Canadian REITs Report
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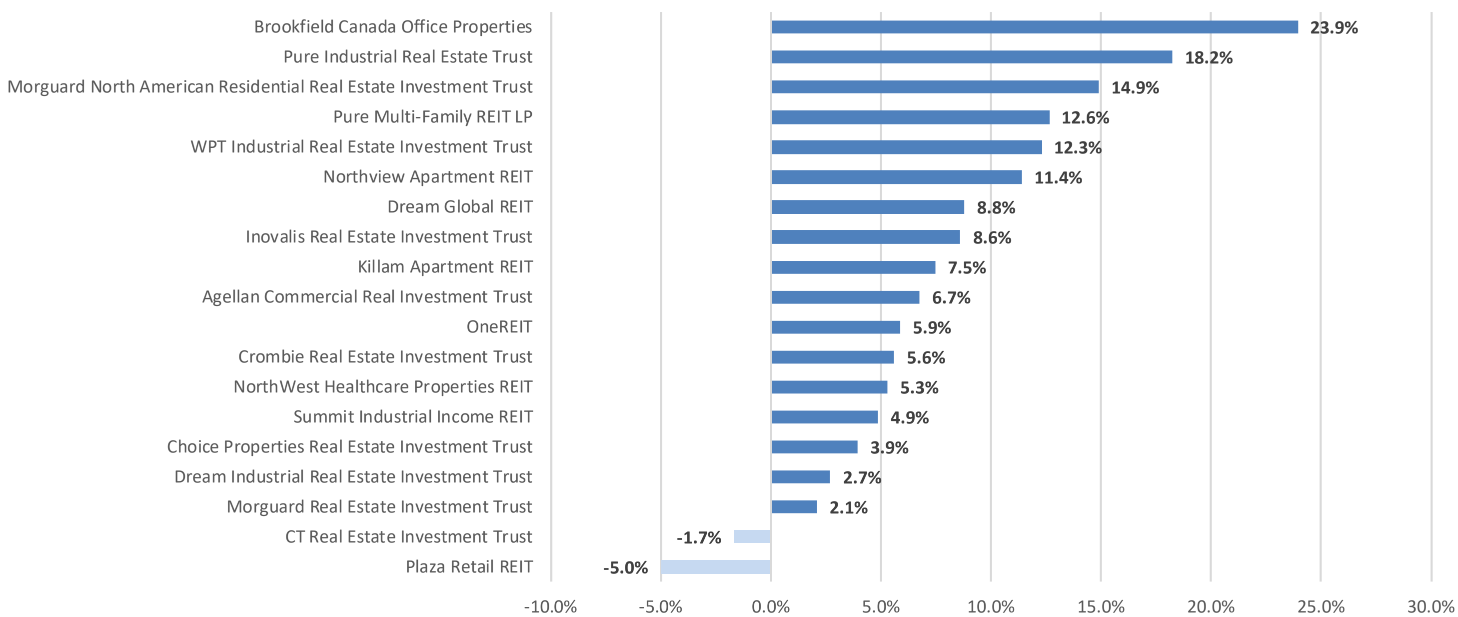
Red Hot Real Estate Industry Sends REITs Soaring, but can the Heat Wave Last?

Canada's Real Estate Industry is performing well right now, as Canadian REITs have outperformed the TSX Y/Y and YTD. Canadian REITs slightly edged past the TSX over the last year returning 16.5% compared to the 16.4% TSX return. More impressively, Canadian REITs YTD return has crushed the TSX, returning 8.4% compared to the 1.9% TSX return. There are 31 REITs listed on Canadian exchanges, comprising a total $40B in market cap. Furthermore, REITs selected for discussion in this report have returned 7.8% YTD.

High demand for and lack of supply for land in Toronto and Vancouver has resulted in price increases for real estate assets, which have greatly benefited REITs with exposure to these markets. Furthermore, investors and Real Estate professionals are cautiously optimistic for the year ahead, as some wonder if Real Estate prices can remain this high.

In this report, we will give some recent highlights of the Canadian Real Estate industry and identify three companies that have performed well this year, and how they are positioned to perform in the future.

Figure 1: Industry Performance (2017 YTD)



Source: Ubika Research

Industry Highlights

- **Housing affordability is on the decline**: High prices in Toronto and Vancouver continue to squeeze affordability, mortgage to income ratios forecast to remain well above the Canadian average. A report from PWC forecasts that double-digit growth in housing prices will stop, however, Toronto housing prices are expected to rise by 4.6%, as foreign investors still view the market as attractive. In total, the report forecasts Canadian housing prices to drop by just under 1%.

