Grant Thornton
An instinct for growth™

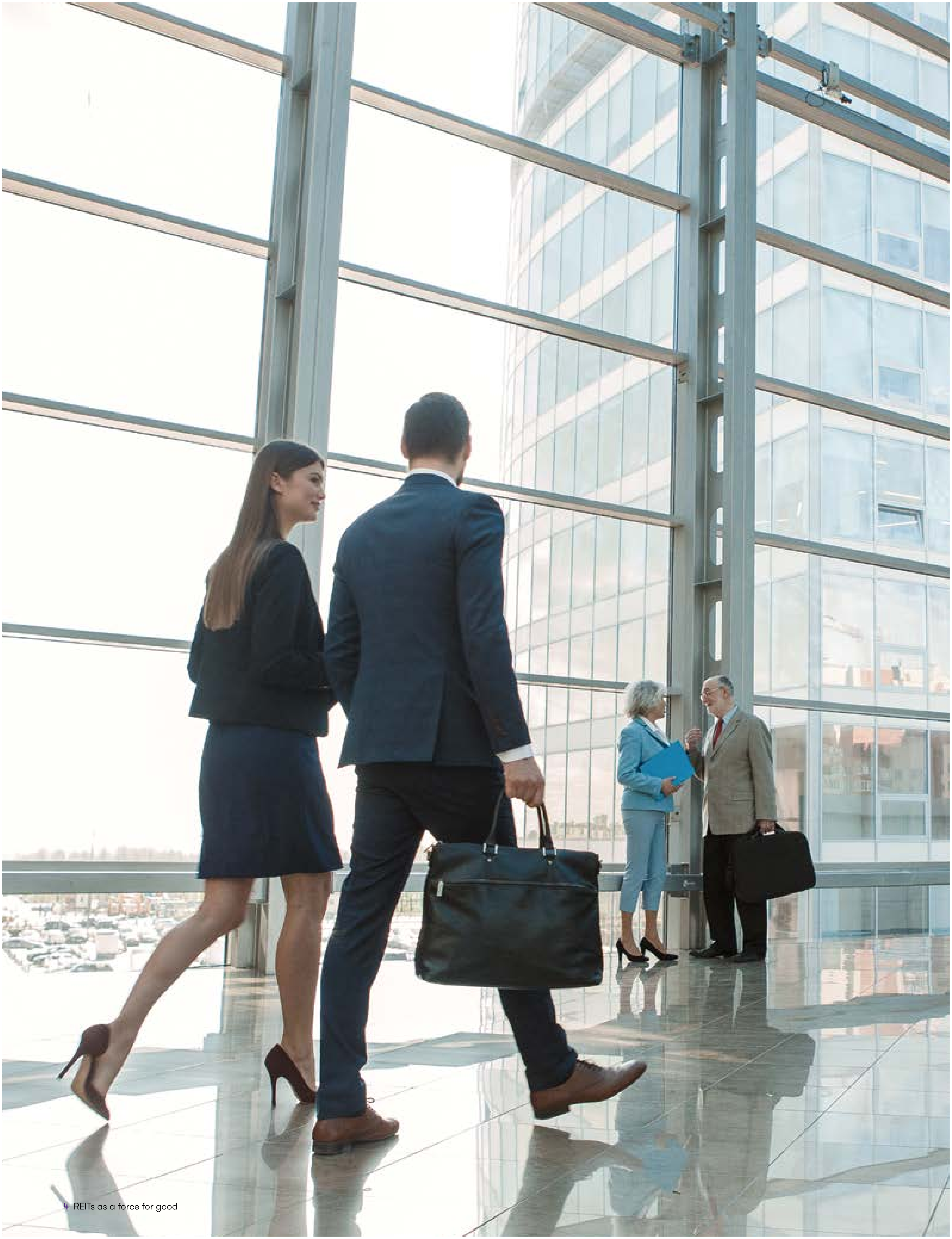
Real estate

Investment

Insights

REITs as a force for good

Contents



Foreword

The rise in popularity of Real Estate Investment Trusts (REITs) has been remarkable since their creation in 1993. Along with being one of the most successful investment sectors in the public markets with listings of 48 REITs, private REITs have seen success as an alternative investment. Each of these is attractive to investors looking for stable investments with an orientation toward income distribution.

