Residential REITs: Stuck in a Bubble

Description

Recent reports from the *Economist,* Bloomberg, and the World Economic Forum all shared a common message: Canadian real estate is overpriced.

Rents and median earnings haven't kept up with the stellar rise in house prices across the country, especially in the nation's two largest cities, Vancouver and Toronto.

Besides the countless homeowners and property developers who've benefited from this boom, investors in real estate investment trusts (REITs) have had a lucrative ride as well. The **iShares S&P/TSX Capped REIT Index ETF** (TSX:XRE) has nearly tripled since March 2009.

Along the way, investors have enjoyed monthly dividend yields of between 5% and 10%, so their total return has probably been a lot higher.

Currently trading at a historic high, the market seems to have finally hit a plateau. Median house prices reached a peak in 2017. The **Teranet–National Bank House Price Index**, a composite of average-priced single family houses in the nation's 11 largest markets, has been steadily declining over nearly a year.

This puts REITs in a precarious position. If the residential market is positioned for a correction or if interest rates start climbing back up, REITs with too much debt or too much exposure to the two largest cities will come under pressure.

InterRent Real Estate Investment Trust (TSX:IIP.UN), for example, has $855 million in debt: two-thirds the value of its equity. The portfolio is also highly concentrated in the Greater Toronto Area and Hamilton, both of which are arguably the most overpriced markets in the country besides Vancouver. This region accounts for 30% of the trust's portfolio.

The trust's Adjusted Funds from Operations (AFFO) is expected to exceed $0.35 per unit this year. That means that the current stock price is trading at 40 times the annual AFFO, a sign of overvaluation.

However management has been conservative about the company's finances and has managed to keep the funds distribution rate low. At just below 60%, the cumulative distribution rate is fairly sustainable.

The company also offers investors a reinvestment plan that allows them to receive shares at a 4% discount in exchange for giving up the cash payout.

However, the lower value of assets and higher costs of service debt if the residential market sours could quickly erode the REIT's value. This applies to InterRent's peers as well.

Instead, income seeking investors could take a closer look at non-residential REITs, like office property manager **Allied Properties,** or healthcare REIT **NorthWest Healthcare Properties**, both of which offer sizeable dividend yields as well.

Bottom line

Canadian house prices have had a historic run since the financial meltdown of 2008-09. However, the market is now bursting at the seams with household debt in the country higher than any other developed market.

A sudden economic downturn or a natural correction in real estate prices, especially in the downtown core of the country's two largest cities, could have a detrimental impact on the balance sheets of some residential REITs.

I wouldn't buy these over leveraged, heavily metropolitan REITs, just as I wouldn't buy a condo in Toronto's Entertainment District, at the moment.

Instead, investors should look for more sustainable income stocks like the industrial, commercial, or healthcare-related REITs on offer.

CATEGORY

1. Dividend Stocks
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TICKERS GLOBAL

1. TSX:IIP.UN (InterRent Real Estate Investment Trust)
2. TSX:XRE (iShares S&P/TSX Capped REIT Index ETF)

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