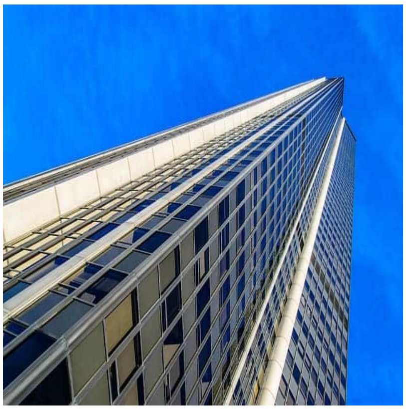

After a 2nd Increase in Interest Rates, Is Now the Time to Double Down or Sell REITs?

Description

After a second round of interest rate hikes, shares of Canada's REITs (real estate investment trusts) are now perceived to be facing headwinds as the cost to refinance each mortgage will have to be done at higher rates of interest. Before deciding if it is time to sell out of this sector (or double down), investors must first ask a very important question:

What effect will higher interest rates have on rents?

As interest rates increase, there are two possible outcomes. The first is that rents will have to increase enough to make up for the landlords' higher interest costs (which would be good for investors). The second option is not nearly as good; the value of each property would decline to adjust for the higher financing costs (assuming a level monthly repayment to the lender). The very simple approach is that the total monthly payments would not change, but would be made up of a higher amount of interest costs instead of debt repayment.

Dream Office Real Estate Investment Trst (TSX:D.UN) has recently trimmed the dividend in anticipation of the higher funding costs in addition to selling core holdings in the Scotia Plaza. The good news for investors of this REIT is the lag time before the higher costs of borrowing kick in across the board. Given that many of Canada's REITs operate in the longer-term office and industrial markets, many leases and mortgages financing these buildings are long term in nature. The higher borrowing costs will take several years to kick in.

The result of these long-term loans and leases is, in many cases, an escalating monthly rental cost, which is set at the onset of the lease. The mortgages, which are also long term in nature, will most often come due at different times, leading to minimal changes in interest costs in any one year. In the case of Dream Office Real Estate Investment Trst, the mortgages maturing during 2017 are at an average rate of more than 5%, while the years 2018-2028 have an average interest rate of less than 4%. It is very clear that investors will enjoy the long-term benefits of lower interest rates by holding shares of this REIT!

When looking at the industrial sector, shares of **Pure Industrial Real Estate Trust** (TSX:AAR.UN) are no exception with mortgages carrying an average interest rate of less than 4% and maturing in a staggered way over many years.

For investors wishing to look behind the curtain for themselves, the information about scheduled debt maturities can be found in each company's annual report, which are found in the notes of the company's financial statements.

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