GRANT'S
INTEREST RATE OBSERVER®

Vol. 35, No. 22b Two Wall Street, New York, New York 10005 • www.grantspub.com NOVEMBER 17, 2017

About that dividend

On Monday, General Electric Co. halved its quarterly dividend, surprising few longtime *Grant's* readers (we virtually predicted it in, let's see, 1990—see the issue dated Nov. 3). "We are focused on driving total shareholder return and believe this is the right decision to align our dividend payout to cash flow generation," said chairman and CEO John Flannery in the accompanying press release. Which is to say, GE had previously not covered its dividend.

Desperately seeking income, people have reached for risk in the course of grasping for basis points. Corporate managements, heeding their cries (or watching their own stock options), have leveraged assets with low-cost debt to generate higher, if more precarious, dividends. And when the pretense stops? GE may provide a template. In the wake of Monday's announcement, shares in Thomas A. Edison's old lightbulb business had fallen by 43% in the year to date.

Paying out more than you operationally take in is more than a General Electric problem—more, in fact, than an American problem. Some Canadian real-estate investment trusts routinely distribute more than they earn, funding the deficit by borrowing and/or issuing equity. Our old friend Canadian Apartment Properties REIT is one such offender (CAR-U in Toronto; *Grant's*, May 20, 2016). In preview, we bring new evidence to bear in support of our thesis that CAPREIT's wheels are starting to wobble.

CAPREIT is the largest residential landlord in Canada with 42,055 apartment units and 6,455 lease sites for manufactured homes. The real estate might be charitably described as vintage: Last year, before he died, Thomas Schwartz, the company's founder, told *Grant's* that the average building is between 40 and 50 years old. Those were the Canadian buildings. Starting in the fourth quarter of 2016, CAPREIT turned its attentions to the Netherlands; today it owns 1,548 Dutch apartments. As of Sept. 30, the average monthly rent for a CAPREIT flat came to C$1,127 ($884), slightly higher than the C$962 Canadian national average.

"Real-estate investors speak their own language," as colleague Evan Lorenz observes. "REIT earnings are expressed in terms of funds from operations (FFO), i.e., net income plus depreciation, less the sum of dividends on preferred shares and net gains on property sales. While REITs must pay out at least 90% of net income each quarter, the sustainability of dividends is reckoned against adjusted funds from operations (AFFO), which is FFO minus maintenance capital expenditures.

"CAPREIT and its peers justify payout ratios well in excess of free cash flow," Lorenz goes on. "They do it by underestimating maintenance spending and thus boosting AFFO. So, in its 2016 annual report, CAPREIT stated that maintenance outlays totaled C$450 per apartment—it was a plug number, Schwartz told me last year. Using this figure, the dividend amounted to 75% of AFFO. In reality, the company spent C$4,158.23 per unit—old buildings need more love. Had CAPREIT used actual capital expenditures, rather than its lowball estimate, the dividend would be seen as representing 411% of AFFO.

"So," Lorenz proceeds, "while free cash flow only amounted to C$54.8 million in 2016, CAPREIT paid C$109.4 million in cash dividends and made C$387.7 million worth of acquisitions. New debt in the sum of C$254.9 million and new equity in the sum of C$161.9 million furnished the wherewithal. As of Sept. 30, CAPREIT's net debt totaled 10.7 times trailing earnings before interest, taxes,

Canadian Apartment Properties REIT
all figures in C$ millions unless otherwise indicated

	YTD thru 3Q17	Less 3Q17	Implied first half from 3Q17 report	First half from 2Q17 report
Cash provided by operating activities	C$250.4	C$105.5	C$145.0	C$114.0
Changes in working capital	(16.6)	12.4	(29.0)	(60.0)
Maintenance capex	42.4	14.3	28.1	23.9
ACFO (3Q17 definition)	127.2	63.9	63.3	36.5
Dividend declared	131.5	44.3	87.3	87.3
ACFO payout ratio (%)	103.4%	69.3%	137.8%	238.9%

source: company reports

depreciation and amortization. Unrated, the company is largely funded by insured mortgages. The mortgages are underwritten by the Canada Mortgage and Housing Corp., the Fannie Mae or Freddie Mac of the North. (Not a little like the Fannie Mae of yore, CMHC is straining on the leash of leverage. On June 30, the agency showed C$496 billion of insurance in force against C$17.5 billion in equity, a ratio of 28.4 times risk to equity.)"

