DBRS Canada Newsletter
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CANADIAN REITs EMERGE FROM DOWNTURN RELATIVELY UNSCATHED

DBRS maintains a stable outlook on the Canadian real estate sector following the release of Q2 2010 results. The stable outlook largely reflects the sector's overall liquidity position, continued access to favourably priced capital, stabilizing operating metrics and, in some cases, resumption of portfolio growth through property acquisitions. For the most part, same-portfolio net operating income (NOI) growth for the sector appears to have stabilized and, particularly for retail real estate investment trusts (REITs) and real estate operating companies (REOCs), have shown improvement from the lows posted over the last several quarters.

Overall occupancy levels in the sector have held up relatively well over the course of the current downturn and are generally in the mid- to high 90% range. Going forward, REITs and REOCs should experience modest recovery in property-level cash flow growth as economic conditions show further signs of recovery and as future job creation takes hold and translates into demand for space. However, the recovery may vary depending on the market and segment; for example, office and industrial, which have supply imbalances and higher sublet space, will likely be slower to recover and more challenging.

The Canadian real estate sector continues to benefit from remarkably low interest rates on five-year and ten-year mortgages. For example, current spreads on five-year mortgages are in the 180 basis points (bps) range and on ten-year mortgages, in the 200 bps range. In addition, investment-grade issuers continue to have good access to the public debt markets, with recent issuances producing spreads in the 200 bps to 215 bps range, a significant improvement from 2009, when we saw deals done in the 450 bps to 500 bps range.

In the near term, the low interest rate environment should continue to translate into further interest expense savings as REITs and REOCs refinance higher-cost, older debt with lower-cost, new debt. Debt maturities for the sector are fairly modest in the near term and predominately consist of maturing mortgages. In addition, the sector's next senior unsecured debenture does not come due until Q1 2011. Overall, the liquidity position of Canadian REITs and REOCs remains at an appropriate level and any refinancing and interest rate risk is mitigated by the conservative loan-to-value ratios on maturing debt and good access to the debt and equity markets.

The stable outlook also takes into consideration that Canadian REITs and REOCs will begin to restore their EBITDA interest coverage and balance sheet ratios to levels that are more consistent with their respective rating categories. Generally, higher debt levels and negative property-level cash flow growth have put downward pressure on EBITDA interest coverage levels over the past couple of years. Fortunately, the low interest rate environment has afforded the opportunity to moderate EBITDA interest coverage deterioration with the refinancing of higher-cost, older debt with new debt at lower interest rates.

Q2 2010 Highlights

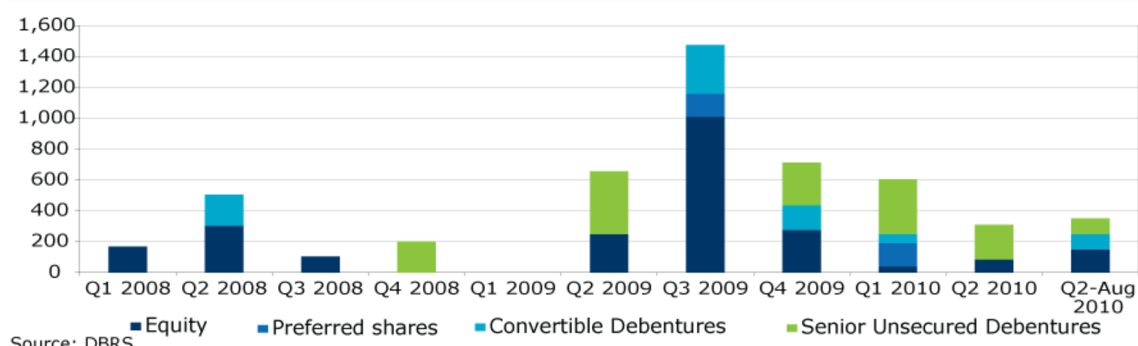
- On June 7, 2010, DBRS upgraded the debt and stability ratings of Canadian Real Estate Investment Trust (CREIT) to BBB and STA-3 (high) from BBB (low) and STA-3 (middle), respectively.
- Favourable credit conditions have resulted in spreads on mortgages and senior unsecured debt tightening significantly over the last year.
- Capital markets have proven highly accessible for Canadian REITs and REOCs.
- Occupancy levels for the sector remain solid, in the mid- to high 90% range.
- The retail segment has seen modest same-portfolio NOI growth.

Canadian REIT and REOC Expansion Plans outside Canada

A majority of Canadian REITs and REOCs have portfolios entirely focused in Canada and have achieved growth by acquiring and developing assets domestically. However, several REITs and REOCs, particularly RioCan Real Estate Investment Trust, have more recently displayed a greater interest in acquiring properties in the United States. Higher property valuations and low capitalization rates on domestic properties have been the main drivers that have prompted REITs and REOCs to seek investment opportunities outside Canada. For example, capitalization rates on a domestic grocery-anchored retail property are in the 6.5% to 7.0% range; a similar property in the United States has capitalization rates in the 7.5% to 8.0% range. In addition, many of the high-quality properties that are available in the United States are owned by financially stressed operators, unlike in Canada, where operators are far less financially stressed and, therefore, there are fewer investment opportunities at reasonable valuations.

Overall, Canadian REITs and REOCs are well positioned to take advantage of investment opportunities in the United States, with access to attractively priced capital markets and financial flexibility. This theme should continue to unfold over the next year or so. Although there are inherent risks associated with entering into new markets, measured growth with local scale and/or forming partnerships with experienced operators would be an acceptable approach from a credit risk perspective.

Financing Acitivity of DBRS-Rated REITs and REOCs, Q1 2008 to August 2010



Source: DBRS.

Starting in Q2 2009, Canadian REITs and REOCs have made good progress in improving their balance sheet flexibility and liquidity positions through a flurry of financing activity. As illustrated in the chart above, REITs and REOCs were fairly active in Q3 2009 and into 2010, with debt (senior unsecured debentures and convertible debentures) and equity (common shares, trust units and preferred shares) issuances, following several quarters of minimal or no activity. This can be attributed to several factors:

- Unthawing of the credit markets with the return of the investor class.
- Indications of a global economic recovery.
- Solid underlying quality of real estate portfolios.
- Comparatively good operating fundamentals and financial flexibility for the sector.

Canadian REITs and REOCs continue to have good access to conventional mortgages that, as previously discussed, still offer attractive rates. While conventional mortgages are not included in the above chart, this type of debt remains a key component of the capital structure of REITs and REOCs (accounting for approximately 80% of total debt outstanding as at Q2 2010) and is the primary source of debt for real estate entities in Canada. Going forward, REITs and REOCs can be expected to deploy their capital in property acquisitions and, to a lesser extent, in development projects. However, a return of meaningful development activity will not likely occur until the overall economic picture improves and tenant demand resurfaces.

DBRS has just published *Mid-Year Review: Canadian Real Estate, Q2 2010*, the 12th issue of its quarterly real estate study, which is available by contacting us at info@dbrs.com. For more information, please contact Mark Newman, mnewman@dbrs.com.

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