There has been a significant increase in new REITs since 2008 when income tax rules changed to lower barriers to entry and encourage new entrants to launch. The majority of REITs are listed on the Toronto Stock Exchange.

This report draws together insights into the rise of REITs as a vehicle for investment in property assets with a wider purpose, in particular the emergence of REITs focusing on social property.

We look at what is working currently, how the use of REITs as a force for good might develop in the future and lessons that can be learned from other countries.

"Canadian REITs have been around for over 25 years now, and they have evolved significantly since they were introduced. From initial take up by the large listed property companies, REITs have become more of a sector-driven investment vehicle. REITs are really contributing to place making, creating places for people to live, work and play. Adding the REIT brand on top of this helps to build trust and integrity in the economy."

Bo Mocherniak, Construction, Real Estate & Hospitality, Sector Leader, Grant Thornton LLP

Executive summary

Our discussions are based around three key questions facing the evolving Canadian REITs market, as detailed below. The key theme emerging is the opportunity to expand the success of the REIT market to further categories of investment, which would contribute to the social good and create jobs in the underlying activity that is contributing to the social good.

How is the REITs market evolving?

The consensus is that the Canadian REITs market is incredibly dynamic and flexible. Investors are attracted by the benefits of the REIT structure, including liquidity, onshore management and the globally recognized REIT brand, which is widely trusted by investors.

Access to capital markets is a key enabler of growth for REITs.

There is an opportunity and an investor appetite for many new REITs focused on specialist sub-sectors, such as healthcare and social housing. It is clear that both government policies and changing cultures have important roles to play.

How are REITs having an impact as a force for good?

The office, retail and industrial investment products are already benefitting from investment from REITs but there is significant untapped potential. In healthcare, facilities such as retirement homes, chronic care facilities and hospitals are in need of expansion and upgrade. Social housing is in strong demand given the rise of housing costs and the influx of new citizens to Canada. Other social programs, such as correctional facilities, are also in need of expansion and upgrade.

How can we use REITs to make a greater impact?

The government has signalled that Canada is open for business and welcomes global investment. Opening up the REIT regime to new investment opportunities by widening the permitted activities in which REITs can invest would be a welcome step.

Building effective partnerships between investors, REITs, developers and operators will be key to enabling greater investment in and development of real estate with a social purpose.

How is the REITs market evolving in Canada?

A REIT is an internationally-recognized investment vehicle, promoted by governments to encourage the wider public and institutional investors to pool their investment in real estate.

REITs offer certain tax advantages to encourage this investment. In Canada, a REIT is not taxed on income and gains from its property rental business. Instead, shareholders are taxed on a REIT's property income when it is distributed, and some investors may be exempt from tax.

When considering the expanded use of REITs, it is imperative to review the conditions that need to be met to classify as a REIT. Specifically, the conditions relating to holding inventory, trust on trust structures, specified investment flow-through tax rules and ancillary services allowed by the REITs should be reassessed.

Use of REITs as an investment vehicle has increased in popularity since changes were introduced in 1993 to relax the rules and make it easier to adopt REIT status. Since then, REITs have become an attractive, onshore, tax-efficient vehicle for investors, offering the benefits of liquidity and access to specialist sectors such as healthcare and social housing. On the actual sale of property to the REIT for REIT units, a direct transfer would be taxable. The deferral is accomplished by transferring the property to a limited partnership (LP) where the REIT is a partner and having your LP units convertible to REIT units.

The donation of REIT units qualifies for the same preferred capital gains treatment as is the case with the donation of public company shares.

Benefits of REITs

A REIT can offer significant benefits for investors and operators alike. The REIT brand is globally recognized and trusted—most major economies have an equivalent regime. In public REITs, the fact that the structure is approved by the securities regulators promotes transparency and effective governance to help build trust and confidence in the REIT market.

Liquidity
The liquidity of publicly-traded REIT shares on a major stock exchange encourages a wide base of individual and institutional investors, by providing a potential exit route through the sale of their REIT shares, rather than disposing of the underlying property assets. This allows management to focus on a long-term business plan and strategy.

"If someone wants to get their capital out, there's a secondary market to trade those shares and take liquidity rather than having to force a sale of the underlying assets, which is one of the factors that has historically created boom and bust and swings of property prices."

