 2017 acquisitions will continue to enhance our results this year, augmented by ongoing strong organic growth and further accretive acquisitions."

Risks: Although they have not been significantly impacted to date, REITs are sensitive to rising interest rates for two reasons: they are heavily leverage (that's the nature of the business) and higher returns on safe government bonds puts downward pressure on the unit price. Another risk to consider is a recession, which could result in lease defaults, lower occupancy rates, and impact the trust's ability to raise rents.

Distribution policy: Payments are normally made monthly and are currently running at $0.043 per unit. In addition, the REIT made a special distribution of $0.018 per unit in May.

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Tax implications: In 2017, all the distributions were classified as return of capital. That means they are not taxed in a non-registered account, but the amount of the payment is deducted from the cost base, which increases the capital gain when the unit is sold. For example, if you paid $8 for your units last year, you would deduct the total distribution of $0.516 from that amount, giving you an adjusted cost base for tax purposes of $7.484.

Who it's for: This REIT is suitable for investors who are willing to accept a moderate amount of risk in exchange for an above-average yield.

How to buy: The units trade on the TSX with daily volume in excess of 100,000 so you should have no problem being filled. U.S. investors who do not have TSX access will have to buy in the over-the-counter market, where the daily volume is very small. Place a limit order and be patient.

Summing up: This REIT is not well-known, but it is focused on an area of high demand and the track record suggests strong management. It is aggressively expanding its portfolio and the market performance in recent months has been very positive.

Action now: Buy.

GORDON PAPE'S UPDATES

Enbridge Inc. (TSX, NYSE: ENB)

Type: Common stock
Trading symbols: ENB
Exchanges: TSX, NYSE
Current price: C$46.69, US$35.61
Originally recommended: Sept. 21/06 at C$19.58
Annual payout: $2.68
Yield: 5.7%
Risk: Moderate
Recommended by: Tom Slee
Updated by: Gordon Pape
Website: www.enbridge.com

Comments: Enbridge announced on July 4 that it is selling 19 natural gas processing plants and liquids handling facilities, with a total operating capacity of 3.3 Bcf/d (billion cubic feet per day) and 3,550 km of natural gas gathering pipelines. These are located in the Montney, Peace River Arch, Horn River, and Liard basins in British Columbia and Alberta. The sale price is $4.31 billion, and the buyer is a group headed by Brookfield Infrastructure Partnership (TSX: BIP.UN, NYSE: BIP), which is updated below.

The company received more good news last week with the announcement that its Line 3 replacement project has been ratified by the Minnesota Public Utilities Commission, which also approved most of the company's preferred route. Line 3 is a major part of Enbridge's development plan and rejection would have dealt a major blow to future growth. The company is aiming to have the replacement line in service by the second half of 2019.

Action now: Buy. The share price is up about 25% since the April low and should continue to gradually move higher in the coming months. The yield has dropped from 7.2% at the low to 5.7% now. That suggests investors are regaining confidence in the stock.

Brookfield Infrastructure Limited Partnership (TSX: BIP.UN, NYSE: BIP)

Type: Limited partnership
Trading symbols: BIP.UN, BIP
Exchanges: TSX, NYSE
Current price: C$53.31, US$40.70
Originally recommended: Sept. 15/10 at C$12.60, US$12.25 (split-adjusted)
Annual payout: US$1.88
Yield: 4.6%
Risk rating: Moderate
Recommended by: Gordon Pape
Website: www.brookfieldinfrastructure.com

Comments: The report of the Enbridge deal triggered a positive reaction from Brookfield Infrastructure investors. The share price jumped $3.28 (6.5%) between July 3 and July 5, before pulling back a little.

BIP's equity commitment towards this investment will be about $500 million, representing an approximate 30% stake. It will be funded by available liquidity; no new shares will be issued.

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"This investment represents an exciting opportunity to invest in scale in one of North America's leading gas gathering and processing businesses based in Western Canada," said CEO Sam Pollock. "The business is strategically positioned for the continued development of the prolific Montney Basin. Cash flows from the business are anchored by a firm contract profile with a weighted average life of 10 years."

The deal is expected to close in two phases. The facilities that are subject to provincial regulation are expected to close in 2018 and those subject to federal regulation are anticipated to close in mid-2019.

Brookfield's first-quarter results were positive. Net income came in at $209 million ($0.42 per unit) compared with a loss of $16 million ($0.03 per unit) the year before. (Brookfield reports in U.S. dollars.) However, the first-quarter profit was entirely attributable to the gain from the sale of the partnership's interest in Transelec, a Chilean electricity transmission business.

The more relevant number was a 28% increase in funds from operations (FFO) to $333 million ($0.85 per unit) from $261 million ($0.71 per unit) in 2017.

Brookfield increased its quarterly distribution by 8% at the start of the year, to $0.47 per quarter ($1.88 per year).

Action now: Hold. Brookfield is performing well but trade wars and rising interest rates are headwinds.

Chorus Aviation Inc. (TSX: CHR, OTC: CHRRF)

Type: Common stock
Trading symbols: CHR, CHRVF
Exchanges: TSX, Grey Market
Current price: C$7.12, US$5.49
Originally recommended: May 26/16 at C$6.33, US$4.86
Annual payout: $0.48
Yield: 6.7%
Risk: Higher risk
Recommended by: Gordon Pape
Website: www.chorusaviation.ca

Comments: Chorus is an aviation holding company headquartered in Halifax. Chorus has been leasing regional aircraft to Jazz's Air Canada Express operation since 2009. The company established Chorus Aviation Capital Corp. as a global provider of regional aircraft leases and support services. Chorus also owns Jazz Aviation and Voyageur Aviation, based in North Bay.

The stock hit an all-time high of $9.86 in mid-January, but the shares turned down after the company completed a new equity issue in March of about 13 million shares at a price of $8.60. The stock dilution was not well received by investors, who pushed the price as low as $6.77 in mid-June. It has staged a modest rally since then.

First-quarter results were positive. Chorus reported operating revenue of almost $348 million, up 8.7% from the same period in 2017. Adjusted net income was $26.5 million ($0.21 per share). Chorus pays a monthly dividend of $0.04 per share ($0.48 per year) and that appears to be sustainable based on the financial returns.

Action now: Hold. The stock appears to have recovered from its sell-off and is yielding an attractive 6.6%. However, aviation is a cyclical business, which makes this a higher-risk asset.

YOUR QUESTIONS

Yield curve

Q – Should we be concerned about the flattening yield curve re U.S. Treasuries and, if so, what action would you recommend, especially with the apparent trade conflicts? – Ed P.

A – A flattening yield curve (the difference in yields between short and longer-term bonds) is something to keep an eye on but not a cause for immediate concern. If the curve becomes inverted (short-term bond yields are higher than long-term ones) that's usually a signal that a recession is looming.

As for trade conflicts, they have the potential to disrupt world commerce significantly and Canada is in the cross-hairs. Remember, President Trump has pledged that Canadians will pay dearly because he feels Prime Minister Trudeau insulted him. He's not going to forget that. Defensive actions include taking profits, raising cash, and avoiding stocks in companies that are highly export oriented. – G.P.