GRANT'S

INTEREST RATE OBSERVER®

Vol. 34, No. 10c | Two Wall Street, New York, New York 10005 • www.grantspub.com | MAY 20, 2016

Yield from hunger

Canadian Apartment Properties Real Estate Investment Trust (CAR-U on the Toronto Exchange) is a dividend aristocrat of the North. The fifth-largest listed REIT in Canada by market cap (C$3.9 billion) and the largest apartment REIT in the country by a mile, CAPREIT is priced to deliver a 3.9% yield to its income-famished stockholders. We are about to contend that the payout is unsustainable.

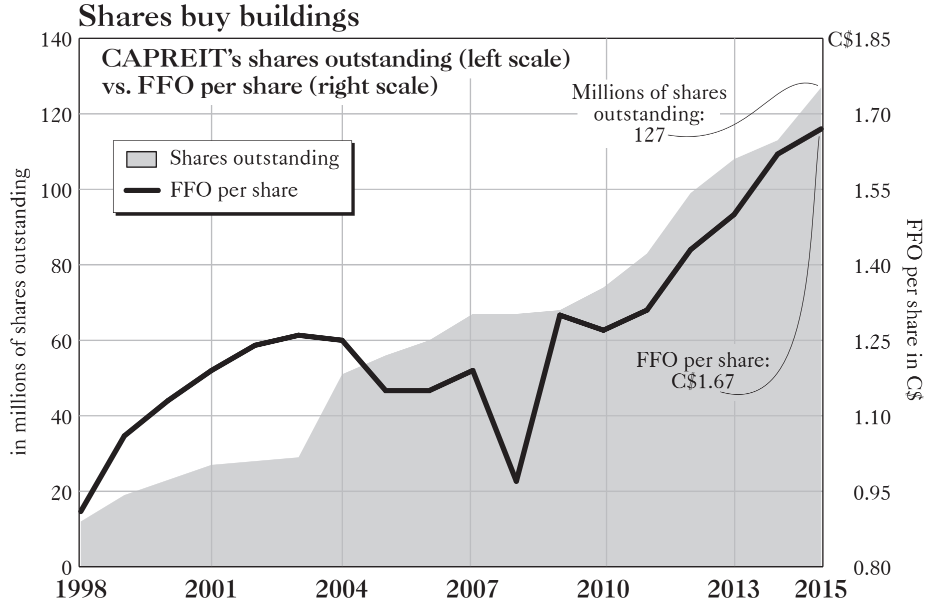
The previous issue of *Grant's* shone a spotlight on SL Green Realty Corp. (SLG on the Big Board), the big New York City office REIT. To finance its dividend, we observed, Green relies on selling buildings as much it does on deriving revenue from operating them. CAPREIT, by contrast, absolutely does not fund its dividend with cash from operations. Neither does it peel off properties to sell. To plumb the mystery of how it does what it does is what set us to writing.

CAPREIT is in its 19th year of operations under its founding CEO, Thomas Schwartz. It owns and manages 41,177 apartments in older buildings, mostly in Ontario, Quebec and British Columbia, from which it derived 95% of first-quarter operating revenues; manufactured housing sites, chiefly in Ontario and New Brunswick, chipped in the balance. CAPREIT's middle-class apartment dwellers pay an average monthly rent of C$1,065, slightly higher than the national average of C$939.

Schwartz's pride and joy has grown and grown. "When we started," the CEO tells colleague Evan Lorenz, "we were Canada's first apartment REIT and there was a lot of skepticism about whether you could build an apartment REIT in Canada. It was drilled into my head that our mission was to build a steady stream of cash flows for our shareholders. Our total return in the 18 years we've been public is 1,034% versus a TSX REIT index of 601%. We've done exactly that, and we've done better than anyone could have ever dreamt. We've done it with a pretty straightforward formula. We have a simple mission, and we pursue that mission, and it works. We care about our tenants. We treat our tenants like customers. Our goal is to have the best buildings in all our markets. It helps us to attract the best tenants. We certainly have the best staff, and we've built a stellar team. That allows us to collect the highest rents and give off a growing stream of cash flow to shareholders."

