Aren’t Apartment REITs Supposed to Be Safe?

Description

You’ll often hear that as an industry, residential REITs are safe. Heck, I’ll admit that I’ve said so myself. However, I’d mentioned back in September that **Boardwalk REIT’s** (TSX:BEI.UN) distribution is risky.

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I didn’t go to the extent to say that the company will cut its distribution, because there are ways for companies to maintain their distributions in the short run, despite not having enough earnings or cash flow to do so.

My close call with Boardwalk

Here’s my story with the stock. Thinking that residential REITs were a defensive asset class, I dabbled in Boardwalk in March 2015 and bought a bigger position in November of the same year to average down. I even managed to reinvest the special distribution in January 2016 at a low point to further average down.

However, as I saw deterioration in its cash flow generation, I realized its distribution may be in danger down the road. So, I strategically sold out of my position in May 2016, when the market gave me an opportunity to do so — with an 8.2% total return after trading fees. Since I’d held the position in my RRSP, there was no tax event.

The stock is 25% lower than when I sold. Now that Boardwalk has cut its distribution (in January, by more than a half), investors might consider it a turnaround story.

The problem with Boardwalk

Boardwalk has large exposure to resource regions. From the last reported quarter, the REIT had about 60% and 16%, respectively, of its portfolio in Alberta and Saskatchewan. So, Boardwalk will be directly impacted by the business cycle in the energy sector.

On a positive note, job vacancies in Alberta have risen in 2017, which may indicate that the economy there is turning around. If so, there will be higher demand for housing, and Boardwalk's occupancy and rental income should improve over time.

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Is this apartment REIT a safer buy?

Canadian Apartment Properties REIT (TSX:CAR.UN), or CAPREIT, is well known for its quality portfolio. It generates about half of its net operating income in Ontario.

In the most recent reported quarter, the apartment REIT continued to experience steady growth with average monthly rents up 3% and a portfolio occupancy of 98.7%. It pays out about 70% of its cash flow, so its distribution is sustainable.

CAPREIT has quality management and excellent assets. However, I can't wrap my head around investors paying a multiple of about 18.8 right now for a company that's going to grow about 3-4% a year.

Investor takeaway

Investors should be careful when they hear others say that a sector or stock is safe or stable. Apartment REITs are generally defensive. However, in the case of Boardwalk, its business and performance will be cyclical. So, investors need to be careful about when they buy the stock.

Ideally, they should buy as the Albertan economy recovers after a decline. Boardwalk's distribution looks safe now, but it's probably unattractive to most income investors with a ~2.5% yield. Currently, it's really a turnaround play.

In the case of CAPREIT, it's expensive most of the time. So, there's risk that investors will overpay for its units and get below-average returns.

Higher interest rates will also weigh on these REITs.

CATEGORY

1. Dividend Stocks
2. Investing

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2. TSX:CAR.UN (Canadian Apartment Properties Real Estate Investment Trust)

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