- **Renting is on the rise**. With home prices in Toronto and Vancouver skyrocketing, many consumers are opting to rent for longer periods of time, and some even renting permanently. Some older homeowners are taking advantage of high housing prices as many people have sold their homes and moved into high-end luxury rental units. More found here.

- **Technology is changing the landscape** for office property owners. The need for big, traditional offices is on the decline as technology has enabled workers to work remotely, which is especially appealing to Millennial workers. Furthermore, work place preferences have shifted and people are moving towards open concept spaces, flexible hours, and working remotely. Even traditional workspaces like accounting firms and banks are transforming. Owners of older buildings are finding it hard to compete with newer ones that have stayed ahead of the curve. This PWC report expects big capital expenditures from older building owners in the near term.

- **Technology is transforming the residential market**. As hydro costs are on the rise and technology prices are declining, residential consumers are demanding more energy efficient properties and amenities, such as LED lighting, green roofs, and Energy star appliances. Furthermore, this report suggests an increase in demand for net-zero-sum buildings as climate change continues to be a concern.

Upcoming Events

- Calgary Real Estate Strategy & Leasing, May 25, 2017 at the Calgary Telus Convention Center, Calgary, Alberta, Canada

- Atlantic Real Estate Forum, June 1, 2017, at the World Trade & Convention Centre, Halifax, Nova Scotia, Canada

- Canadian Apartment Investment Conference, September 6, 2017, at the Metro Convention Centre, North Building, Toronto, Ontario, Canada

- RealREIT, September 7, 2017, at the Metro Toronto Convention Centre, North Building, Toronto, Ontario, Canada

- Real Estate Strategy & Leasing, September, 19, 2017, at the Metro Toronto Convention Centre, North Building, Toronto, Ontario, Canada

REITs up 8.4% Year to Date

Brookfield Office Properties REIT (TSX:BPO)

Brookfield Office Properties (“BOX”) owns and operates a 26 property, 20 million sq. ft. portfolio consisting of office properties in Toronto, Calgary, and Ottawa. BOX reported strong Q1-17 earnings on the back of incremental revenues from prior acquisitions, and made some major announcements including a proposed going-private transaction. BOX is up 23.9% YTD.

BOX released solid Q1-17 earnings including a 433% gain in net income from Q1-16. FFO, AFFO, and NOI were all flat from the same period a year ago. The Company reported a $20.3mm revaluation gain on its properties, compared to a $27.6mm revaluation loss in Q1-16. Management says this speaks to the strength of the Toronto market.

BOX announced some major operational highlights, such as a 15 year, 57,000 sq. ft. lease with Harlequin Enterprises at Bay Adelaide East, a seven-year, 34,000 sq. ft. lease with EventMobi at Queens Quay Terminal, and continued construction for Brookfield Place Calgary East. Most importantly, BOX announced a going-private transaction, in which they would redeem all their issued and outstanding shares, and sell a 17% stake to Brookfield Property Partners.

On April 20, 2017, the Company announced it plans to redeem all issued and outstanding shares, not already owned by BPY or its subsidiaries, for a price of $32.50 per share. The BOX board of trustees approved the redemption agreement and plan to unanimously recommend that shareholders do the same. The fate of the deal now lies in the hands of the shareholders, and institutional holders who own a combined 22% stake, such as Morgan Stanley, have announced they support the proposal and have agreed to vote in favour of the transaction. The vote will take place on June 28, 2017 at 1pm EST.

BOX is currently trading at $32.50 per share, implying a high probability the deal will go through. We recommend avoiding the shares all together as the redemption is fully priced into the stock, and buying them now would result in a net loss due to brokerage costs.

Pure Industrial REIT (TSX:AAR.UN)

Pure Industrial Real Estate Trust (PIRET) owns and operates a diversified portfolio of income-producing properties in leading markets. PIRET is up 18.2% YTD due to a strong Q1-17 earnings release and announcements of new business developments.

PIRET announced a 32.9% increase in FFO compared to the same period last year, and a 3.2% increase in FFO per share. The Company states the increase was due to an increase in same property NOI, incremental NOI earned from prior acquisitions and from several successful development and expansion projects completed throughout 2016.

