Real Estate Investment Trusts: To Buy or Not to Buy?

Description

As measured by the major REIT indices, prices of Canadian and U.S. Real Estate Investment Trusts (REITs) declined by around 15% from their May 2013 peaks.

At the same time, the broad market indexes in Canada and the United States increased by 13% and 16%, respectively, leading to a substantial underperformance of REIT shares (see chart below). In addition, commercial and residential property prices continued to increase in both Canada and the U.S. over this time period.

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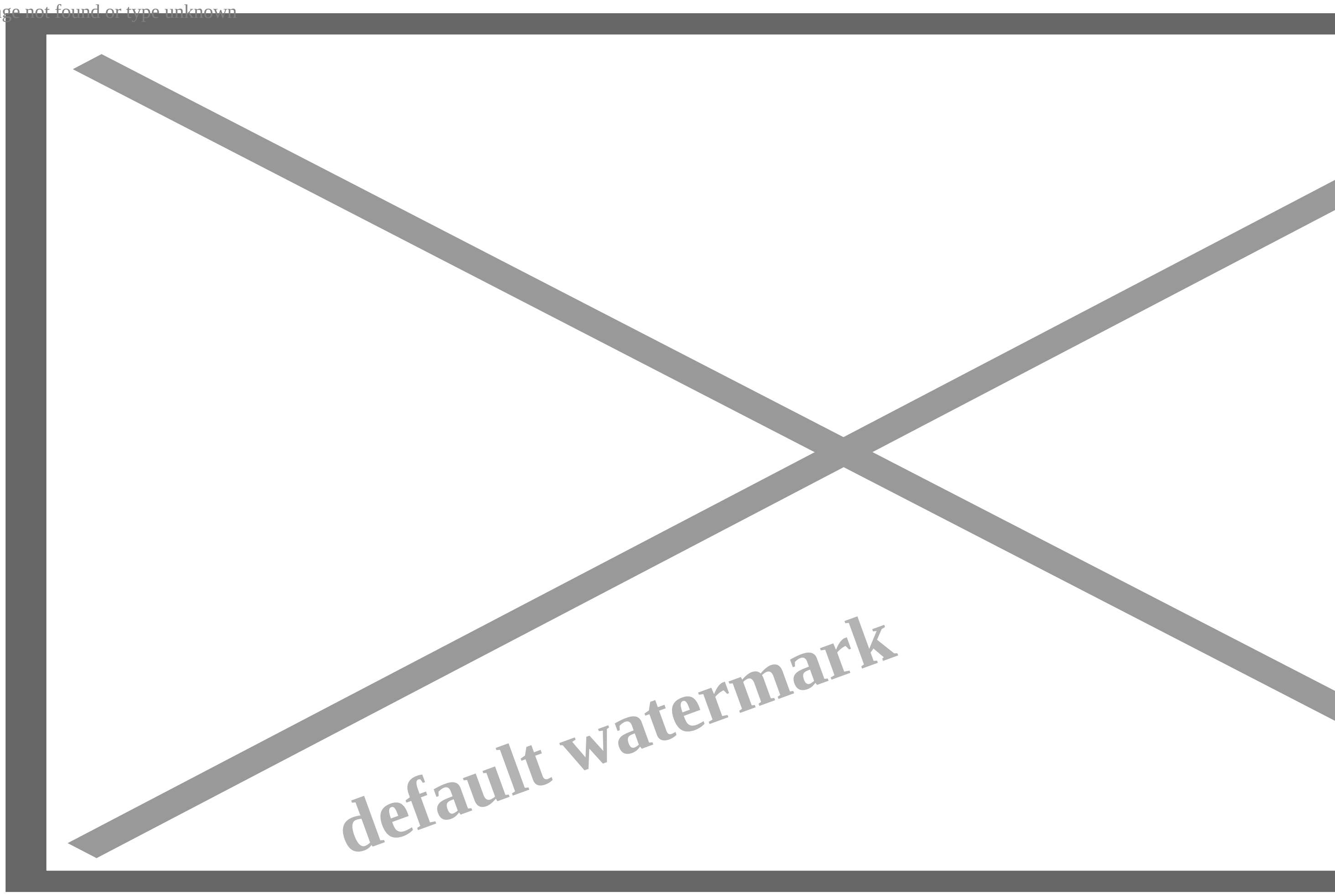

The simple explanation for this substantial underperformance of both Canadian and U.S. REITs was an increase in bond yields, which impacted the relative attraction of all assets held mainly for income-producing purposes.

Government bond yields in the 10-year maturity range in both the U.S. and Canada have increased by around 90-100 basis points since May 2013 while the dividend yields on REITS in Canada increased by 90 basis points (now 5.9%) and on USA REITS by 80 basis points to 4.4%.

While we acknowledge their income-producing capabilities, REITS have profit, dividend growth and volatility characteristics that should cause them to behave more similar to equities than bonds under normal market conditions.

The recent increase in bond yields, which was initially caused by the expectation that monetary accommodation in the U.S. (and by implication Canada) will eventually end, should have positive implications for general economic activity and for property rental income growth. It would seem that the sharp underperformance of REITS relative the wider equity market indices has not taken this into account.

Is it time to buy?

I find U.S. REITs particularly interesting, with absolute yields that are substantially higher than U.S. government bond yields and equity market yields. With signs that the wider U.S. economy is improving, prospects for rental growth is also improving. In this context, I favour **Health Care REIT** (NYSE:HCN) and **Realty Income Corporation** (NYSE:O).

Health Care REIT owns a variety of senior housing facilities spread throughout 46 states in the U.S., with a few in Canada and the United Kingdom. The facilities include skilled nursing/post-acute facilities, hospitals, medical office buildings, and life science facilities.

The share price has declined by 29% from the recent peak in May 2013, has an initial yield of 5.5% and boasts a long-term track record of uninterrupted dividend payments. In addition, it has managed to grow the dividend income by 3% annually over the past 10 years through the economic crisis period. Growth prospects appear reasonable with analysts expecting dividend growth of 3.6% and 3.7% in 2014 and 2015 respectively, according to Thomson Reuters SmartEstimates.

The Realty Income Corporation owns 3,866 properties spread across 49 states in the U.S., mostly in the retail sector with some exposure to the industrial and distribution sectors as well. The share price has declined by 29% since the May 2013 peak, has an initial yield of 5.5% and the company has an outstanding long-term track record of growing dividend payments (7.5% per annum over the past 10 years).

Growth prospects appear reasonable – according to Thomson Reuters, analysts are expecting dividend growth of 3.3% and 3.6% in 2014 and 2015 respectively.

Foolish bottom line

The positive case for REITs in Canada is based on an absolute attractive yield (5.8%), which is 2.25 times higher than Canadian 10-year government bond yields and 2.1 times higher than the yield on the wider equity market. However, given our concerns over real estate valuations in the Canadian housing market and seemingly weaker growth prospects than the U.S., we prefer to take advantage of the attractive opportunities currently available in the U.S. REIT market.

CATEGORY

1. Investing

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