REIT Investors: Why You Shouldn't Worry About Rising Interest Rates (and Pick Up This Industrial REIT)

Description

There is a common misconception that interest rate–sensitive sectors such as REITs and utilities tend to perform poorly during times of rising interest rates. However, evidence has shown that a REIT's performance is more predicated on general economic trends than an inverse sensitivity to credit conditions. As Canada's economy continues to showcase strong performance, especially in the export sector, REITs such as **Dream Industrial REIT** (TSX:DIR.UN) should be considered as part of an income-generating portfolio.

Rising interest rates: the death knell for REITs?

Most investors believe that when interest rates rise, high-yielding dividend stocks such as REITs tend to underperform the market. This theory does make sense on paper; after all, when rates and subsequently safe-haven bond yields climb, the riskier payouts that investors receive from stocks look less and less appealing.

However, a rising interest rate environment is often a proxy for a growing economy, as central banks pursue contractionary monetary policy to curb inflationary pressures. And as history has shown, REITs have outperformed the general equity indices such as the S&P500 during central bank tightening cycles, as the REIT sector's earnings drivers (net migration, employment, personal consumption, and industrial activity) all pick up in tandem with interest rates.

Finally, this period of normalization we have been experiencing was signalled well ahead of time by the Bank of Canada, and one can make the case that REIT valuations have had ample time to price in the next few years' worth of rate hikes.

Focusing on the strongest part of a strong economy

While not at the same level as last year, Canada's GDP is growing robustly as the country's main economic driver shifts from household consumption to the export sector. For example, in August's report, Canada's merchandise trade deficit narrowed from $2.7 billion to $626 million, the smallest deficit since January 2017.

Furthermore, total exports grew 4.1% to $50.7 billion in June, led by strong performances with non-U.S. trading partners. These export numbers point to an increase in demand for machinery, warehousing, and industrial space, which are the main growth drivers behind an industrial REIT such as Dream Industrial.

Dream Industrial REIT: a well-positioned midcap

Dream is a fast-rising name in the industrial space, with $1.9 billion worth of assets (19 million square feet) across Canada and the United States. As for its metrics, Dream boasts a strong lease renewable ratio of 77.8% and 96.9% portfolio occupancy, with same-property net operating income growth of 2.2% year to date in 2018. Currently yielding 7%, Dream's dividend is in good shape thanks to its low leverage (debt to book value of assets of just 41.4%) and a weighted average interest rate of 3.8% over 4.1 years. More importantly, Dream also offers investors access to industrial properties in the southeastern United States at comparatively low cap rates to its peers.

Currently, the major focal point for Dream is its western Canadian portfolio, which experienced early lease terminations and subsequently declines in net operating income when compared to its eastern Canadian assets, which delivered year-over-year lease and net operating income gains.

This drag on its portfolio net operating income from western Canada has led the stock to trade at a discount to peers (11.6 times trailing funds from operations (FFO) versus 15.5 times FFO for its Canadian peers and 23.8 times FFO for its U.S. peers). However, management has guided western Canadian momentum to pick up in the later innings of 2018, and as U.S. exposure ramps up, Dream's discount to peers should narrow and its current valuation should prove to be a long-term buying opportunity.

Given the strength of the Canadian economy, particularly in the export sector, a discounted valuation and cross-border growth prospects, Dream Industrial REIT offers investors a stable source of dividends and capital gains even as interest rates rise.

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