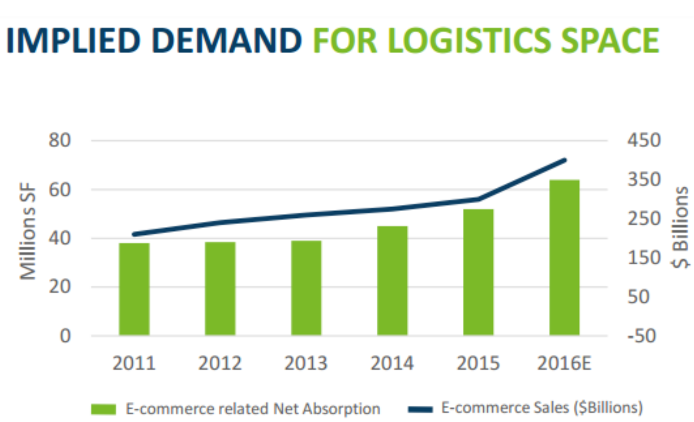
On the downside, the Company reported slowed leasing completions, resulting in a 1.4% drop in occupancy rates, driven primarily from a tenant vacating a 240,000-sq. ft. property in North Carolina. Management expects occupancy to improve in the coming quarters as leasing activities accelerate, which should result in an increase in same property NOI.

Management expects NOI, FFO, and AFFO to increase in 2017 and beyond, due to developments and expansions in the pipeline, including:

- Construction of a 330,000-sq. ft. distribution facility in Richmond BC, which costs funded by a $22mm construction loan and existing working capital. There is no tenant yet, but management is in talks with a prospect, which they are confident they can land as they expect this project to increase NOI in 2017 and beyond.
- Acquired two Class A distribution centres, in Houston for $85.3mm. The centres are 100% leased to IKEA Distribution Services, and will serve as their distribution and e-commerce hub for Texas and surrounding markets. The acquisition was funded with existing cash and the Company's line of credit.
- Acquired 16 acres of land adjacent to an existing property in San Antonio, Texas, for $3.8mm, funded by cash on hand. The land will be used for future developments, with a forecasted yield of 9%

The Company expects to continue to make acquisitions this year as they raised $125mm in equity on March 27, 2017, which will be used to pay down debt and make acquisitions. Furthermore, they expect to redeploy all the capital they got from selling non-core assets by the middle of this year.

Figure 2: US e-Commerce Retail Sales and Implied Demand for Logistics Space



Source: CBRE Research Q4-2016, US Census Bureau

Going forward, PIRET looks to be a good bet due to the growth opportunities mentioned above, and the increased demand for logistics space, however valuation would suggest staying away from the shares.

PIRET's long-term success depends on their ability to capitalize on the increased demand for logistics space due to the trend towards e-commerce. They have 120 distribution/e-commerce centers in their portfolio, their strategy is to acquire Class A distribution centres. This suggests they are positioned well to take advantage of this trend.

However, it is likely the market has realized this and the growth that the trend towards e-commerce is already priced into the stock, as they are trading above peers in Price/AFFO, Price/FFO, and Price/NAV.

Figure 3: Canadian REITs Valuation Table

Ticker	Company Name	Price/FFO	Price/NAV
MRG_u.TO	Morguard North American Residential Real Estate Investm	3.96	0.77
PLZ_u.TO	Plaza Retail REIT	14.26	1.06
CRT_u.TO	CT Real Estate Investment Trust	17.34	0.52
MRT_u.TO	Morguard Real Estate Investment Trust	2.90	0.59
DIR_u.TO	Dream Industrial Real Estate Investment Trust	5.27	0.89
CHP_u.TO	Choice Properties Real Estate Investment Trust	4.75	2.25
SMU_u.TO	Summit Industrial Income REIT	7.79	1.29
NWH_u.TO	NorthWest Healthcare Properties REIT	5.28	0.79
CRR_u.TO	Crombie Real Estate Investment Trust	4.03	0.91
ONR_u.TO	OneREIT	11.26	0.68
ACR_u.TO	Agellan Commercial Real Investment Trust	3.72	1.21
KMP_u.TO	Killam Apartment REIT	5.52	1.27
INO_u.TO	Inovalis Real Estate Investment Trust	6.17	0.41
DRG_u.TO	Dream Global REIT	5.94	0.96
NVU_u.TO	Northview Apartment REIT	2.22	0.97
WIRu.TO	WPT Industrial Real Estate Investment Trust	4.03	1.25
RUFu.V	Pure Multi-Family REIT LP	8.59	0.94
AAR_u.TO	Pure Industrial Real Estate Trust	11.88	1.29
BOX_u.TO	Brookfield Canada Office Properties	2.83	0.27
Average (excluding AAR_u)		***6.43x***	***0.95x***

