How to Pick the Best REIT

Description

It's time to become a virtual landlord! Leave the clogged toilets and the bounced rent cheques to the other guy. As I laid out in part 1 of this series, real estate investment trusts (REITs) are the smarter way to invest in the industry.

Of course, this raises the obvious question: How do you evaluate a trust? Like any sector, there are industry-specific metrics to understand if you want to separate the stars from the duds. Today I'd like to share the top three things you should keep in mind when evaluating a REIT. Along the way I'll use **RioCan REIT** (TSX:REI.UN), Canada's largest REIT, as an example.

AFFO: The only metric that matters
In most industries, net income is a good measure of profitability. But this isn't the case with REITs because of one line item — depreciation. In almost any other business, assets wear out and this must be reflected in the company's financial results. But real estate, in contrast, will rarely lose its value.

When assessing the performance of a REIT, the No. 1 metric professionals use is adjusted funds from operations, or AFFO. This figure is simply net income plus depreciation, less gains from asset sales and less capital expenditures. AFFO is the single best gauge of residual cash flow to unitholders. It's also the best way to determine a trust's ability to finance its debt and pay dividends.

In the case of RioCan, we can use the AFFO to highlight one red flag: the trust is actually paying out more cash to unitholders than it is generating. In 2012, RioCan generated $0.34 per unit in AFFO but paid $0.345 per unit in distributions. That's not a large deficit, but it could limit the firm's ability to raise distributions in the future.

Growth prospects
Next, you want to evaluate the attractiveness of the company's assets. There's no magic metric to turn to in this case. Only a careful analysis of the trust's underlying business.

What are the prospects for rent increases? What are the prospects to improve occupancy rates? Does management have a plan to upgrade its assets? Often, management teams will acquire low-end properties and improve them to attract higher-quality tenants. Better tenants lead to higher occupancy rates, fewer evictions, and higher rents.

You want to have a good sense as to what types of properties the trust owns. Residential? Commercial? Industrial? Where are they located? Vancouver? Toronto? Montreal? A commercial trust in Calgary is exposed to a very different set of risk factors than a residential trust in Halifax. Who are the tenants? Can they pay? It's time to think like a landlord.

You'll also need to be on the lookout for tricks management might use to beef up financial results. Often, executives will delay needed repairs — a shortsighted move that is a really hidden liability.

RioCan is actually well-positioned to grow its AFFO over the next few years. With 350 retail properties across the continent, more than 85% of the company's revenue comes from national and anchor tenants like **Wal-Mart**, **Target**, **Canadian Tire**, and **Staples**. With as much as 45% of leases due for renewal over the next five years, RioCan should be able to pass on some rent increases. That could mean higher distribution payout for unitholders.

Who's running the show?
A simple way to think of a REIT is as a real estate mutual fund. Investors pool their money together and hire a manager to buy, manage, and sell assets. Obviously, the performance of the fund, like any business, will be determined in large part by the people who run it.

When evaluating a trust, you want to closely evaluate the track record of the management team. How much experience do they have? What is their track record?

Equally important is to look at how executives are compensated. You want to make sure management's incentives are aligned with the unitholders. Does the chief executive own many units? If the fund isn't good enough for his or her portfolio, it probably doesn't belong in yours.

One look at the stock chart is probably enough to convince you that Ed Sonshine has done a good job as head of RioCan. Over the past 20 years, RioCan has generated a 15% annualized return. Sonshine is also a highly respected figure in the Canadian real estate industry.

Foolish bottom line
As you can probably tell, investing in REITs comes down to asking the right questions. But the general principle is just like any other stock — find a great company with a good management team and pay a reasonable price.

And while RioCan is one of my favorite names in the space, there are three trusts that present an even better value. I'll discuss those in part 3 of this series tomorrow.

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Disclosure: Robert Baillieul has no positions in any of the stocks mentioned in this article. The Motley Fool owns shares of Staples.

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