The Ontario Securities Commission (OSC), Canada's SEC, began asking REITs about the sustainability of their dividend payout ratios last year. In response, the Canadian real-estate industry has come up with definitive calculations for AFFO. And it's created a new accounting metric, too: adjusted cash flow from operations (ACFO). Importantly, both measures require the use of actual, rather than estimated, maintenance outlays.

"CAPREIT, in its first quarter results, opted for the ACFO approach," Lorenz notes. "While the ACFO calculation entails 15 adjustments, there are three, especially, to mark. Each is a deduction from cash flows from operations. They are: changes to working capital; interest expense included in cash flows from financing; and maintenance capex. Under the new approach, CAPREIT tripled its 2016 estimate of maintenance spending to C$1,251 per unit, which yielded a dividend payout ratio of 99.9% for the year. Voila: ACFO conveniently just covered its payout."

Lorenz continues:

"The company's adherence to the REALpac-defined ACFO was short lived, however. In the third quarter, CAPREIT stopped adjusting ACFO for changes in working capital. I surmise (no help from the company) that the reason was simple: In the first half of the year, a buildup in working capital allowed the addition of C$60 million to ACFO. In the third quarter, working capital fell by C$12.4 million. Based on the bespoke ACFO calculation, the ACFO payout ratio was 69.3% in the third quarter and 103.4% in the first nine months.

"But there appears to be more going on below the surface of this change. Subtract third quarter ACFO of C$63.9 million from the year-to-date total of C$127.2 million and you get C$63.3 million in ACFO for the first half of 2017. But, in the second quarter report, CAPREIT announced that ACFO was C$96.5 million in the first six months and that the increase in working capital was the aforementioned C$60 million. In other words, under the new definition, ACFO in the first half was C$36.5 million. The figures from the second- and third-quarter reports don't match up.

"In digging through the numbers, it appears that CAPREIT effectively issued a restatement for the first half of the year without issuing a formal restatement. The third-quarter report implied that cash flows from operations, maintenance capex and the buildup in working capital were, respectively, C$31 million higher, C$6.3 million higher, and C$31 million lower in the first six months of the year than what was reported in the second-quarter report. We called and emailed to ask why the numbers were changed. Radio silence.

"Perhaps the regulators will take an interest. 'Recent reviews of real-estate investment trusts (REITs) in Ontario have resulted in important disclosure improvements in this area, although inconsistencies remain in how these non-GAAP financial measures are presented…,' the OSC wrote in its Sept. 21 corporate-finance-themed annual report. 'As distribution sustainability is of key importance to an REIT, issuers should adequately disclose the sources of cash flow for distributions in a particular period, the impact to the REIT and its ability to sustain distributions over the longer term.' CAPREIT released its third quarter report on Nov. 6, a month-and-a-half after the OSC report."

Our May 2016 analysis of CAPREIT concluded as follows: "If you asked us to identify the catalyst for a dividend cut, we would reply, 'arithmetic.' If you asked us to forecast the date of a future CAPREIT press release to announce that bearish event, we would have to shrug." We now judge, a little less inexactly, that the date for a prospective dividend cut may be sooner rather than later.

Management, in deeds if not words, seems almost to agree. Thus, over the last 12 months, insiders sold a net 264,620 shares for proceeds of C$8.9 million. Nevertheless, the stock is priced to yield 3.5% and is well-loved by Bay Street, with eight analysts rating it a buy and four a hold. "Hold on tight," we would venture to correct the latter four.

•