Source: Ubika Research, Thomson Reuters

Morguard North American Residential REIT (TSX:MGR.UN)

Morguard North American Residential REIT owns and operates a portfolio of 13,214 suites at 46 multi-suite residential properties in North America. The Company's units are up 14.9% YTD, due to strong 2016 and Q1-17 earnings releases. Furthermore, the Company has a growing asset base and plenty of room to increase their payout.

In 2016, the Company increased NOI by 10.7% relative to 2015 due to acquisitions completed in previous years, and an increase in same property NOI in Canada and the U.S., mainly driven by higher rental revenue. The Company increased FFO and AFFO per unit by 12.7% and 16.5%, respectively, due to the increased NOI. The Company also increased its distribution by 6.7% from 0.60 per share to 0.64 per share representing a 4.1% yield. In Q1-17 the Company reported a 3.3% increase in NOI and a 9% increase in FFO relative to Q1-16. The increases were due to incremental revenue from an acquisition completed during Q1-16 as well as higher rental revenue in Canada and the U.S.

The Company has only made one acquisition since their 2012 IPO, when they acquired a 370-suite rental apartment in Ottawa for $67 million, as the Company has allocated capital towards improving existing properties in order to maximize occupancy and rent. This strategy has evidentially been working as seen by the picture below.

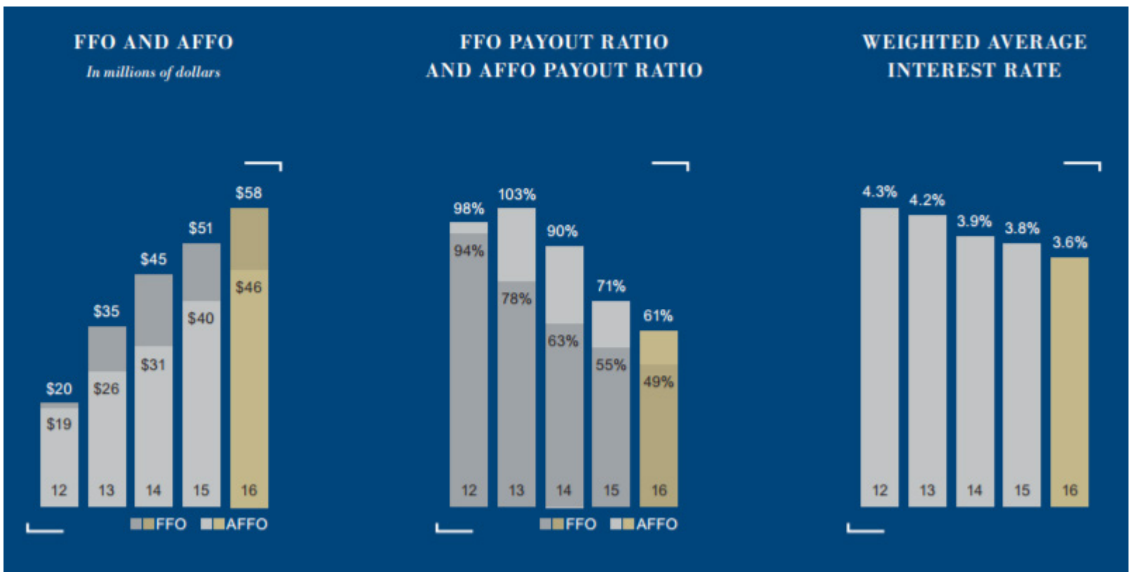
Figure 4: Average Monthly Rent and Occupancy by Region

Source: Company Filings

Expect the Company to make an acquisition this year as they raised $60mm in equity in January, which the Company states "the REIT intends to use the net proceeds of the offering to fund future acquisitions, repay debt and for general trust purposes."

The Company pays a monthly distribution, which has increased by 333% since 2012. What's even better is that the Company's FFO and AFFO growth have driven payout ratios down significantly, meaning it has plenty of room to increase their distribution, which management intends to as they have outlined a key part of their strategy is to "generate stable and growing cash distributions." .