From a standing start of 1,286 units in 1997, CAPREIT has burgeoned to 47,476 units (apartments plus manufactured housing sites). In that first year of public ownership, the company generated C$5.4 million in funds from operations; FFO, a mainstay term of art in the REIT world, is defined as net income plus depreciation, less dividends on preferred shares and less net gains on property sales. In the 12 months ended March 31, FFO weighed in at C$208.6 million. That's a 23% compound annual rate of growth.

Shares buy buildings



source: The Bloomberg

There is no such growth bonanza in FFO per share. Since 1998, the per-share FFO metric has compounded not by 23% but by 3.4%. Over those 18 years, the share count has climbed to 129.4 million from 12 million, or by 975%. It has jumped by 14.4% in the past 12 months alone. As might be surmised, the stock does double duty as a company-issued currency; Schwartz uses it to buy buildings.

Debt, nearly all of it mortgage debt, likewise figures in the CAPREIT growth saga. At March 31, the company showed C$3.3 billion in borrowings, of which 91% were insured by Canada's national mortgage guarantor. Tiny interest rates facilitate leverage on the order of 10.2 times debt to trailing EBITDA. In the first quarter, CAPREIT paid an effective borrowing cost of 3.5% on its net debt outstanding.

Valued at 19.5 times trailing FFO per share (vs. 15.7 times for its Canadian comps) and priced to yield the aforementioned 3.9% (vs. 4.5% for the field), CAPREIT stands apart in many ways, including the ingenuity of its accountants. It's their pencil-pushing that makes the dividend possible.

REITs pay out dividends from what is known as available funds from operations, which is defined as FFO minus maintenance capital expenditures. In the first quarter, FFO came to C$52.3 million and maintenance capital expenditures to C$4.5 million. Subtract the latter from the former, and you get C$47.9 million; add back C$1.2 million in amortized share-based compensation, a noncash charge, and you get AFFO: C$49 million.

On the face of things, C$49 million would seem more than adequate to cover the C$39.6 million in dividends declared, especially since one-third of the shareholders opt for payment in kind—new shares—rather than cash. Just C$26.6 million in cash went out the door to pay the first-quarter dividend.

It's below the surface that the plot thickens. AFFO is a defined term—FFO minus maintenance capex—and management decides how to define it, specifically how to apportion overall capital spending between maintenance and investment. Schwartz has presided over a long-running reduction in identified maintenance outlays. They amounted to 21% of overall capex in 2008, 15% in 2010 and 9% in 2015.

Roof repair is maintenance capex; renovating a kitchen is investment. Because CAPREIT is on a growth spurt, some analysts say that investment capex is necessarily outgrowing maintenance capex. If growth stopped, the argument goes, the accounting would take on a more conventional cast.

We have our doubts about that. "If CAPREIT were investing as much in growth as the sell side believes," observes colleague Evan Lorenz, "you would expect the company to be generating higher-than-nationwide rental growth. It does not. In 2015, rents in the stabilized portion of the CAPREIT portfolios rose by 1.7% vs. average growth across Canada of 2.6% and growth within Ontario of 3.2%. Here is indicative—albeit inconclusive—evidence that much of CAPREIT's capital expenditures are earmarked for maintenance, not growth."

There are other clues that point in the same direction. Thus, Boardwalk Real Estate Investment Trust (BEI-U), a CAPREIT peer, has bumped up its estimated maintenance spending to C$525 per unit in the first quarter 2016 from C$425 per unit in 2007. CAPREIT, by way of contrast, has used the same yearly maintenance estimate—C$450 per suite per year—since 2007.

"I am a real-estate guy," Schwartz tells Lorenz in response to these facts. "This is my first experience with public companies. I still think like a real-estate guy, and real-estate guys think about buildings and cash. The number you are throwing around—the C$450 per unit per year—we give that out because the market wants it from us because it is the average in the industry. The reality is we don't even look at it, and it has nothing to do with the day-to-day business. We look at it as: How much capital does a building need when we buy it? Did we anticipate it properly? Do we have the money to pay for it? Is the building still accretive after we spend the capital?

