Will the Housing Slump Hurt Canadian REITs?

Description

REITs are some of the most lucrative income investments on the TSX. With yields ranging anywhere from 5% to 10%, they can add some much-needed juice to your RRSP or TFSA income stream. For years, dividend investors have been quietly amassing fortunes by investing in REITs–which not only have higher-than-average yields, but often pay out monthly instead of quarterly.

Recently, however, a protracted housing slump has cast doubt on real estate investments in general. This past week, *The Financial Post* reported that Canadian home prices had their worst February since the financial crisis, which follows four months of already sluggish sales. Not only have house prices been falling, but mortgage growth has been slowing and impacting banks' lending operations, among other things.

REITs, being heavily invested in real estate, are theoretically vulnerable to falling real estate prices. However, REITs that are more invested in commercial real estate than residential may be less affected.

Residential vs. commercial real estate

Residential and commercial real estate prices are both influenced by the local economy, which means that factors such as population growth, average incomes and consumer spending habits will influence both types of real estate in a given area.

However, it's possible for residential real estate to decline while commercial real estate thrives. One example would be if a cottage industry springs up catering to tourists in an area that's seeing declining (permanent) population growth. In this area there would be huge demand for retail space, and for temporary lodging (i.e., hotels), but declining demand for permanent lodging. Situations like this are far from uncommon, and can be seen in any town that's home to a lot of resorts.

Houses vs. apartment buildings

In addition to the difference between residential and commercial real estate, there's also a difference between rent and house prices. REITs like **RioCan** (TSX:REI.UN) often deal in residential property, but as landlords, not as vendors. This is critical because rent is not the same as price. A city's price-to-rent ratio shows how expensive homes are in a given area compared to rentals, and a quick look at a breakdown of major North American cities shows it can vary quite a lot. So even with house prices falling in markets like Vancouver, rental income needn't fall as well.

A REIT with no housing exposure

Although home prices and rent aren't perfectly correlated, it's a good idea to buy a REIT that's not too exposed to residential real estate during sluggish markets. A good pick here would be **Smart Centres REIT** (TSX:SRU). Smart Centres is a REIT that invests almost exclusively in "power centres"–areas containing big box stores like **Costco**, **Walmart** and **Best Buy.** Smart Centres is not the fastest-growing company in the world, but it has a 41% profit margin and pays a dividend that yields 5.30% (with a very sustainable payout ratio). For investors looking to get a slice of REIT income without too much housing market exposure, it could be a perfect play.

CATEGORY

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