Figure 5: Key Operating Financial Metrics



Source: Company Presentation

Furthermore, using a dividend discount model with ultra conservative assumptions shows the Company is undervalued. We estimate the Company's cost of capital to be 4.58%, assuming 0 growth in FFO until 2024 and assuming the FFO payout ratio would increase at a steady rate until reaching 70% in 2024. Furthermore, to account for possible errors in our calculations we applied a 50% margin of safety to the cost of capital and discounted everything using a 6.87% rate. For the terminal dividend, we assumed the Company would be able to grow FFO and their distribution by 2% forever. See appendix for calculations.

Figure 6: Dividend Payout Schedule and REITs Valuation Table

	Payment	PV
2016 Dividend	0.61	0.61
2017 Dividend	0.64	0.60
2018 Dividend	0.66	0.58
2019 Dividend	0.68	0.56
2020 Dividend	0.70	0.54
2021 Dividend	0.72	0.52
2022 Dividend	0.74	0.50
2023 Dividend	0.76	0.48
2024 Dividend	0.79	0.46
Terminal Dividend		16.16
Implied price		**$20.99**

The Company trades at a discount to its peers based on Price/AFFO, Price/FFO, and Price/NAV, implying the Company is undervalued, which could result in an increase in unit prices if the market valuations are corrected.

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Average (excluding MRT_u)		***6.93x***	***0.99x***

Source: Ubika Research

The Company trading at a heavy discount to NAV is surprising as their liquidity and leverage is not a concern as seen in their healthy debt as liquidity ratios as seen below.

Figure 7: Liquidity Ratios

As at	March 31, 2017	December 31, 2016
Total indebtedness to gross book value	**51%**	54%
Weighted average mortgage interest rate[(1)]	**3.56%**	3.62%
Weighted average term to maturity on mortgages payable (years)	**5.7**	5.7

(1) Represents the contractual interest rates on mortgages payable and Class C LP Units.

For the three months ended March 31	2017	2016
Interest coverage ratio [(1) (2)]	**2.25**	1.97
Indebtedness coverage ratio [(1) (3)]	**1.53**	1.36

Source: Company Filings

MRG.UN is a company that is undervalued on a relative and intrinsic basis. They have provided solid results in the past and should do so going forward. While we expect the Company to make an acquisition in the near term, which should result in increased NOI, and FFO, capital appreciation will primarily come from distribution increases.

Appendix

Figure 8: Dividend Projections

Morguard North American - Dividend Projections - Ultra Conservative

		2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
FFO		20,000,000	35,000,000	45,000,000	51,000,000	58,000,000	58,000,000	58,000,000	58,000,000	58,000,000	58,000,000	58,000,000	58,000,000	58,000,000
	FFO Growth	-	75%	29%	13%	14%	-	-	-	-	-	-	-	-
Payout Ratio		94%	78%	63%	55%	49%	57%	58%	60%	62%	64%	66%	67%	70%
Dividend		18,800,000	27,300,000	28,350,000	28,050,000	28,420,000	32,776,619	33,759,918	34,772,715	35,815,897	36,890,374	37,997,085	39,136,998	40,311,107
	Dividned Growth	-	45.21%	3.85%	-1.06%	1.32%	15.33%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%
Shares OS		44,592,030.36	45,500,000.00	47,250,000.00	46,750,000.00	46,846,668.64	51,216,668.64	51,216,668.64	51,216,668.64	51,216,668.64	51,216,668.64	51,216,668.64	51,216,668.64	51,216,668.64
Dividend Per share		0.4216	0.60	0.60	0.60	0.61	0.64	0.66	0.68	0.70	0.72	0.74	0.76	0.79
	Div/Share Growth	NA	NA	0	0	1.11%	5.49%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%

Source: Ubika Research

Figure 9: WACC Calculation

BV Debt	1,069,957,000
Weight of debt	67%
Cost of debt after tax	2.2%
MV Equity	531,960,000
Weight of equity	33%
Cost of equity	9.37%
Cost of capital (Marked up 50%)	6.87%

Cost of equity	
Next Year projected FFO/share	1.29
2017 Equity raise offering prcie	13.75
Cost of equity	9.37%

Debt	
Current BV	1,069,957,000
Weighted average interest rate	3.67%
Tax rate	40%
Cost of debt after tax	2.2%

Source: Ubika Research

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