Dividend Investors: Avoid These REITs as Interest Rates Rise

Description

Rising interest rates in Canada are both good and bad news for dividend investors who have real estate investment trusts (REITs) in their portfolios.

First, here's the good news:

In an economy where the central bank raises the borrowing cost, you should expect a lot of good things to happen. This move is a sure sign that the economy is getting out of a slow-growth period, and companies and consumers are ready to spend more.

Generally, this is a great news for REITs. In an environment of growth, there is more demand for commercial real estate, industrial warehouses, and residential complexes. Also, there is a less chance of tenants going bust.

The latest data show that the Canadian economy is firing on all cylinders; job creation has picked up, and export shipments are on the rise. On these encouraging signs, the Bank of Canada has started to raise interest rates. After its July hike, the central bank has signaled that it's ready to act again.

For investors in REITs, there is a negative side to this positive development. If interest rates start to rise quickly, some REITs might struggle.

The ones that will be in trouble are those that have the highest leverage ratios.

REITs work just like fixed-income securities. They distribute most of their cash that they generate from long-term leases in dividends. As interest rates rise, so do REITs' borrowing costs. Because their leases are long term, they can't immediately seek more rent to balance the equation.

For REITs, Canada's slowing real estate market is another threat to deal with. Home prices in the nation's largest city, Toronto, have been falling fast since May as the government tries to cool demand.

As sales plunged over 40% last month, average home prices also dropped 19% from their peak, making the specter of a possible housing market crash.

What dividend Investors should do?

I don't think there is a general threat to Canadian REITs in this uncertain environment. The majority of Canadian REITs are in a good shape with their leverage ratios well within the manageable limit.

However, there are some companies that will struggle as the borrowing costs rise, and dividend investors should try to avoid them.

Cominar REIT (TSX:CUF.UN) is one of them. Its shares are under pressure after it cut its dividend payout last week and after its credit rating was downgraded by DBRS Limited from an investment to speculative grade. After this credit downgrade, Cominar will find it hard to refinance its maturing debt.

Cominar is the third-largest diversified REIT in Canada and currently remains the largest commercial property owner in Quebec. Its 12% dividend yield looks quite attractive, but I think it's better for long-term income investors to stay away from this name.

The second REIT which I think will come under pressure as the Bank of Canada tightens its monetary policy is **Dream Industrial Real Estate Invest Trst** (TSX:DIR.UN), which, as its name suggest, focuses on industrial properties. There is no doubt that a strengthening economy should increase demand for industrial spaces, but I think Dream Industrial's growth will be strained due to its higher indebtedness.

Though the company was able to cut its leverage by 90 basis points to 52.4% in the second quarter of 2017 from 53.3% in the same period a year ago, its leverage ratio is still remains close to the maximum limit allowed for REITs in Canada.

Just like Cominar, Dream Industrial offers an attractive 7.9% dividend yield. But it may soon find itself in a situation where it has to cut the dividend or sell its income-producing assets.

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