



## Are Rising Interest Rates Bad News for REITs?

### Description

Bank of Canada's second interest rate hike in early September saw the overnight rate increase 25 basis points (bps) to 1% and surprise financial markets. This triggered concerns about how it would impact business and financial markets. While rising interest rates indicate that the economy is expanding more robustly than expected, they cause the cost of capital to rise, making finance costlier, which, it is feared, could cause business investments and sentiment to fall.

Nonetheless, the impact is far more severe on capital-intensive industries, with one of the most vulnerable being Real Estate Investment Trusts (REITs).

### Now what?

Investment in REITs exploded over the last 10 years as investors flocked to their high yields and almost bond-like stability. This was because with interest rates at historical lows in the wake of the global financial crisis (GFC) and fears of yet another economic calamity, traditional income-generating assets like bonds were yielding little to nothing.

Those exceptionally low interest rates also caused the cost of capital to fall, making it far cheaper for businesses operating in capital-intensive industries to raise the necessary funds to expand their operations. This was particularly beneficial for REITs, especially because they are unable to retain corporate profits and must pay 100% of their income in the form of distributions to unitholders.

As such, historically low near-zero rates allowed REITs to load up on debt to finance the expansion of their property portfolios. That saw income grow and costs remain low, allowing them to reward investors with juicy yields that, in many cases, are well over 5%.

It also means that because rising rates cause financing costs to rise, the profitability of REITs comes under pressure, threatening those tasty yields and making them more vulnerable to financial shocks.

The ability of REITs to obtain capital through equity finance is also impacted.

This is because higher rates cause the yields on newly issued bonds to rise, making them more

attractive to investors seeking lower-risk income-generating investments. That causes the risk-free rate to rise, which means that investors want a greater rate of return to justify investing in equities.

While rising rates certainly have a disruptive effect on REITs, it is difficult to see this occurring for some time to come.

You see, even after the last two rate hikes, the headline rate is only at 1%, or less than half of where what was at the end of 2008 when the fallout from the GFC was at its worst. This is roughly a sixth of the average annual rate over the last 27 years, indicating that it would take a considerable number of hikes for rates to reach the level where interest rates could threaten the viability of REITs.

For those reasons, it is difficult to see the last two rate hikes having any material impact on consumption or business confidence.

Rates would need to rise significantly to have a catastrophic impact on Canada's deeply indebted households or business spending.

Let's not forget that higher rates signify stronger economic growth. A more robust economy signifies that demand is rising, leading to firmer prices, thereby making REITs more profitable. Increased profits are passed on to investors in the form of increased distributions, because REITs are unable to retain profits.

### So what?

For these reasons, the latest rate hikes will have little material impact on REITs and signify that they are superior investments to other income-focused assets. One of the best opportunities is Canada's largest REIT, **RioCan Real Estate Investment Trust** ([TSX:REI.UN](#)). It reported solid second-quarter 2017 results, operating income shot up 8.5% compared to a year earlier, committed occupancy rose by 1.6% to 96.7%, and renewal rent increases grew by 1.4% year over year to 4.7%.

Despite these impressive results, RioCan is down by 11% for the year to date because of fears that **Amazon.com Inc.** will continue its assault on traditional retail and lead to the end of shopping malls. This is despite RioCan having key anchor tenants that have proven resistant to Amazon's advances, including **Loblaw**, **Cineplex**, **Dollarama**, and **Wal-Mart**.

For these reasons, RioCan, along with its juicy 6% yield, is an attractive investment regardless of recent rate hikes.

### CATEGORY

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2. Investing

### TICKERS GLOBAL

1. TSX:REI.UN (RioCan Real Estate Investment Trust)

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