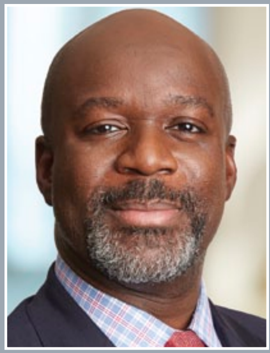
SPROTT FOCUSED STRATEGY

Why REITs and Why Now?



Dennis Mitchell
Senior Vice-President,
Senior Portfolio Manager

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Global Growth & The Outlook for REITs

When investing in real estate, many investors become overly focused on interest rates. The thinking is that REITs are highly-levered, bond proxies with very little growth. Therefore, when interest rates rise, REIT yields must also rise, leading to capital losses. We believe the causal link in this argument is false. REITs do NOT underperform because rates are rising. Rates rise **and** REITs lag the broader market because **growth** is accelerating. As growth accelerates, inflation expectations pick up and long bond yields begin to rise accordingly. This effect is magnified by fund flows out of bonds and into equities. In this environment, REITs tend to underperform the market because they are relatively lower growth, later cycle investments.

One of the benefits of REITs is their long term contractual revenue and expense streams. This structure provides transparency and predictability and makes valuation work more precise. It also means that during economic expansions, REITs will have to wait until leases are up for renewal in order to move rents higher and participate in the growth wave. Thus, operationally, they will lag other businesses on the way up and peak operationally well after economic fundamentals do. In addition, part of the benefit is lost as higher rates mean higher financing costs when the REIT's debt matures. So on balance, the elements of a REIT's structure that make it attractive as an investment (transparency and stability), make it a poor choice in a high growth environment.

However, at 3% for 2016, global growth remains below the long term trend. Developed markets, such as the US, Eurozone and the UK are poised to grow at approximately 1.5% in 2016 with little acceleration in 2017. Even China is targeting lower growth going forward as it transitions its economy. Food and commodity inflation remains low and long bond yields have remained near historic lows. In such an environment, it is difficult to see how central banks would be able to raise rates materially. Accordingly, we feel that interest rates and inflation will remain near current levels, supporting current REIT valuations.

IMF GLOBAL GDP FORECASTS

Country/Region	2015	2016	2017
World	**3.2%**	**3.1%**	**3.4%**
United States	2.6%	1.6%	2.2%
Canada	1.1%	1.2%	1.9%
Euro Area	2.0%	1.7%	1.5%
United Kingdom	2.2%	1.8%	1.1%
Japan	0.5%	0.5%	0.6%
China	6.9%	6.6%	6.2%
India	7.6%	7.6%	7.6%
Brazil	-3.8%	-3.3%	0.5%

Source: IMF, October 2016

OECD GLOBAL GDP FORECASTS

Country/Region	2015	2016	2017
World	**3.1%**	**2.9%**	**3.2%**
United States	2.6%	1.4%	2.1%
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Euro Area	1.9%	1.5%	1.4%
United Kingdom	2.2%	1.8%	1.0%
Japan	0.5%	0.6%	0.7%
China	6.9%	6.5%	6.2%
India	7.6%	7.4%	7.5%
Brazil	-3.9%	-3.3%	-0.3%

Source: OECD, September 2016

Growth Levers for REITs

REITs are often maligned for being low growth. On a relative basis, this is true but it does not mean that publicly-traded real estate is devoid of growth. REITs have several levers they can utilize to generate growth, some of which are often overlooked by investors. They are discussed here in descending order of attractiveness based on the magnitude of the impact on the portfolio and the capital required to generate this growth.

Asset & Property Management

Collectively, these are the scale and scope advantages that accrue to a skilled operator with a large and clustered portfolio of assets. Skilled property management (operating individual properties) and asset management (optimizing the portfolio) should yield revenue gains and expense savings that allow for cash flow per unit growth, independent of market factors. These benefits tend to accrue to most of the portfolio and perpetuate into the future. For instance, newer, more efficient appliances purchased at a larger discount, unsecured debt issuances in the capital markets and lower property taxes from assessment appeals should all result in higher rents and/or lower expenses. Rolled out across an entire portfolio this should result in meaningful value creation through the business cycle.

Contractual Rent Increases

These represent return on past negotiations and result in current period revenue gains based on past period expenditures (leasing costs and tenant inducements). A quality real estate portfolio should see annual contractual rent increases across most (if not all) of the portfolio leases that don't expire that year. Indexing these rent increases to inflation creates a natural inflation hedge to offset some of the impact of rising rates and capture some growth.

Positive Lease Renewals & Occupancy Gains

These levers are similar in that capital is required to retain an existing tenant or acquire a new tenant. Positive lease renewals result in increased revenue from the existing asset. Depending on the capital outlay required, this is generally cheaper and preferable to finding a new tenant. Occupancy gains involve securing a new tenant for an existing and unoccupied space. The capital required is generally higher but partially offset by the impact of taking vacant space off the market and tightening up current supply and demand fundamentals.

Accretive Acquisitions & Developments

Both of these activities grow cash flow per unit by adding new assets to the portfolio. Acquisitions are of existing assets and so more operating information is available to make an accurate assessment of the value of the asset. However, developments are usually more lucrative from a return standpoint but they are also carry greater risks (over budget, delays, economic downturn). Both of these options entail significant current capital outlays for at risk future cash flows.

So Why REITs and Why Now?