Farrah Khimji, Construction, Real Estate & Hospitality, Grant Thornton LLP

Where necessary, investors can trade out quickly in the secondary market without disturbing the strategic long-term investment plan, or the operational aspects of a tenant's business.

However, reliance on the market to determine a REIT's share price introduces an element of volatility. REIT shares may trade at a premium, or a discount, to the net asset value of the business, depending on wider market sentiment.

Sector specialization

The emergence of specialist REITs focused on specific asset classes is good news for investors and end users alike.

Investor demand for listed property funds with a focused strategy has encouraged the launch of new REITs focused on specialist asset classes within the broad real estate market. This includes REITs focused on healthcare, student accommodation, social housing, care accommodation and retirement living. This trend of specialization in emerging real estate sub-sectors looks set to continue.

Investors are able to control their exposure to specific sub-sectors of the real estate market, such as healthcare or housing, while a REIT management team with a focused strategy will be better placed to outperform the market by providing state-of-the-art property solutions in their particular area of expertise.

Specialist REITs have the ability to understand and foresee their tenants' future property needs, using their expertise and working with third-party developers to deliver fit-for-purpose real estate to meet demand. This enables them to deliver long-term value for investors.

This type of constructive partnership allows both parties to focus on what they do best—allowing the REIT owner of the real estate to maximize the income and value of the property in their portfolio, while operators focus on the quality of service they provide.

Tax advantages of REITs

Apart from the advantages noted above with respect to the income tax treatment on the income and gains from the REIT's rental business, the REIT itself can provide a very compelling income tax/estate planning and succession opportunity.

Where a taxpayer(s) has accumulated a significant rental property portfolio and a family succession plan is not viable or available, the sale of a property portfolio to a REIT can be very income tax effective for the vendor taxpayer.

When such a sale includes REIT units as proceeds, an income tax deferral is available for any accrued/unrealized income (recapture) and capital gains. Unlike a sale involving proceeds that include a vendor take-back (which has a maximum five year deferral; none on recapture), the REIT units would provide an unlimited deferral period until such units are sold.

In addition, where the taxpayer has a philanthropic intent, if the REIT units are in turn donated to a foundation (private or public) the capital gain thereon would be fully non-taxable and the corresponding donation would be eligible for an income tax credit in the amount of the fair market value (FMV) of the REIT units. This would provide more funds to the foundation/charity versus an outright sale of the asset(s) and a donation of the after income tax proceeds realized therefrom.

Also, from a Canadian domestic sector perspective, one class of rental properties that is garnering more attention with REITs and their management is the residential property market. This should provide practical and realistic opportunities to realize on estate and succession plans as noted above.

REIT sector trends

In many respects, investment by REITs broadly mirrors wider investment in Canadian real estate. While demand for offices and industrial remains strong, partly driven by the trend for flexible co-working, investment in alternative sectors such as apartments, student accommodation and care homes is increasing rapidly, albeit from a relatively low base.

These trends are set to continue, following the pattern of the more mature US REITs market, where investment in residential sectors by REITs forms a substantial portion of the market.

Investor base

The presence of institutional investors in the REIT sector, such as pension funds and governments, has grown steadily over the past five years. With people retiring later and employers required to enroll employees into pension schemes automatically, pension funds have larger pots to invest in the market.

While REITs are particularly appealing to institutional investors, technology is also making it easier for individuals to participate in large scale property investment projects, such as social housing. One such example would be the investment into REITs using online platforms—a concept similar to crowdfunding.

Private investors have the flexibility of selling REIT shares whenever they want, as well as benefitting from the "feel-good factor" of investing in socially sustainable projects.

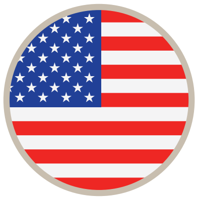
International perspectives on REITs

While most major economies have a REIT regime equivalent to Canada's, take-up has varied.

Based on the views of our international panel of experts, there are lessons Canada might learn from policies that work well in other REIT markets, for example in encouraging investment in residential development.

"REITs are a great opportunity for private investors to participate in the same investments as large private funds. For private investors who have invested in property through a private limited company, it's a great way to exit. They can sell to a public REIT in a tax efficient manner, whereby they can receive cash and shares in the public REITs. Apart from an income tax deferral they can also benefit from an ongoing return."

