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A four-letter word every REIT investor should know

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Investors who are fans of REITs are likely familiar with another acronym, AFFO.

That's "adjusted funds from operations," one of the most important earnings measures for evaluating real estate investment trusts.

The problem, however, has been that there was no precise definition for AFFO, much like there's no standard definition for "adjusted EBITDA," a metric that can give investors fits because one trust's preferred number could be calculated differently from another's, making the two not comparable.

That is, until now. The Real Property Association of Canada, or REALPAC, stepped into this void, not long after the Ontario Securities Commission expressed concern in 2015 on how some unnamed REITs were describing and calculating AFFO.

After extensive dialogue with industry participants, REALPAC established a definition earlier this year for AFFO and also introduced a second measure, "adjusted cash flows from operations." (REALPAC already had a definition for the basic funds from operations, or FFO, but nearly everyone was adjusting that, creating their own little AFFOs.)

The idea was that the standardized AFFO would be a measure of earnings and ACFO would be a standardized proxy for cash flow that could be used to assess a REIT's payout ratio. Investors would then have clear numbers to use to compare one REIT with another.

The early results are in. And it seems, unfortunately, that it will take some time for REALPAC's vision to become a reality.

Analyst ***Howard Leung*** at ***Veritas Investment Research*** reviewed 16 Canadian REITs that presented either AFFO or ACFO metrics in the first quarter of 2017. (All 16 present the basic funds from operations.) His tally: While 13 REITs used an AFFO measure, only five completely followed REALPAC's AFFO standard "to the letter." Just seven of the 16 REITs used an ACFO metric and only four of those followed the REALPAC standard.

"While the REALPAC paper recommends that investors use ACFO to assess [distribution] payouts, ACFO is not likely to have the traction that AFFO does, at least in the near term," ***Mr. Leung*** writes. "The majority of REITs still use AFFO while ACFO is more sparsely adopted. As a result, we expect a mixed approach to payout ratios, with some companies using an ACFO basis and others sticking to AFFO."

(For an explanation of how the two are calculated, please see below.)

Nancy Anderson, REALPAC's chief financial officer, says that given how long there have been discrepancies in how REITs use AFFO, "the fact everyone didn't instantly change in [the first quarter] – we expected that. Change takes a long time. We didn't expect it to be instantaneous."

Asked whether REALPAC's having two measures that are neither universally adopted nor universally followed has created more confusion, not less, she says, "I don't think we have."

There were "many, many definitions" of AFFO before, she says. "Now we have fewer and an industry standard definition. AFFO was being used both as an earnings measure and as a cash-flow metric, and there wasn't consensus as to what it should be used for. All we are doing is clarifying where people were using AFFO in two different ways."

There is still, certainly, some room for management discretion. One major place is in capital expenditures for property maintenance. Under the REALPAC guidelines, REITs can use an estimate of maintenance capex, deducting an amount that's based on, but not identical to, actual capital expenditures. The number management chooses must be used in both the AFFO and ACFO calculation.

"Our preference is that actual capex and leasing costs be used instead of [estimates], as actuals require far less judgement … allowing for better apples-to-apples comparisons across REITs," ***Mr. Leung*** writes. "While we understand the argument that using [estimates] 'smooths out' volatility in capexs, we think there is something to be said for showing the volatility and allowing readers to make their own judgements on whether these fluctuations are representative."

Mr. Leung says that Killam Apartment REIT, a residential REIT based in the Maritimes, is an example of best practices in the use of capex estimates. Killam is very clear, he says, on why it excludes certain capital expenditures such as building enhancements and suite upgrades from the calculation of maintenance capex. It also has a minimum return-on-investment hurdle of 10 per cent for its upgrades, which ***Mr. Leung*** writes "is a good sign of management's capital discipline."

For now, ***Mr. Leung*** says, ***Veritas*** will continue using AFFO, not ACFO, to evaluate REIT's payout rates. Investors can make their own adjustments to reported funds from operations to standardize AFFO, he says, and can still calculate an AFFO metric for REITs that don't report it themselves.

By contrast, standardization is far more difficult for ACFO due to the subjectivity of working capital adjustments and problems divining the ACFO of equity accounted investments.

"Given ACFO presents a stronger picture, however, we believe that this metric will gain traction over time, which may spur better disclosures," ***Mr. Leung*** writes.

Until then, REIT investors will have to turn a keen eye to the A in AFFO.

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The nitty-gritty
Industry group REALPAC has created a definition for adjusted funds from operations (AFFO), an earnings measure that departs from the industry group's own standard for funds from operations (FFO). Here are the only permitted adjustments:

Funds from operations (FFO)

plus …

- Capital expenditures (capex)
- Leasing costs
- Tenant improvements
- Straight line rent
- Non-controlling interests in respect of the above

… equals AFFO

The industry group has also created adjusted cash flow from operations (ACFO), as a proxy for operating cash flow and a measure by which a REIT's payout can be compared. Here is how it is calculated:

Cash flow from operations per IFRS statement of cash flows
plus …

- Change in working capital
- Interest expense included in cash flow from financing
- Amounts from joint ventures not included in cash flow from operations
- Capital expenditures (capex)
- Leasing costs
- Tenant improvements
- Realized gains/losses on marketable securities not included in cash flow from operations
- Taxes related to non-operating activities
- Transaction costs associated with acquiring investment properties
- Transaction costs associated with disposing of investment properties
- Deferred financing fees
- Debt termination costs
- Off market debt (either favourable or unfavourable)
- Interest income/expense
- Non-controlling interest in respect of the above

… equals ACFO.

Source: REALPAC