5 Reasons to Prefer REITs Over Rental Properties

Description

Many Canadian investors have used real estate's great performance over the last couple of decades to build themselves a pretty good portfolio.

Emboldened by what they think is a sure-fire path to success, many newer investors are loading up on physical real estate, afraid if they don't get in now, they'll forever be priced out of the market. This phenomenon combined with ultra-low interest rates and a general distrust of the stock market has pushed values sky high and cap rates to historical lows.

That is not a formula to success. Crowding into a much-loved asset class at what could be the top of the market all but ensures returns will suffer over the next few years. A cap rate of 4-5% is tolerable when real estate prices increase 5%. When values decline 5%, it's a disaster.

Canada's real estate bubble isn't the only reason why buying rental real estate isn't ideal at this point. Here are five more reasons why REITs should be your preferred real estate-investing vehicle.

Diversification

Buying real estate in one neighborhood is the equivalent of taking a big, leveraged bet on that place.

This bet has worked out pretty well. As values across Canada have shot up, buyers looking for bargains have moved from mature neighborhoods to crummier ones. This has helped revitalize these neighborhoods to a certain extent.

But this isn't guaranteed to work. If the market starts to correct and people find deals in more desired places, there's little need to go slumming in crummier areas.

REIT buyers aren't taking on that risk. Canada's largest REITs have diverse operations that stretch across the country, sometimes even into the United States or Europe. You're not taking neighborhood risk with any of them.

Passive management

Investors in physical real estate are left with a choice. They can hire a property manager, giving up a big slice of profits in exchange for not having to worry about collecting rent or making repairs. Or they can do all that stuff themselves and not pay a manager.

REITs are large enough that hiring out management costs almost nothing on a per-share basis. All that's left is for investors to sit back, relax, and collect their passive income.

Responsible leverage

When a real estate investor first starts out, they'll often put as little as 5% down, especially on their first purchase. This kind of leverage can lead to great returns on the equity when the value of the property goes up, but it's disastrous when values decline.

REITs are much more responsible with debt. Most have debt-to-assets ratios of less than 50%, which means greater protection compared to a portfolio stuffed with properties bought with only 5% or 10% down.

Cash flow

In many Canadian cities, the yield from rental properties is anemic, coming in at just 4% or 5%. Once the owner pays interest on the mortgage, property taxes, and other expenses, there's often no profit left over.

REITs are a much better choice. An investor who buys **Boardwalk REIT** (TSX:BEI.UN) today is getting a yield of 4.4% after the company pays all of its expenses. And since the payout ratio is only 65% of funds from operations, investors are getting that yield plus cash that gets reinvested back in the business or used for acquisitions. Plus, Boardwalk's management team has proven to be smart enough to not chase apartment buildings when the return isn't there.

Cheap assets

When you buy an investment property, chances are you're paying pretty close to the fair market value for it. Real estate is a fairly efficient market, after all.

Sometimes, certain situations happen where REIT investors can get a nice deal on a whole portfolio of properties thanks to market sentiment. **Dream Office Real Estate Investment Trst** (TSX:D.UN) shares currently trade hands at just over $19 each, but the company reports that its net asset value per share is $32.

This discount exists because the market hates Dream's 30% portfolio exposure to Alberta and has discounted the company accordingly. But Alberta will come back at some point, and, in the meantime, investors can buy assets for more than 40% off while collecting a well-covered 7.8% dividend to wait.

CATEGORY

1. Dividend Stocks
2. Investing

POST TAG

1. Editor's Choice

TICKERS GLOBAL

1. TSX:BEI.UN (Boardwalk Real Estate Investment Trust)
2. TSX:D.UN (Dream Office Real Estate Investment Trust)

Category

1. Dividend Stocks
2. Investing

Tags

1. Editor's Choice

Date
2025/08/24
Date Created
2016/05/17
Author
nelsonpsmith