Dennis Tmej, Tax Partner, Grant Thornton LLP



The United States perspective

REITs in the United States were established by Congress in 1960 to give all investors access to income-producing real estate. Since that time, the US REIT approach has continued to gain popularity and has served as the model for over 35 countries.

With improving labour markets and low unemployment rates, the macro economy and real estate markets have been strong in the United States. The demand for real estate across all sectors continues to rise along with occupancy levels and rental income. The commercial sectors have benefitted the most with warehousing, industrial space and mixed use really displaying consistent growth in value and demand. Commercial construction has been moving upwards due to the large sector demand, but there are some risks in REITs as we move forward.

Outlook

While the Federal Reserve has signalled rising interest rates and the labour markets have been very strong, how long can this continue. This is especially true in light of the changes Washington is making relative to trade negotiations and taxes. Will this impact the real estate markets? Generally speaking, US REIT investments have continued gaining traction with the improvement of the US economy and the growth in GDP, and we expect this to continue moving from 2018 to early 2019. All the real estate indicators leave us cautiously optimistic in our outlook for the REIT market.

The United Kingdom perspective

The rise in popularity of UK REITs has been remarkable. The REIT regime came into force on January 1, 2007 and by February 2007 nine of the United Kingdom's largest listed property companies had converted to REIT status. Fast forward 10 years and there are now more than 70 UK REITs.

There has been a significant increase in new REITs since 2012, when HM Revenue & Customs (HMRC) made wide-ranging changes to the REIT regime designed to lower barriers to entry and encourage new entrants to launch REITs. The majority of REITs are listed on the London Stock Exchange (LSE), but a growing number are listed on AIM or overseas stock exchanges, such as The International Stock Exchange (TISE) in Guernsey.

Specialty sub-sectors

Many new REITs focus on specialist sub-sectors, such as healthcare and social housing. Our panel felt that the trend towards specialist REITs is likely to continue, but that effective partnerships with developers and operators is vital to ensure the model is sustainable. The consensus is that there is significant untapped potential for REITs to invest in new homes for rent.

The UK healthcare sector is already benefitting from investment from REITs but there is significant untapped potential. In primary care, REITs are working with the NHS and local authorities to build out a substantial development pipeline of primary care centres.

There is massive demand for care homes and assisted living property. New REITs are entering the market, working with operators to provide capital and property expertise.

In the face of public funding changes, social housing is also benefitting from investment from REITs into suitable properties.

Specialist build-to-rent (BTR) REITs are emerging as an institutional asset class in the United Kingdom, although the market is still developing.

Going green

While the use of REITs as a force for social good has been limited to date, they have arguably been beneficial in encouraging investment in more environmentally-friendly real estate.

"Greener" real estate assets incorporating, say, cleaner air or lower heating and power costs, are increasingly in demand and offer commercial benefits to tenants, as well as potential new revenue streams to operators such as the sale of surplus solar power. This makes them attractive to investors looking for long-term stable returns.

However, opening up the tax regime to allow greater investment within the REIT structure in real estate assets that generate non-rental income is likely to be necessary if REITs are to play a greater social role in the future.

REITs in Germany

The REIT market in Germany is somewhat limited in comparison to others around the world, with tax advantages not as compelling as other types of investment funds. However, institutional investment in the residential sector is strong in Germany. Thomas Wagner of Grant Thornton Germany, looks at why German REITs (G-REITS) have not yet taken off.

Since G-REITs were introduced in 2007, take-up has been very low. Only five have been launched under the regime to date. All focus on office and retail properties, with investment in industrial, residential and other asset types playing a small part.

G-REITs are publicly-traded real estate stock corporations. They are exempt from local trade tax, which can be between 10% and 17%, depending on the municipality. However, the eligibility requirements for these structures are very strict and there has been little incentive to use them.

G-REITs must pay out 90% of distributable earnings to investors through dividends. Seventy-five percent of the revenues must be generated through the letting or selling of real estate. However, if a G-REIT sells more than half of the value of its portfolio within five years, this is considered to be trading and the REIT will fall out of the scope of exemption. A G-REIT may also manage real estate portfolios held by third parties through separate management subsidiaries. The revenues from these activities must, on a consolidated basis, not exceed 20% of the G-REIT's total revenues. Furthermore, if the portfolio includes, say, a solar energy capability, then this activity should qualify as an energy supply, which would be harmful if the 75% requirement in terms of revenues can no longer be met.