Much has been made about low central bank policy rates driving up equity valuations. Traditional safe havens (REITs, Utilities, Consumer Staples) are expensive on a historical basis and many are calling for a correction. While this is possible, historically valuation alone has not been enough to end a bull market. A catalyst is generally required, and many investors feel that rising interest rates will be the catalyst this time. However, we are skeptical that rates will increase in a manner or at a magnitude that will produce a prolonged and deep sell off in equity markets.

With that in mind, REITs continue to offer what the market is paying a premium for – stability. Contractual revenues paired with contractual expenses yields a consistent cash flow stream that investors can forecast with a great deal of certainty. Generally, the better the portfolio, the more resilient and consistent the results are and the richer the valuation premium. So from our standpoint, REITs with high quality assets in core markets should continue to attract capital and should have sufficient operating leverage to deliver growth in distributions and capital values.

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We do recognize that the Federal Reserve is poised to raise the Federal Funds Rate by 25bps in December. If the market reacts similarly to last year's telegraphed rate hike then this will create buying opportunities in the global real estate sector that we intend to leverage. As growth picks up in the US, we will allocate capital to specialty REITs (towers, datacenters, healthcare) and real estate related companies (construction, brokerage and banking) to capture more early cycle growth. In other markets where growth remains modest, we will continue to purchase high quality REITs with better growth potential and rising distribution profiles.

Historically, long term REIT returns have been split evenly between distributions and capital appreciation. REIT distributions in some jurisdictions come from pre-tax income (i.e. the REIT pays no tax on its income) and so investors are NOT subject to double taxation as they are from corporate dividends (dividends are paid out of after-tax income and are further taxed in the investors hands). In addition, in some jurisdictions, REIT distributions have material amounts of "return of capital" which is generally exempt from taxation in the investor's hands. This results in even greater after-tax yields to REIT investors versus other competing investments such as preferred equity or high yield bonds.

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COMBINED FEDERAL & ONTARIO 2016 TOP MARGINAL TAX RATES			
	Business Income	Capital Gains	Eligible Dividends
	53.53%	**26.76%**	**39.34%**
AFTER-TAX YIELD COMPARISON			
Security	Nominal Yield	After-Tax Yield	RioCan Yield Advantage
RioCan REIT	5.41%	**4.07%**	
High Yield Bonds	5.38%	2.50%	62.71%
Preferred Equity	5.02%	3.05%	33.52%

Source: High Yield Bonds represented by iShares iBoxx High Yield Corporate Bond ETF, Preferred Equity represented by BMO Laddered Preferred Share Index ETF. As of October 31, 2016

Recently the Global Industry Classification System ("GICS") has been expanded to include Real Estate as a standalone sector. Real Estate is currently 2.9% of the S&P 500, making it larger than Telecom and Materials and slightly smaller than Utilities. Financials declined to 13.3% of the S&P 500, still trailing Technology but now behind Health Care as well. In making this decision, MSCI and S&P Dow Jones noted the increased specialization of the Real Estate sector (13 sub-industries and 2 industry groups) and the low correlation of Real Estate returns with the rest of the Financials sector. It helps that over 35 nations globally, including all G7 countries, have adopted the REIT structure. We feel this change to the GICS will drive increased allocations to real estate from generalist and passive money managers. These allocations will likely be more strategic and long term in nature since these managers will have to have an opinion on real estate through the cycle.

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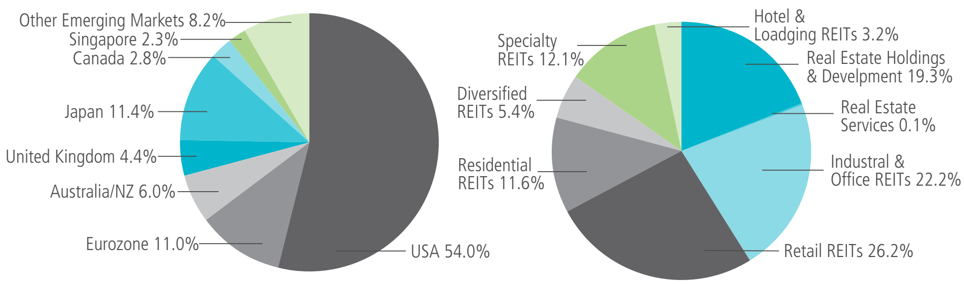
Countries that Have Adopted the REIT Approach

Source: NAREIT®
Date indicates adoption year of REIT rules.

Many investors have done well investing in the S&P/TSX Capped REIT Index over the last several years. However, it's important to note that Canadian REITs represent a very small fraction of the publicly-traded real estate available to investors. While the US still dominates at just over 54% of the FTSE EPRA NAREIT Developed Index (our benchmark), there is representation from over 20 different countries. At just 2.8% (19 total names), Canadian REITs are the seventh largest geographical allocation in this benchmark. By limiting themselves to Canadian REITs, investors are foregoing opportunities to own investment grade commercial real estate in world class cities such as New York, London, Paris, Singapore and Hong Kong. These are markets where supply is generally limited and demand is usually robust, yielding rising real estate values and strong risk-adjusted returns. In addition, several global REIT sectors don't exist in Canada (towers, datacenters, self-storage, student housing) and are only available to global REIT investors.



Our fund will leverage all of the global opportunities that exist in real estate. The fund will not resemble the S&P/TSX Capped REIT Index and should be able to deliver superior returns by virtue of the larger investable universe and the ability to allocate capital to regions with more accommodative financial environments.

Thanks and Stay Focused,

Dennis Mitchell
Senior Vice-President,
Senior Portfolio Manager
Sprott Asset Management

"By limiting themselves to Canadian REITs, investors are foregoing opportunities to own investment grade commercial real estate in world class cities such as New York, London, Paris, Singapore and Hong Kong."

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