"If we stop making acquisitions that capex would run off very quickly in 5 to 6 years, and it would probably be that number you quoted," Schwartz continued, "that C$450 per unit per year. The bulk of our capex is driven by the heavy acquisition program."

It has not worked in just that way

Canadian Apartment Properties REIT
All figures in C$ millions

	2008	2009	2010	2011	2012	2013	2014	2015
Cash flow from operations	86.1	76.0	175.7	189.0	228.6	260.3	284.0	292.8
"Maintenance" capex	(11.7)	(11.9)	(11.8)	(12.3)	(13.8)	(15.1)	(15.5)	(16.3)
Free cash flow per CAPREIT	74.4	64.1	163.9	176.7	214.8	245.2	268.5	276.5
Cash flow from operations	86.1	76.0	175.7	189.0	228.6	260.3	284.0	292.8
Actual capex	(55.5)	(86.7)	(78.4)	(117.3)	(131.3)	(158.4)	(164.9)	(174.0)
Interest expense			(82.9)	(83.1)	(88.7)	(94.9)	(98.1)	(100.5)
Free cash flow per *Grant's*	30.5	(10.6)	14.4	(11.5)	8.6	7.0	21.0	18.3
Distribution declared	72.8	73.8	75.5	86.1	101.2	119.3	131.0	146.2
FCF per CAPREIT less distribution	1.6	(9.7)	88.4	90.6	113.6	125.9	137.5	130.3
FCF per *Grant's* less distribution	(42.2)	(84.4)	(61.1)	(97.5)	(92.6)	(112.2)	(110.1)	(127.9)

sources: company reports, the Bloomberg

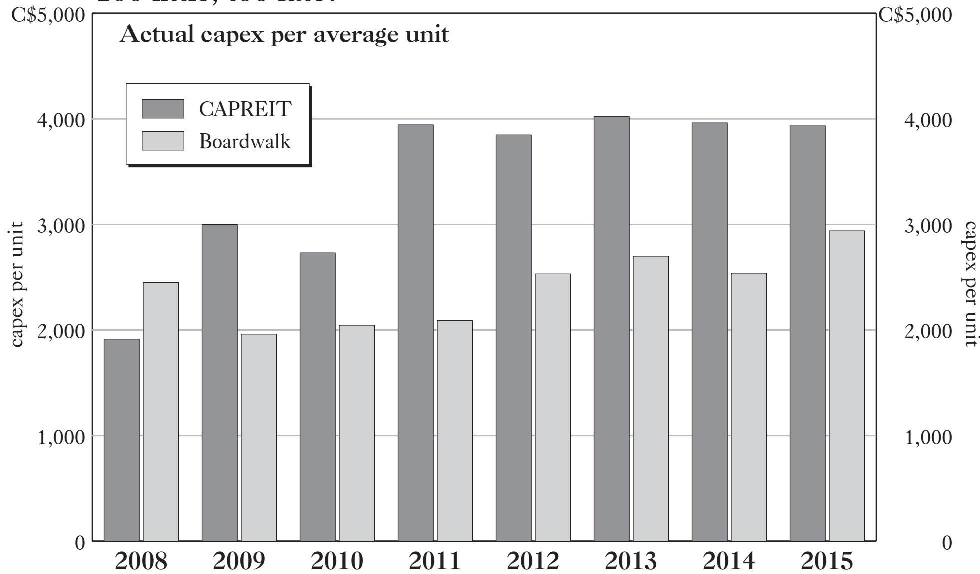
for Boardwalk. A seller, not a buyer, of apartments, Boardwalk has a portfolio, expressed in units, that declined to 32,947 from 35,386 in the past two years. Yet, over the same period, total capex per unit increased to C$2,939.34 from C$2,698.87. Even so, in 2015, Boardwalk deducted just C$500 per unit from its AFFO.

"The market convention of $300–$500 capex per unit is unrealistically low," pronounces Green Street Advisors in a Sept. 30, 2015 report about the U.S. apartment REIT sector (the Canadian dollar equivalent today is C$387–C$645). "Operators know true capex costs are huge, but never speak of them—like a crazy aunt in the basement." Assume, instead, $1,500 per unit per year for U.S. operators, concludes Green Street.

