How to Choose REITs for Rental Income

Description

Some people think it's a hassle to collect rent from tenants. Moreover, if there's anything that needs fixing at the properties, the tenants will definitely go to the landlord. That's why some investors choose to invest in real estate investment trusts (REITs) and become passive landlords instead. Essentially, you can sit back and collect rental income every month like clockwork.

However, there are some essential metrics that investors should check.

Change in funds from operations per unit

The funds from operations (FFO) are the cash flow that REITs earn. It's not enough for REITs to just have FFO growth. You want to know the per-unit metric, so you can see if the REIT is generating stable (or better yet, higher) cash flow for its shareholders over time.

Here are some examples. In the past five years, **H&R Real Estate Investment Trust** (TSX:HR.UN) increased its FFO per unit by 4.6%. In the same period, **Cominar REIT** (TSX:CUF.UN) decreased its FFO per unit by 22.4%, **Allied Properties Real Estate Investment** (TSX:AP.UN) increased its FFO per unit by almost 19%, and **Canadian Apartment Properties REIT** (TSX:CAR.UN), or CAPREIT, increased its FFO per unit by +24%.

Just by looking at this metric alone, an investor should consider owning CAPREIT over the rest. Notably, Cominar's huge FFO-per-unit decline is due to the fact that it's in the midst of a transformation and has been selling non-core assets. With fewer assets, its FFO has naturally dropped off.

Payout ratio

Most investors buy REITs for income. If that's you, you should ensure the REITs that you're interested in have sustainable payout ratios.

This year, H&R REIT's FFO payout ratio is estimated to be under 80%. Cominar's payout ratio is estimated to be under 63%, while Allied Properties REIT's and CAPREIT's payout ratios are estimated to be ~71% and ~68%, respectively.

Normally, the lower the payout ratio, the safer the distribution. Investors should also compare a REIT's payout ratio to those of its peers. If its payout ratio is in line with or lower than those of its peers, then its distribution is probably safe.

Cominar's payout ratio looks very conservative. However, as noted earlier, it is under transition. So, there's a chance that it can cut its distribution again, like it did last year and this year.

Investor takeaway

At the minimum, investors should check a REIT's change in FFO per unit over time and its payout ratio. Generally, you want to see growing FFO per unit over time and a sustainable payout ratio — the lower, the better.

Additionally, a REIT's debt levels should align with, if not be more conservative, those of its peers. Lastly, aim to buy REITs at a reasonable valuation.

CAPREIT seems like the best REIT from the list, but the stock is too expensive for investment, in my view. At ~$39.70 per unit, it trades at a multiple of ~21.4, while the stock is estimated to grow ~4% per year.

CATEGORY

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TICKERS GLOBAL

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2. TSX:CAR.UN (Canadian Apartment Properties Real Estate Investment Trust)
3. TSX:HR.UN (H&R Real Estate Investment Trust)

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