



What Should Investors Do With Their Northern Property REIT Units?

Description

One month ago, **Northern Property REIT** (TSX:NPR.UN) cost \$23 per unit and yielded close to 7.1%. Today, the REIT costs under \$20.50 per unit and yields almost 8%. In other words, its units are 10.9% cheaper than a month ago, and investors buying today are gaining 12.7% more income than they were a month ago.

The average return of the market is typically 7-10%. By buying Northern Property units today, you essentially only need 2% capital gains every year to get the market returns because you're getting paid an 8% yield to wait.

But what caused the dip?

Acquisition of True North Apartment REIT Trust

A company that plans to acquire another typically ends up falling in price. That's what happened to Northern Property. It proposed to acquire **True North Apartment REIT Trust** (TSX:TN.UN), but it still requires 50.1% of Northern Property unit-holder approval and two-thirds of True North unit-holder approval to be successful.

The true reason behind the fallen price

But even before the acquisition announcement, Northern Property had already fallen over 20% from its 52-week high of \$29 to \$23. And that's because most of its properties are in the north, where the resources are.

The intention of the acquisition is to diversify its property assets into other provinces, mainly Ontario, New Brunswick, and Nova Scotia, where it didn't own any properties before.

Is the acquisition a smart move?

The market certainly doesn't think so because at one point Northern Property's price fell as much as 8% on the announcement day. It seems like Northern Property management wants to improve the

company by diversifying into other geographical locations that are not resource rich, but are the properties in other provinces good deals?

True North is priced at a price-to-book ratio of 0.8, implying it's about 20% discounted from its book value, so I don't believe Northern Property overpaid for True North as some have said.

Unit holders should have expected poor near-term performance

Before buying Northern Property units, investors should have anticipated poor near-term performance from its units because of the oil-price plummet. That's why investors get a higher yield from it compared with other residential REITs such as **Boardwalk REIT**, which yields only 3.7% today, but is expected to be a better performer.

You can see the difference by comparing how far off Boardwalk and Northern Property are from their 52-week high prices. Boardwalk has retreated 20% from \$70 to under \$56 per unit. Northern Property has declined over 29% from \$29 to \$20.50 per unit.

Dividend

This month Northern Property maintained its monthly distribution. With a payout ratio under 70%, there is no reason to believe the REIT's 8% yield is in danger. If the acquisition closes, the payout ratio would still be around 70%.

From 2002 to 2014, over 12 years, the REIT has never cut its distribution and even increased it eight times. No matter if the transaction is successful or not, Northern Property's dividend still looks safe because its payout ratio has a margin of safety.

Tax on the income

REITs pay out distributions that are unlike dividends. Distributions can consist of other income, capital gains, foreign non-business income, and return of capital. Other income and foreign non-business income are taxed at your marginal tax rate, while capital gains are taxed at half your marginal tax rate.

So, to avoid any headaches when reporting taxes, buy and hold REIT units in a TFSA or an RRSP. However, the return of capital portion of the distribution is tax deferred. So, it may be worth the hassle to hold REITs with a high return of capital in a non-registered account.

Of course, each investor will need to look at their own situation. For instance, if you have room in your TFSA, it doesn't make sense to hold investments in a non-registered account to be exposed to taxation.

In conclusion

There's no reason for current Northern Property unit holders to sell because it is doing poorly in the near term or medium term because of the grim oil-price outlook.

However, the REIT's above-average yield of 8% is still sustainable. In fact, now that it has dipped so much, investors should consider buying more units to reduce their cost basis.

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