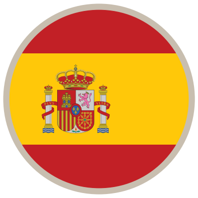
Investor preference

Private and institutional investors in Germany generally prefer to invest directly in real estate or indirectly through open- or closed-end funds. These investment vehicles can be structured in a way that mirror a number of the benefits of REITs (e.g., exemption from trade tax). The same is the case for regular corporations, including those traded on a stock exchange, if they limit their activity to the letting of real estate. As such, these vehicles tend to be preferred by investors over G-REITs. The German real estate sector would like to see G-REIT criteria relaxed, but the government has shown little willingness to amend the regime.

Despite the shortage of affordable housing in Germany, there is little to encourage investment in this type of asset, with the majority of development in higher price brackets. Despite the clear affordability issues, the potential for G-REITs to provide a solution under current rules remains limited.

Notwithstanding the limitations of the G-REIT, the listed real estate market in Germany remains strong, and its value topped that of the United Kingdom for the first time in Q1 of 2018, according to data from the European Public Real Estate Association (EPRA). Germany's residential property companies, in particular, have grown rapidly. For example, Vonovia, the biggest property company in Germany and Europe, with a market cap of around €20 billion (£17.5 billion), has more than doubled the number of homes it owns since its 2013 IPO through portfolio deals and mergers and acquisitions. It remains to be seen whether this trend by institutional investors will be replicated in the United Kingdom, and whether any incentives can be introduced.

Only five 'G-REITs' have been launched under the regime to date.



Spanish REITs

The REIT market in Spain has mirrored the United Kingdom's to some extent, with a change in the rules in 2012 coinciding with a recovery in the Spanish real estate market. Alongside a shift in culture from home ownership to home rental, this has resulted in an increasingly attractive market for investors. David Calzada Criado of Grant Thornton Spain gives an overview.

Spain first adopted a type of REIT structure in 2009, known as a "SOCIMI," but the tax regime was not sufficiently attractive to investors compared to REIT regimes of other countries and take-up was very low. In 2012, the new Spanish government revised the SOCIMI rules to make them more attractive for investors.

The new regime, together with the recovery of the Spanish economy and a period where real estate prices were at their lowest ever, has created an opportunity for a refocus on real estate. There are currently 55 listed SOCIMIs in Spain, including five on the main market. SOCIMIs have proved increasingly attractive to foreign investors.

SOCIMIs have invested primarily in commercial property assets such as offices, retail, logistics and hotels, and have only recently starting investing in residential property.

Cultural shift

Spain is seeing a gradual shift in attitude towards rented accommodation, particularly among the younger generation, who have traditionally tended to live with their parents until they get married, before buying their own properties. In part, this is due to a lack of finance to enable typical working families to afford their own homes.

This has led to the emergence of some SOCIMIs in the private rental sector, primarily catering to demand from people with lower incomes. Growing demand and rental yields have stimulated rental property development and made this an increasingly attractive market for investors. In this sense, the residential REIT market in Spain has growth potential similar to the United Kingdom, where we are starting to see private rental REITs attract investment.

Future prospects

There are no restrictions on the type of property assets in which SOCIMIs can invest and, to date, there has been little interest in social housing, given the lower returns. However, as the wider SOCIMI market in Spain continues to flourish, new asset classes such as student accommodation and retirement homes are starting to emerge.

Most SOCIMIs are relatively small. There has already been one merger and further consolidation in the market appears likely as they seek economies of scale.

There are currently 55 listed SOCIMIs in Spain, including five on the main market. SOCIMIs have proved increasingly attractive to foreign investors.

The view from Australia

The REITs market in Australia continues to evolve and has seen increasing specialization in recent years. Sian Sinclair, Global Head of Real Estate for Grant Thornton, explains the measures that the Australian government has introduced to encourage REITs investment in affordable housing.

Although the REIT market in Australia is relatively mature and can offer generous tax advantages for eligible overseas investors under the Managed Investment Trust (MIT) tax concessions, the use of REITs with a social element is still in its infancy.

In Australia, a REIT can qualify as an MIT if it meets certain regulatory requirements in relation to its investors, allowing it to provide concessional tax rates of 15% on investment returns to overseas investors.

