The rise of the one-tenant REIT

Much more selection with arrival of new challengers

BY GARRY MARR, FINANCIAL POST AUGUST 14, 2013

Hudson's Bay Company is among the publicly traded entities considering entry into the REIT world.

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If you want to own publicly traded retail real estate, your choice until recently was RioCan Real Estate Income Trust, Calloway REIT or First Capital Realty Inc. - old school real estate landlords, behemoths now after one to two decades of growth in the ever-expanding Canadian retail market.

But a new challenger has come to the forefront: the one-tenant REIT controlled by a major retailer.

Hudson's Bay Co. is talking REIT. Canadian Tire, too. The new Choice REIT, which garnered major headlines when Loblaw Cos. Ltd. agreed to put a huge swath of its properties into a trust, will generate 91% of its net operating income from the grocery chain.

It sounds like a disaster if the tenant goes bankrupt, but the retailers' strategy of turning their property into publicly traded entities has become the flavour of the month in the REIT world, which yield-hungry investors have been targeting of late.

A big part of the trend had been driven by retailers seeking to get better value for their property holdings, which happens when they are listed as a standalone entity. Loblaw, for example, got a pop in its stock price for separating out its real estate.

It's not a new formula. Crombie REIT, which is tied to grocery chain Sobeys through its parent corporation, has been at it for a while and before that there was Scott's REIT, which went public with 99% of its tenant base either KFC or Taco Bell Restaurants.

The owner of those fast-food franchises, Priszm Income Fund, was at one point in court protection under the Companies' Creditors Arrangement Act, creating a headache for Scott's REIT, which is now known as Key REIT. The filing proved to be an opportunity for Scott's to diversify its portfolio, but underscores the risk, too.

Investors don't get diversification with some of the REITs anchored mostly by one tenant. Of course, investors pay to get that diversification.

RioCan, the largest REIT in the land, is committed to never having more than 10% of its income from one tenant, and it trades at a multiple of 15.2 times funds from operations - a common real estate measure - while Crombie REIT trades at 12.4 times FFO.

"When I started RioCan 20 years ago, we were coming out of a real estate depression and we asked ourselves, 'Why did everyone get in so much trouble'?'" said Ed Sonshine, RicoCan's chief executive. "The biggest reason was debt/leverage, but one of the other big ones was diversification of revenue sources."

RioCan's goal is to make sure any one retailer doesn't make up more than 10% of revenue, but it's below even that level to the point that no one entity makes up more than 4%. "The reason is stuffhappens, particularly in the retail world," he said. "Things change. Wal-Mart didn't exist 30 years. Look at who the great retailers were 30 years ago and there are an awful lot of them not here today."

But the last thing Mr. Sonshine wants to do is badmouth Loblaw or any of the other retailers considering a REIT play. "Loblaw is a great retailer and we love them," he said.

Business is business and great sites are great sites. Even if RioCan in the past managed to beat Loblaw to a development site - the grocery chain had a real estate arm long before it went public - Loblaw often ended up renting that same space from the REIT.

"I can tell you for sure that when there was a good site on the market for the last 15 years, both Loblaw, through their real estate arm, and Sobeys, through theirs, were trying to buy," said Dori Segal, chief executive of First Capital Realty Inc.

First Capital is not a REIT, but it's still one of the largest publicly traded players in the urban mall world with 164 properties and 24.1 million square feet of gross leasable area. Mr. Segal said retailers want to be in the best corners. "That's the ultimate fight," he said.

There must be, however, a limit to how much REIT product investors want and that might be the bigger issue for companies such as RioCan, First Capital and Calloway REIT - which is almost a Wal-Mart Stores Inc. play because the retailer makes up about 25% of its tenant base.

But Mr. Segal notes the REITs and real estate operating corporations are not the

tiny entities they used to be so growth is not as big a concern. "Go back to 1998 and if they had gone out with those REITs, it might have been a lot harder for us to grow," he said. "But First Capital today is almost an $8-billion company in total assets. We are all large enough and spread out nationally. There isn't this huge pressure to grow the top line (revenue)."

Nevertheless, the less diversified REITs are going to trade at a lower multiple and "that's the way it should be," said one analyst who didn't want to be identified. "You can't just diversify overnight," he said.

At same time, he said the real estate owned by the new REITs is mostly generic property that will always have value. "If it's not them, then something else can go in there. You buy Hudson's REIT today, you are buying a great location on Queen St. (in Toronto) or Fifth Avenue (in New York)," the analyst said, referring to HBC's recent purchase of Saks Inc.

Dennis Mitchell, chief investment officer at Sentry Investments, said it cuts both ways for the new REITs: They may not be as diversified, but they have a pipeline to new assets.

"Crombie REIT is a beneficiary of Sobeys' expansion. It bought [Canada] Safeway (Inc.) and low and behold there is ($990-million) of real estate being vended into Crombie," Mr. Mitchell said.

The flip side is that Crombie once again becomes more heavily focused on one tenant after trying to diversify its portfolio.

Avi Behar, chief executive of the Behar Group Realty Inc., said the bad news for the new REITs is that there are only so many tenants around. "It's not like the U.S. where there are hundreds of grocery chains. Here we have four five types of things. There's like five or six banks. We are very limited in our categories," he said.

But the new grocery-anchored REITs have one thing that everybody wants: A big-name store. "A bank, a Starbucks, you target those centres. They will compete to a degree," Mr. Behar said. "If you have a centre without a grocery store, I'm guessing the bank will want to go to the new Loblaw centre. A lot of tenants want to be with them."

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