QC INVESTMENT MEMO

To:	Kelvin Li
From:	Danny Kim and Mike Vanderlinden
Date:	July 18th, 2015
Re:	**Smart REIT (Calloway REIT) (TSX:SRU.UN)**

COMPANY PROFILE

Industry:	Canadian REITs
Main Asset(s):	149 Shopping Centers across Canada
Market Capitalization:	$4,046.1 mm
Debt:	$3077.4 mm
Cash:	$51.3 mm
Enterprise Value:	$7680.0 mm
NTM(E) Revenue:	683.85 mm
NTM(E) EBITDA:	434.06 mm
NTM(E) AFFO/Unit:	$2.08 per unit

INVESTMENT PROFILE

Current (Proposed) Investment Size:	N/A
Position Cost Basis:	N/A
Current Share Price:	$29.91
Life to Date Profit (Loss):	$3440.3 mm
Life to Date Percentage Return:	33,355.56 %
Base Case Valuation:	$33.28 (16.5% 1 year upside)
Downside Case Valuation:	$26.70 (5.1% 1 year loss)
Upside Case Valuation:	$40.46 (40.6% 1 year upside)

COMPANY DESCRIPTION

Smart REIT (TSX:SRU.UN), formerly Calloway REIT, is a Canadian based open ended Real Estate Investment Trust. Calloway REIT recently acquired the SmartCentre franchise for ~$1.16 billion and changed its company name/ticker. The company owns and manages shopping centers in Canada, both directly and through its subsidiaries. The company has a relatively diverse tenant mix, with Wal-Mart Canada as their core tenant (accounting for ~27% of Smart's pro-forma revenue). Smart REIT owns approximately 149 shopping centers, 7 development properties, one office building and one industrial building. The company controls gross leasable area of ~31 million square feet, of which ~99% is currently occupied. Besides Wal-Mart, the company's core tenants include Canadian Tire/Marks, Winners and Best Buy. Calloway is led by Huw Thomas, and with the acquisition of SmartCentres, management also secured Mitch Goldhar as their chairman, an industry veteran with a 20+ year relationship with Wal-Mart. With a multi-billion dollar market capitalization, Smart REIT is one of 6 large cap REITs listed on the TSX, alongside Choice Properties, Crombie, CT, First Capital & RioCan.

VALUATION

Valuation I – Comparable Analysis

Real Estate Investment Trusts - Retail				EV/EBITDA			Distribution	AFFO
Company Name	Market Capitalization	Enterprise Value	Premium (Disc) to NAV	LTM	2015E	2016E	Yield (%)	Payout (%)
Riocan Real Estate Investment Trust (TSX:REI.UN)	$6,790.80	$12,149.10	1.10%	20.8x	19.60x	18.70x	5.3%	90.0%
Choice Properties Real Estate Investment Trust (TSX:CHP.UN)	$3,492.10	$9,050.20	0.54%	16.8x	14.90x	14.70x	6.0%	82.0%
First Capital Realty Inc. (TSX:FCR)	$3,133.20	$6,017.10	-8.81%	19.5x	20.00x	19.20x	4.9%	89.0%
CT Real Estate Investment Trust (REIT) (TSX:CRT.UN)	$1,838.90	$4,216.50	3.51%	nmf	22.00x	20.50x	5.4%	82.0%
Crombie Real Estate Investment Trust (TSX:CRR.UN)	$1,303.90	$2,913.50	-12.46%	16.1x	15.16x	14.10x	7.1%	94.0%
Morguard REIT (TSX:MRT.UN)	$812.40	$1,831.80	-22.97%	15.2x	14.50x	14.50x	5.7%	76.0%
Smart Real Estate Investment Trust (TSX:SRU.UN)	$3,192.20	$6,000.30	-5.05%	20.1x	17.92x	16.60x	5.6%	82.2%
High	$6,790.80	$12,149.10	1.10%	20.8x	22.0x	20.5x	7.1%	94.0%
Low	$812.40	$1,831.80	-22.97%	15.2x	14.5x	14.1x	4.9%	76.0%
Mean	$2,937.64	$6,025.50	-6.31%	18.1x	17.7x	17.0x	5.7%	85.0%
Median	$3,133.20	$6,000.30	-5.05%	18.2x	17.4x	16.7x	5.6%	82.2%

Sources: Capital IQ, Thomson One, Research Reports

- A full comparable analysis table is shown in the supplementary Excel exhibit. Smart REIT trades at a ~5% discount to NAVPU, while RioCan and Choice trade at premiums to NAVPU. SRU trades at median AFFO payout, distribution yields and Debt/GBV levels. While Smart REIT trades slightly above the comparable median on a P/FFO and P/AFFO basis, RioCan, Choice Properties and First Capital, arguably the most comparable companies in the universe trade at significantly higher multiples.
- Therefore, we believe that the market has not priced in Smart REITs recent acquisition, stability and compelling portfolio fundamentals – Smart REIT should trade at significantly higher multiples.

