Investors: Forget Physical Real Estate and Buy These 2 REITs Instead

Description

Let me tell you about the apartment block that's for sale in my neck of the woods.

It's a 20 suite property that was built approximately 40 years ago. The structure of the building was built well, with plenty of brick and cinder block used. The owner has done a reasonable job maintaining the overall building, but many of the units need upgrades. Carpets are worn out, appliances are more than 15 years old, and things like wall colours and kitchen cupboards are dated.

The owner of this apartment complex did the same thing many other real estate owners do. He under invested in maintenance over the years to keep his cost base low. This increased his return as a percentage of his original investment. It's a smart move on his part.

This owner is currently offering this apartment block for sale for a cap rate of 6.3%. Personally, I'm not interested in the property at that rate of return, and neither are the other real estate investors I know. It simply isn't high enough for a property that we think needs some upgrades.

And yet, the property is getting strong interest from other buyers. Heck, the seller might even have an offer by now. I wouldn't be surprised.

I highlight this situation because I think it's the very epitome of the logical flaws being made by real estate buyers all across Canada. Here's why.

Compare to passive options

Running an apartment building is hard work. You have to screen tenants, collect rent, coordinate repairs and suite transfers, make sure the grass gets cut, and a million other small jobs. There's a reason why many owners contract much of that work out to a tenant, offering free rent as a perk for doing all the extra work.

Assuming an owner does all that themselves, that's a lot of work for a 6.3% return.

Compare that to another option, which is simply buying shares of a real estate investment trust (REIT).

One REIT is **Boardwalk REIT** (TSX:BEI.UN), one of Canada's largest owner of apartments with some 33,000 units spread out over four provinces. Approximately 60% of units are in Alberta.

Boardwalk shares currently trade hands at $53.00 each, give or take a few cents. Using the company's guide in its most recent investor presentation, this gives Boardwalk shares an implied cap rate of approximately 6.25%. Investors are getting a comparable return for an asset that gives you all the benefits of owning residential real estate without having to do any of the work.

There are other reasons why investors might want to own Boardwalk, too. It has a stellar balance sheet with debt at just 38% of its gross real estate value. Shares also pay out a 4.2% dividend–excluding any special dividends, which have happened at the end of 2014 and 2015–which is a payout ratio of approximately 60% of the company's earnings. This ensures plenty of cash flow that can be reinvested back into the business, either for growth or capital improvements.

Boardwalk actually offers one of the lowest implied cap rates in the Canadian REIT sector. Many of the companies that own office or retail space offer much higher potential returns.

H&R Real Estate Investment Trust (TSX:HR.UN) is a diverse operator, owning office, retail, and industrial property across North America. It has in interest in 517 total properties comprising of 47.2 million square feet of gross leasable area.

For 2015, H&R generated $1.95 in funds from operations per unit. With a current share price of $21.57, this means shares of Canada's second-largest REIT are trading at approximately 11 times funds from operations. This implies a cap rate of approximately 9%.

H&R currently pays investors a 6.3% dividend yield for a payout ratio of approximately 70%. Even if we ignore the 30% of earnings that are being reinvested into the business, H&R still generates an attractive 100% passive return today just from the dividends.

Investors used to buying physical real estate must face facts. In many markets, the return offered just isn't very attractive. Perhaps they should consider putting capital into REITs instead.

CATEGORY

1. Dividend Stocks
2. Investing

TICKERS GLOBAL

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2. TSX:HR.UN (H&R Real Estate Investment Trust)

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Author
nelsonpsmith