Australian REITs have traditionally invested in commercial property assets, although there has been a growing trend towards sector specific REITs, such as those with interest in health assets (e.g., private hospitals and specialist medical real estate), driven by the demands of an aging population.

In its 2017 Budget, the Australian government introduced new tax concessions for REITs that qualify as Managed Investment Trusts (MITs) if more than 80% of their assets are affordable housing managed through an eligible Community Housing Provider.

Housing issues

Housing affordability is a hot topic in Australia, to the extent that the federal government has extended the MIT tax concessions to eligible REITs that invest in affordable housing.

As part of the housing affordability measures in the 2017 Budget, the Australian government allowed REITs that qualify as MITs to access the concessional tax rate for foreign investments if more than 80% of the funds' assets are affordable housing properties that are managed through an eligible community housing provider.

In the same year, the government confirmed that MITs would be prohibited from investing in residential property generally, unless it met the affordability criteria. However, this approach could be considered counter-productive to the affordability objective, as this now prevents large-scale take-up by REITs of the build-to-rent asset class in Australia.

The intention was to make the investment in this class of asset attractive to foreign investors, to encourage greater supply.

These changes mark a shift on the part of the Australian government towards a more targeted approach to boosting affordable rental housing through investment tax incentives, and away from multi-family type assets by removing access to MIT tax concessions for the build-to-rent sector. Many industry observers had seen growth in the build-to-rent asset class as a promising solution to address the shortage of housing supply in itself.

The challenge with the new focus on affordable housing is creating a reasonable return for investors where assets are required to be rented at a discount to market rates and held for at least 10 years. While the changes are still in their infancy, they have yet to result in any new affordable housing REITs coming to the market.

Further refinement of the rules may be required to deliver the returns necessary to attract both domestic and international investors.

Outlook

Future developments in this area will likely continue to be influenced by government policy, overseas REITs and the asset classes they are looking to acquire.

The market is likely to see growing interest in aged care and retirement living assets among REITs—although there is a raft of regulatory hurdles to be resolved, along with a greater focus on emerging industrial and logistics related property assets.

The Australian market is also seeing a rise in online collective property investment platforms where investors come together to invest in individual residential developments through syndicates that are typically structured as unlisted REITs.

The Australian government is seeking to remove some of the barriers to the collective investment approach and announced a new type of investment vehicle similar to a REIT, which does not take the form of a trust. The intention is to enhance the competitiveness of the Australian funds to attract foreign investors not familiar with trust structures.

How are REITs having an impact as a force for good?

The significant potential for specialist REITs focused on asset classes such as healthcare, social housing and government infrastructure projects provide alternative investment opportunities that meet the demand for both a financial and a social return.

REITs are well suited to act as the owners of property assets with a social role, provided the partnership with the operator is structured appropriately. Where this works well, REITs can provide property management expertise to complement the expertise of either public or private operators in meeting the needs of their customers.

Supporting healthcare

An aging population is increasing demand for healthcare property in both the public and private sectors. This includes community-based medical centres, retirement living supported living real estate and hospitals.

The care home market is experiencing a chronic shortage of beds with occupancy rates at a very high level, driving demand for new purpose-built developments to meet the growing needs of the aging population.

However, specialist sectors such as healthcare currently make up only a very small percentage of the total REIT market in Canada.

In more mature global REIT markets, such as the United States, there is a stronger track record of the use of the listed property vehicles to develop infrastructure, retirement living and healthcare property assets. There is therefore significant growth potential for Canadian REITs to play their part in delivering property that will meet the needs of the growing and aging population in communities across Canada in the future.

Social housing

There is massive demand for care homes and assisted living property. New REITs could be entering the market, working with operators to provide capital and property expertise.

In the face of public funding changes, social housing could also benefit from investment from REITs into suitable properties.

"REITs can be a force for good as part of the solution to the Canadian housing crisis by adding to the portfolio of social housing available and helping local authorities fill desperately-needed housing provision."

Bo Mocherniak, Real Estate Sector Leader, Grant Thornton LLP

Satisfying infrastructure needs

The potential for REITs to meet the need for government infrastructure projects is gaining increasing interest. With the overcrowding of correctional facilities, REITs offer investors an opportunity to be part of a financial solution to help provide more facilities which will lead to more jobs at the facilities and, at the same time, satisfy a social need.