Valuation II – Net Asset Value (NAVPU)

Valuation II - Net Asset Value (NAVPU)		$mm
2015E NOI		454.64
Target Cap Rate		5.75%
Gross Property Value		7906.78
Assets		8357.88
Less: Investment Properties		7549.09
Other Tangible Assets		808.79
Total Assets		8715.57
Less: Total Liabilities		3993.12
Net Asset Value		4722.45
Units Outstanding		152.5
NAVPU	$	30.97

NAVPU Sensitivity Analysis

		2015E NOI ($mm)				
		425	440	455	470	485
Cap Rate (%)	6.05%	$ 25.18	$ 26.81	$ 28.43	$ 30.06	$ 31.69
	5.90%	$ 26.35	$ 28.02	$ 29.69	$ 31.36	$ 33.02
	5.75%	$ 27.59	$ 29.30	$ 31.01	$ 32.72	$ 34.43
	5.60%	$ 28.88	$ 30.64	$ 32.40	$ 34.15	$ 35.91
	5.45%	$ 30.25	$ 32.06	$ 33.86	$ 35.67	$ 37.47

- Our NAVPU analysis shows a net asset value for each unit (share) of Smart REIT of ~$31. At current market prices, this implies a discount to NAVPU of approximately 5%. In order to arrive at our NAVPU, we used a capitalization rate of 5.75% and consensus 2015 NOI. Our capitalization rate was between the 5.9% used by National Bank Financial to value SRU and the 5.6% capitalization rate used by CIBC World Markets to value the company.
- While some would value SRU solely on NAVPU, we believe that, as a result of Smart REIT**s** sustainable presence and growth prospects, the REIT can sustain a moderate premium to NAVPU.

Valuation III – Multiples & Target Price

Price Target Sensitivity Analysis

		2015E P/AFFO				
		15.0x	15.5x	16.0x	16.5x	17.0x
AFFO 2015E	$ 1.78	$ 26.70	$ 27.59	$ 28.48	$ 29.37	$ 30.26
	$ 1.93	$ 28.95	$ 29.92	$ 30.88	$ 31.85	$ 32.81
	$ 2.08	$ 31.20	$ 32.24	$ 33.28	$ 34.32	$ 35.36
	$ 2.23	$ 33.45	$ 34.57	$ 35.68	$ 36.80	$ 37.91
	$ 2.38	$ 35.70	$ 36.89	$ 38.08	$ 39.27	$ 40.46

- We valued Smart REIT by applying a 16.0x AFFO multiple to consensus AFFO of $2.08 per unit. While this target price of $33.28 represent a ~7% premium to our NAVPU, we are confident that Smart REIT can sustain such a valuation, given that RioCan and First Capital trade at significantly higher multiples. Therefore, our base scenario represents an equity upside of ~11% with a distribution yield of ~5.6% for a 1 year return of approximately 16.5%.

- Our bear scenario features a 16.0x AFFO multiple at pessimistic AFFO of $1.78 per unit. This equates to a target price of $26.70, implying an equity downside of ~10.7%, but a 5.6% stable distribution yield implies a 1 year all-in loss of ~5.1%.
- Our bull scenario features a 17.0x AFFO multiple at extremely optimistic AFFO of $2.38 per unit. This equates to a price target of $40.46, implying an equity upside of ~35% - with a stable distribution yield of 5.6%, the 1 year all-in return equates to ~40.6%.

INVESTMENT THESIS

- *Investment Thesis I – Compelling Portfolio Fundamentals and Stability Through Wal-Mart*

  Smart REIT is large, geographically diverse and controls a large GLA, which has consistently reached near maximum occupancy (~99%). Demand for the REIT's properties is visible, with a weighted average lease term of 7.5 years. Rents have also grown, with a 2014 average 6.3% over expiring rents, which showcases tenants' desire to retain prime real estate. Wal-Mart has consistently been a core, stable tenant, accounting for approximately 27% of Smart's pro-forma revenue. Wal-Mart offers both stability and attracts other high quality retailers who are anxious to claim their share of Wal-Mart's traffic. Thus, Wal-Mart's presence offers Calloway a significant degree of pricing power over other tenants. The REIT's exposure to Alberta (where consumer spending and real estate markets have cooled) is also extremely limited, with ~4% of total portfolio GLA. Calloway's recent acquisition of the Smart Centre franchise has only strengthened their relationship with Wal-Mart, adding 20 Wal-Mart anchored properties to their portfolio.