Then, too, the years are no kinder to most buildings than they are to most people. CAPREIT's buildings, according to Schwartz, average between 40 and 50 years of age. Green Street, in the report just cited, prescribes $2,000 per unit per annum in maintenance capital spending for buildings that have passed their 30th birthday. Let's say that the CAPREIT portfolio is age-resistant—an assumption, incidentally, which few of the scathing reviewers of CAPREIT properties on Canadian social media are likely to share. Nevertheless, assume that each apartment requires the Canadian equivalent of just $1,500, or C$1,935, every year. (Last year, CAPREIT spent $3,933.79 per unit, including manufactured housing sites.) In that case, to maintain them, CAPREIT would be spending not C$4.5 million per quarter, but C$19.8 million. (This assumes there are zero dollars in maintenance spending for CAPREIT's 6,299 manufactured housing sites—an assumption it appears CAPREIT uses in calculating its own maintenance capex figures.) And in that case, first-quarter AFFO would have been not C$49 million but C$33.7 million. Compare and contrast the C$39.6 million in dividends actually declared and the C$26.6 million in cash dividends actually paid.

Canada's SEC, the Ontario Securities Commission, issued in January 2015 a blast against financial gamesmanship in the property REIT industry. The regulators warned against the practice of paying dividends in excess of "the cash flows generated by the REIT's underlying real-estate properties."

Too little, too late?



source: company reports

Quoth the regulators: "In practice, a REIT which distributes more cash than it generated in the period from its operating activities may be using financing activities, such as the incurrence of additional debt, in order to provide distributions. Such distributions represent a return of capital, rather than a return on capital, since they ultimately decrease the value of the REIT's remaining net assets and therefore also decrease the value each unit holder will receive when they ultimately dispose of their units. REITs which consistently obtain cash flows from other financing sources aside from operations have a higher risk profile."

Were the authorities thinking of CAPREIT? In the first quarter, our featured subject showed cash flow from operations of C$64.7 million and capital expenditures of C$33.3 million. Subtract the latter from the former, and you get C$31.4 million of free cash flow. Too little to cover dividends declared, but more than enough to cover cash dividends.

Or so it would seem. The catch is that, on the flow-of-funds statement, CAPREIT runs mortgage-interest expense through "cash flows from financing" rather than "cash flows from operations." International Financial Reporting Standards allow for the use of this arithmetic hamburger helper, but only half of Canadian apartment REITs avail themselves of it; Boardwalk does not. Nor did CAPREIT until 2010. If interest expense were subtracted from "cash flows from operations," as we believe it logically should be, first-quarter free cash flow turns out to be not C$31.4 million but C$4.5 million. It's a far cry even from that $26.6 million in cash dividend disbursements.

In 2015, CAPREIT's free cash flow—as we would define it—less dividends declared came in at negative C$127.9 million; free cash flow minus cash dividends disbursed came in at negative C$80.5 million. "Yield-hungry retirees, pension funds and mutual funds have been baited with fabricated adjusted cash flow," says Richard Rubin, founder of the deep-value investment fund Hawkeye Capital Management, who kindly brought the idea to our attention; Hawkeye is short CAPREIT.

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. The regulators might intervene, but Schwartz says he has heard nothing from them. Nor, he says, has he even read the afore-cited 2015 OSC warning. (When Rubin reached the OSC to agitate against CAPREIT's—and, for that matter, Boardwalk's—dividend policies, the regulators told him he had to call back, this time dialing the commission's help line. When he sputtered out, "Why?" they replied, "We have a formal process.")

Neither is the Canada Mortgage and Housing Corporation, CAPREIT's mortgage guarantor, likely to withdraw financing any time soon. The agency restricts the total indebtedness of a borrower like CAPREIT to the greater of 60% of the fair value of its real estate or 70% of the historical cost of that real estate. As of March 31, CAPREIT's borrowings weighed in 45.8% and 55.7%, respectively, of fair value and historical cost. Which is to say, management can keep on doing just what it has been doing.

Management, and the other insiders, have been doing something else. Over the past 12 months, they have sold a net 252,113 shares for proceeds of C$7.1 million. Follow the leaders.

•