With a rising focus on social purpose among investors, whether they are institutions, wealth managers or individuals, REITs can provide alternative investment opportunities that meet the demand for both a financial and social return by providing a platform for investment.

"REITs are a much needed source of long-term capital in the healthcare sector to drive future investment to help build the infrastructure we need to meet demand from an aging population."

Gregory Gallant, Construction, Real Estate & Hospitality, Grant Thornton LLP

How can we use REITs to make a greater impact?

It is vital that the REIT regime is continually reviewed by policymakers to ensure that it remains fit-for-purpose to facilitate investment in key real estate sectors in support of government policy.

Modernizing the REIT regime

The Canadian REIT regime is still relatively new and there is an opportunity to widen the permitted activities of REITs to open up investment opportunities in priority areas, such as healthcare, housing development and infrastructure projects.

There are currently restrictions on activities both within REITs themselves and with regard to their structuring.

Arguably this aspect of the REIT regime could be modernized to accommodate funding arrangements for vital investment projects that the REIT intends to hold long term for the benefit of the income.

In terms of healthcare REITs, different business models may be required, in addition to conventional sale and leaseback arrangements. To achieve sustainable investment, it will be important to learn the lessons of the past and ensure that lease terms are sustainable.

REITs and local authorities

REITs are one of a number of vehicles that could be used by local authorities to invest in social housing.

Local authorities are in an anomalous position in that they can invest in property without necessarily having the expertise to understand the risks involved. They should allow REITs to play a greater role in local authority social housing.

The challenge here is to secure long-term commitment in the face of ever-changing political cycles, which means it can be difficult to provide commitments lasting more than five years. Addressing the social housing shortage will require longer-term commitments from both central government and local authorities and a fresh approach to partnering to build new homes.

Other opportunities

The current structure and policy constraints of most REITs limit the ability for development and re-development activity.

Most declarations of trust limit development activities to a specified percentage of assets. This amount should be increased.

"Local authorities are looking for different investment opportunities to increase their income after reductions in government funding and there is an opportunity for them to invest in long-term, sustainable income streams through REITs. This is something we think local government should take forward."

Joy Shuchat, Construction, Real Estate & Hospitality, Grant Thornton LLP

The taxation of capital gains impacts the strategy of some REITs in that selling of certain real estate may not allow a deferral of gains and may require income treatment instead of capital gains. The ability to defer capital gains into the next generation of capital deployment would significantly benefit the REIT's development strategy.

Over time, if development and re-development activities were provided with more legal and taxation opportunities, we would see an earlier uptake in the REIT's unit value. In the current environment, the value being created by development-focused activities will have some history in considering the value of the REIT unit.

Protecting the REIT brand

It is important to guard against REITs becoming victims of their own success as they become more popular, with the possibility of share price bubbles caused by too much capital chasing too few assets. Good governance is needed to ensure shareholders' interests are protected.

The imbalance between new development and the huge amount of capital going into the sector has the potential to cause inflationary pressures, as is currently the case in the UK and US private healthcare markets, as well as in the retail and distribution sectors, with yields trading at very tight levels. The long-term solution must be for policy makers, planning authorities, investors, REITs and developers to work together to meet demand.

Effective governance and risk management is vital to maintaining success in the REIT regime. The market has seen a shift from internally managed REITs, which are more likely to take a longer-term view to build the business, towards an externally managed model with appropriate checks and balances. It remains to be seen whether this shift will deliver superior returns in the long term.

Incentives for asset managers should be aligned with the social objectives of the REIT, but management incentives are typically driven by net asset value, which does not always sit comfortably with wider corporate social responsibility goals.

It is vital to ensure that the interests of the investment manager, or employees of an internally managed REIT, are properly aligned with the shareholders' objectives. As well as fees related to the performance of the underlying assets, external managers might be incentivized based on other metrics such as share price performance relative to peers.

Ultimately there is no single approach and the effectiveness of each case will depend on the business model.

Purpose + profit = total returns

One potential solution to better align management incentives to social objectives is to link investment mandates to "total return," which includes an element of social purpose. This would of course need to be balanced with achieving the best risk-adjusted returns for investors in the round, but investors are increasingly looking for a social return element.

The concept of "total return"—a return on investment that is not just about financial rewards but also purpose-led social gain—could encourage investment into socially beneficial projects, with REITs well placed to achieve this.

