Do Lower Bond Yields Mean Higher Canadian REIT Prices?

Description

With Canadian government bond yields approaching levels not seen in more than 60 years, one could rightfully ask why the yields on REITs have not followed suit.

The yield on five-year Canadian government bonds dropped yesterday to 1.18% and the yield on 10-year bonds to 1.62%. By comparison, the dividend yield on the Canadian REITs with the highest market values, **RioCan Real Estate Investment Trust** (TSX:REI.UN) and **H&R Real Estate Investment Trust** (TSX:HR.UN) are 4.9% and 5.8% respectively. To be sure, the yields on these REITs have declined over the past few years but not nearly by as much as what would be expected given the declines in bond yields.

Except during times of economic distress, lower bond yields should make other income-producing assets more attractive. The table below indicates that the yield on RioCan, for example, is now 3.0 times the yield on the 10-year Canadian government bond – this ratio is almost 30% higher than the average over the past five years.

Investors are either expecting bond yields to rise substantially over the next few years or that economic conditions will weaken to such an extent that RioCan will not be able to sustain the dividend. The same situation applies to H&R. Neither seems a plausible scenario leaving the impression that REITs are currently undervalued compared to bonds.

Name	**Yield Dec. 2013**	**Current Yield**	**Change in Basis Po**
10-Year Canada Government Bond	2.77%	1.62%	-115
RioCan	5.69%	4.90%	-79
H&R	6.30%	5.80%	-50

Sources: Bank of Canada and Thomson Reuters

Will the lower oil prices impact the dividend payments of these REITs?

RioCan owns a portfolio of mainly retail properties in Canada and the U.S. with the U.S. component contributing 16% of the current rental income with the balance arising from the Canadian portfolio. The portfolio is located mainly in the cities of Vancouver, Toronto, Ottowa, Montreal, and Calgary with the Calgary properties contributing around 15% of the portfolio income. **Loblaw, Walmart,** and **Canadian Tire** are the top three tenants and the weighted average lease term is approximately six years.

RioCan has an excellent track record of consistent dividend payments, although growth has been slow over the past few years. Consensus estimates indicate a dividend of $1.42 for the next 12 months based on a pay-out ratio of 87% of funds from operations, providing a dividend yield of 4.9% on the current price.

H&R owns a diversified portfolio of office, industrial properties and retail properties, of which 22% is located in the U.S, 36% in Ontario and 30% in Alberta. The exposure to Alberta is obviously of concern, given the region's exposure to oil, but it is notable that **Encana, BCE, TransCanada, Canadian Tire,** and **Telus** are among the largest tenants. In addition, the weighted lease term to maturity is almost 10 years and only 16% of the portfolio leases expire in the next three years.

H&R used to have a good track record of consistent dividend payments until it halved its payment in 2009, and is only now getting back to the pre-2009 dividend level. Consensus estimates indicate a dividend of $1.36 for the next 12 months based on a pay-out ratio of 75% of funds from operations providing a dividend yield of 5.8% on the current price .

Selected quality U.S. REITs have followed bond prices higher

In the U.S. bond yields have also declined sharply over the past few weeks with the 10-year government bond yield dropping to 1.90% from 2.97% at the beginning of 2014. In contrast to Canada, many of the better quality U.S. REITs such as **Health Care REIT Inc.** and **Realty Income Corp** have performed strongly over the past year adding 52% and 40% respectively as bond yields moved lower.

Is it time to buy?

Canadian bond yields have declined significantly since the start of 2014 suggesting that the yield on REITS should follow suit. Investor concerns regarding valuations of the residential real estate market and exposure to tenants dependent on the price of oil, are legitimate but do not apply equally to all REITs. RioCan and H&R REIT are relatively well positioned to manage these risks and investors could expect a reasonable return in the current low interest rate environment.

CATEGORY

1. Dividend Stocks
2. Investing

TICKERS GLOBAL

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2. TSX:REI.UN (RioCan Real Estate Investment Trust)

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