- *Investment Thesis II* – Discounted But Favorable Macroeconomic Conditions and Lease Environment

  Globally, REIT shares have dipped recently, as concerns over the Greek Debt Crisis have put upward pressure on most sovereign bond yields. Additionally, the Federal Reserve has hinted to overnight lending rate increases in the near future, which has led to a significant spike in US treasury yields and the potential for higher re-financing costs, hurting REITs. Canadian REITs have felt the spillover effects from these concerns. Canadian retail REITs have also felt the effects of Alberta's real estate meltdown, and the absence of Target and Future Shop in Canada. While Calloway did have significant Future Shop exposure, we believe that the market has not fully priced in Calloway's stability with Wal-Mart and its current high lease/occupancy rates, given that RioCan, Calloway's most comparable competitor, was significantly hit by Target's decision to leave Canada but trades almost 5x higher on a forward P/AFFO basis. Furthermore, with WTI crude prices poised to remain bottomed out for the medium term and disappointing economic forecasts, Canadian interest rates should also remain bottomed out for the medium term. Increased consumer spending from lower oil prices/interest rates outside of Alberta and lower refinancing costs should enable Calloway to maintain its stability and finance further growth through acquisitions, given a moderate Debt/GBV ratio of 46%.

- *Investment Thesis III – Smart Centre Acquisition Poised to Create Value and Earnings Accretion*

  Calloway recently closed a $1.2 billion acquisition of 22 shopping centres, two development properties and SmartCentres' development infrastructure. This transaction adds high quality locations (with 99.7% occupancy and 12.6 year weighted average leases) and adds complimentary management to the REIT, including Mitch Goldhar (the creator/owner of SmartCentres who brought Wal-Mart to Canada). With the acquisition of SmartCentres, Calloway can only strengthen their relationship with Wal-Mart and bank on the experience of one of Canada's shrewdest real estate players. Additionally, analysts estimate that the acquisition will be accretive to 2016E AFFO per unit by ~5%. We believe that Smart REIT's current discount of ~5% to NAVPU is partially due to the market not accounting for Smart REIT's new fully integrated real estate platform, and that this discount to NAVPU will soon be corrected as a result of SRU's stability and superior growth outlook.

- *Investment Thesis IV – Attractive Distribution to Payout Opportunities and Distribution Increases*

  Smart REIT's current 5.6% distribution yield is roughly on par with the TSX large cap REIT average, but its 78.5% 2016E AFFO payout ratio is priced very favorably versus the TSX large cap REIT average 2016E AFFO payout of 83.9% for a comparable yield, given SRU's discount to NAVPU. Therefore, we believe that the potential for distribution increases in the future is very likely, which will only strengthen SRU's position against both other large cap REITs and other fixed income investments, such as bonds, thereby boosting investment returns.

KEY INVESTMENT RISKS

RISK I

Description of Risk I:

- Rising global bond yields and overnight lending rate increases from the Federal Reserve would decrease the attractiveness of Smart's distribution yield, which could put downward pressure on SRU's share price. If oil prices rebounded significantly and Canada's economy recovered, the Bank of Canada could raise interests rates, which would spike Canadian bond yields and increase SRU's re-financing risk.

Mitigating Factor to Risk I:.

- With a Greek deal, we can expect many sovereign European bond yields to fall. If the Federal Reserve chooses to tighten monetary policy, they will do so gradually, and the timeline is flexible. Many economists thought that the Fed would raise rates during its June policy meeting, but a rate hike never materialized. As previously noted, we expect inflation to remain bottomed out as a result of continued low oil prices (due to weakened demand in China, general oversupply and the Iran Nuclear Deal), meaning that the Bank of Canada is unlikely to raise their target for the overnight lending rate in the medium term.

RISK II

Description of Risk II:

- Dependence on Wal-Mart as a core tenant and a lack of pricing power with Wal-Mart. SRU is highly dependent on Wal-Mart to meet its rental obligations and provide foot traffic for other retailers. Given that Wal-Mart's average lease term is ~8.4 years (above average), rental rate growth is also constrained.

