REITs vs. Alternative Lenders in 2018

Description

Canadian housing drew a lot of attention in 2017, as home prices surged to record levels in the opening months of the year, only to come back down to correct following the crisis at **Home Capital Group Inc.** (TSX:HCG) and regulations introduced by the government of Ontario. New rules introduced by the OSFI that will include a stress test for uninsured borrowers are causing further anxiety in the real estate industry.

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Real estate investment trusts (REITs) and alternative lending stocks have struggled in this environment. Will 2018 be any different? And should you buy REITs or lenders? Let's look at the case for both.

The case for REITs

In an early September article, I'd discussed whether or not it was time for investors to avoid REITs after a second rate hike. As the year began, REITs appeared to be an extremely attractive investment. Stocks such as **RioCan Real Estate Investment Trust** (TSX:REI.UN) offer high dividends — a 5.5% yield in the case of RioCan. The companies also promised capital appreciation in what was a very strong real estate market.

Rising interest rates present a threat to Canadian REITs in a variety of forms. Bond yields become more attractive, which can drive away investors chasing the income that a REIT provides. Canadian REITs also tend to have less tenant turnover and longer terms on leases, which prevents landlords from being able to take advantage of higher prices to chase income.

Naturally, higher borrowing costs are also a threat to the growth potential of REITs. However, the benchmark rate remains close to historic lows. And in its latest meeting, the Bank of Canada assured it will proceed slowly and cautiously when it pertains to further rate hikes. Low interest rates could still be the reality for the short to medium term.

The case for alternative lenders

I have also discussed the new OSFI rules for alternative lenders and whether or not this will push down stock prices of companies like Home Capital Group and **Equitable Group Inc.** (TSX:EQB). Equitable Group has continued to post solid results; in the third quarter, the company saw net income rise 7% year over year.

Home Capital Group released its third-quarter results on November 14. Net income was more than halved at $30 million compared to $66.2 million in 2016, and mortgage originations plummeted 85%. Still, reactions were mixed, as Home Capital Group was able to return to profitability after a near collapse earlier in the year.

In previous earnings reports, both companies warned that the new OSFI rules will damage the opportunity for loan growth in 2018. **Toronto-Dominion Bank** projected that housing prices could decline 5-10% in 2018 as a result of the new rules. Both banks and alternative lenders have projected retention rates to improve, which should put a ceiling on recurring revenue.

What should you go with in 2018?

There will be a significant cap on the growth potential of alternative lenders for at least the first half of 2018, as the entire industry adjusts to a new environment. REITs, however, should remain attractive income plays. The Bank of Canada is unlikely to move on interest rates early in 2018, as the fate of NAFTA remains uncertain, and the central bank still wants to see how Canadians will respond to the new higher rates with household debt at record levels.

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