Adopting "social KPIs" may provide a way to enhance public understanding of the good that REITs can do and encourage investors to think more broadly about how their investments have a social impact.

Stimulating development

With the flow of capital into REITs, there will always be pressure on REIT managers to find assets to use the capital available, and therefore the potential to create inflationary bubbles. The key question is how to stimulate development to redress the imbalance of demand and supply. REITs may have a vital role to play in this.

Specialist REITs are generally not mandated to take the development risk of buying undeveloped land, as this usually involves a level of risk that income investors want to avoid.

One possible solution is for REITs to act as development partners for new social housing or care home assets, which the REIT can acquire straightaway on completion.

Forward commitments may also encourage REITs to develop new specialist property, such as co-living spaces.

Educating the market

Raising awareness of the potential for REITs to deliver long-term social benefits calls for greater education of both investors and operators about the risks of the REIT structure.

In particular, there is a need for greater understanding of the specific risks of emerging asset classes and the inter-relationship between REIT yields and how net asset values move over time. Some observers question whether investors and operators really understand that specialist REITs come with different risks, particularly when it comes to property values.

For example, in social housing, where REITs are relatively new players, education is needed so that housing associations understand the risks involved in their lease commitments.

Recommendations

It is clear that REITs are having a significant impact on investment and development in vital Canadian property sectors with a social purpose.

To truly deliver the benefits and have the greatest possible impact on the sectors we have looked at—including supporting healthcare, providing high-quality social housing, and upgrading and expanding infrastructure projects—the key players (be that government, REITs, investors, developers or operators) will need to embrace change. Working together to overcome the obstacles to change will be key to success.

Investors REITs, developers and operators

Demand from investors for property investments that both generate a financial return and have a social purpose is growing. This in turn is encouraging REITs to make sure that their purpose aligns with the values of their investors.

Investors consequently have a vital role to play in shaping the future strategic direction of investment in Canadian property. Improved partnerships between investors and REITs would be welcome to help develop innovative solutions to the pressing investment needs that we have considered in this report.

An effective tri-partite relationship between REITs, developers and operators is vital. REITs can provide both the equity funding and the property management expertise; developers can take on the development risk and return and create innovative and state-of-the-art real estate; operators can continue to deliver excellence in the end user experience and drive quality standards.

All of this requires a flexible planning system that is open to change.

Government

Government has a vital role to play in creating structures that foster innovation, investment and development in property.

REITs are a key enabler of investment in these important property assets. More could be done to demonstrate that Canada is open for business and to encourage global investment in key Canadian real estate projects through the use of REITs.

As a matter of policy, we recommend that government takes this opportunity to review the REIT regime and consider making it available to a wider range of activities than is currently permitted.

The world has evolved significantly since the REIT regime was introduced in 1993, while the rules relating to the qualifying criteria have remained largely unchanged. Targeted improvements to the regime could go a long way towards encouraging investment in priority real estate sectors.

About Grant Thornton

Grant Thornton LLP is part of one of the worlds leading organizations of independent advisory, tax and audit firms. We are dedicated to helping our clients, colleagues, and communities thrive. Our advisors work to obtain a deep understanding of what is important to you, your business, and your industry.

As a Grant Thornton member firm, we are part of a network of over 50,000 people in over 130 countries. In Canada we are led by over 200 partners and over 2000 people across the country.

Our team is here to help

If you would like to explore REITs further, or are considering investing in or setting up a REIT, please contact:

Contributors

Farrah Khimji, CPA, CA, MBA
Principal, Real Estate and Construction
T +1 416 607 4588
E Farrah.Khimji@ca.gt.com

Gregory Gallant, FCPA, FCA, ICD.D
Partner, Real Estate and Construction
T +1 416 360 4987
E Greg.Gallant@ca.gt.com

Grant Thornton
An instinct for growth™

grantthornton.ca

Audit | Tax | Advisory

About Grant Thornton in Canada
Grant Thornton LLP is a leading Canadian accounting and advisory firm providing audit, tax and advisory services to private and public organizations. We help dynamic organizations unlock their potential for growth by providing meaningful, actionable advice through a broad range of services. Grant Thornton LLP is a Canadian member of Grant Thornton International Ltd, whose member firms operate in over 130 countries worldwide.