Mitigating Factor to Risk II:

- As previously mentioned Wal-Mart's presence increases the pricing power of SRU for other tenants and provides necessary stability in Smart's portfolio. Given that Wal-Mart has integrated SmartCentres into its portfolio and Mitch Goldhar is now a member of the REITs management team, SRU's relationship with Wal-Mart will only improve.

RISK III

Description of Risk III:

- Difficult Retail Landscape in Canada – As previously noted, the departure/bankruptcy of several retailers in recent months (Target, Future Shop, Mexx, Smart Set and Jones New York) have created sizeable vacancies in REIT portfolios. If SRU cannot lease its 2 vacant Target stores, 5 vacant Future Shop stores and 11 Smart Set stores, downward pressure on cash flow and revenues could drive down SRU's share price.

Mitigating Factor to Risk III:

- Calloway's management has an exceptional track record, and we fundamentally believe in their ability to fill these leases, especially with the addition of Mitch Goldhar. Given that consumer spending is expected to rise with lower oil and interest rates (besides Alberta), and the fact that 80% of Canada's economy is growing at an annualized pace of 2%, we believe that much of the Canadian retail landscape, excluding Alberta, will rebound.

CATALYSTS

Investment Catalyst I - Lower bond yields and interest rate reductions

- Further reductions to the overnight lending rate by the Bank of Canada (i.e. another 25 bps reduction to the overnight target) would reduce re-financing risk and borrowing costs for SRU, which carries significant leverage. Additionally, if the Federal Reserve were to hold off on raising interest rates, US treasury yields could suffer and US re-financing costs would not rise, which would benefit Smart REIT (and virtually every other REIT). Prolonged low interest rates would thus merit improved valuations for Smart REIT.

Investment Catalyst II – Further Accretive Acquisitions

- Given a prolonged Canadian low interest rate environment and SRU's moderate Debt/GBV level of 46%, Smart REIT could make another accretive acquisition if the opportunity presents itself, improving its position as a fully integrated real estate platform. Such an acquisition could create cost, revenue and management synergies (like the acquisition of SmartCentres), which would in turn put upwards pressure on SRU's share price.

Investment Catalyst III – Expansion of existing retailers and entrance of new retailers

- The entrance of foreign retailers into the Canadian retail market could fill Calloway's vacancies from Target and Future Shop, adding to cash flow and FFO. Other retailers, such as Dollarama, are expanding rapidly throughout Canada and are always on the lookout for premium real estate. As Smart REIT continues to expand and acquire/create new holdings, management's relationships with these companies will become critical in order to boost NOI and rental growth.

KEY INVESTMENT STRENGTHS

STRENGTH I

Description of Strength I: Attractive Leases and Tenants

- As previously stated in the investment thesis, SRU controls premium shopping centers with near maximum occupancies (99%) and leases average 7.5 years. Its core tenants, including Walmart and Canadian Tire are strong Canadian retailers.

STRENGTH II

Description of Strength II: Attractive AFFO Payout Ratio and Potential For Dividend Increases

- As previously noted, Smart REIT's forward AFFO payout ratio is well below the TSX large cap REIT average, meaning that the REIT can easily pay dividends and that future distribution increases are probable.

STRENGTH III

Description of Strength III: Strong Management Team

- With the acquisition of SmartCentres, Mitch Goldhar joined SRU's management team as chairman of the board. His extensive experience in the retail industry and relationship with Wal-Mart can only benefit Smart REIT moving forward, as previously noted.

STRENGTH IV

Description of Strength IV: Large and Liquid

- Even after the ~$1 billion acquisition of SmartCentres, Smart REIT has maintained a Debt to GBV ratio of approximately 46%, which is on par with the TSX large cap REIT average. Thus, the company can finance further acquisitions if need be, since Debt to GBV ratios cap out around 60%. Smart's significant market capitalization and GLA will also minimize downside in the event that other tenants vacant properties.

INDUSTRY DETAILS

Queen's Capital is overweight on the Canadian REIT market and underweight on the American REIT market, as previously noted in this report. Low oil prices and inflationary pressures in Canada should continue to facilitate consumer spending (outside of Alberta) and a prolonged low interest rate environment. Valuations remain low as a result of high bond yields and the potential for a real estate market in Alberta, enabling our sector to capitalize on undervalued, high quality REITs. However, as previously noted, the Federal Reserve will likely raise the federal funds rate in the near future. This will severely increase the re-financing risk of American REITs and push up US treasury yields, which will put downward pressure on REIT share prices. That being said, we will continue to look for attractive valuations in the US REIT market, contingent on external factors such as the strength of the US dollar.