



Top REIT Pick for 2017: H&R Real Estate Investment Trust

Description

Real estate investment trusts (REITs) have been hit hard lately; rising bond yields are affecting mortgage rates acutely in North American markets. I want to look at one REIT that might have the ability to weather the incoming interest rate storm and provide a sustainable long-term yield in 2017: **H&R Real Estate Investment Trust** ([TSX:HR.UN](https://www.scribd.com/document/344444444/TSX:HR.UN)).

The problem: rising interest rates eating into REIT profitability

Bond yields have been steadily increasing in the U.S. and are expected to increase throughout 2017 and 2018 at a slightly faster pace than previously forecasted. The recent Fed rate increase to a target rate of 0.75% last week and the corresponding dot plot data released by Fed participants, which forecasts three rate hikes in 2017 and 2018 instead of the previously anticipated two increases, means financial markets have moved both short-term and long-term bond yields up.

This increase in government bonds is one of the most important factors in determining what lending rates will be moving forward. As banks' cost of borrowing increases due to rising government bond rates, we can expect mortgage rates to increase in lockstep as banks' margins will be under pressure.

The corresponding rising borrowing costs for REITs will theoretically result in reduced profits for REITs, potentially affecting yields moving forward. As REITs are primarily looked to by investors as a source of stable dividend income, any potential cut in distribution yield moving forward can affect the underlying stock prices of REITs, as investors won't be willing to pay as much for income-producing assets that might produce less income in the long term.

Diversification, diversification, diversification

One thing H&R REIT does well, and perhaps better than the average REIT, is diversifying cash flows. H&R has done a very good job of diversifying cash flows over sectors (residential, commercial, retail), geography (mainly Canada and the U.S.), as well as time to maturity (length of leases vs. length of debt term).

While diversifying cash flows over distinct sectors of the real estate market and across geographical

areas helps H&R REIT to reduce risk, probably the most important tool available to REITs to minimize internal interest rate risk is the spread between cash flow maturities (lease terms) and debt maturities (debt terms).

Looking at H&R REIT specifically, it can be gleaned from the company's financial statements that the average lease length moves approximately in sync with the company's average debt term (10 years). In other words, the company's leases expire on an average of 10 years, and the company's debt is refinanced, on average, every 10 years. This positions H&R REIT very well, as the company will presumably be able to raise lease rates in accordance with rising costs in the medium term.

When looking for stability of cash flows and a stable yield over the next 10 years, income-seeking investors should look first at H&R REIT.

CATEGORY

1. Investing

TICKERS GLOBAL

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

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