Will a Canadian Housing Crash Decimate Your Portfolio?

Description

The Canadian housing market is still a hotly debated topic.

On the one hand, we have real estate bulls — folks who are convinced certain Canadian cities are set up to be great places to invest over the long term. Arguments that support this thesis include high levels of population migration to the largest cities, new housing supply not keeping up to that population growth, and a weaker Canadian dollar encouraging foreign ownership.

Real estate bears, meanwhile, are convinced the market is in a giant bubble and is poised to collapse. These investors point to factors like record Canadian debt levels, artificially low interest rates propping up the market, and lax bank underwriting standards being responsible for thousands of ill-advised loans.

I'm the first to admit it doesn't make much sense for a landlord to buy a property in any of Canada's largest cities from a cash flow perspective. Your rent cheque won't even cover the mortgage. The majority of your return will be from capital gains, which makes such an investment risky. Counting on the property to increase in value is a safe bet over a few decades. But it can be hit or miss over just a couple of years.

This could also have a major impact on some of Canada's top real estate investment trusts (REITs). Here's why owners of these securities need to be a little wary.

The power of falling prices

Let's use **Northview Apartment REIT** (TSX:NVU.UN) as an example.

After accumulating a nice portfolio of properties in both northern and Atlantic Canada, Northview has turned its attention to Ontario, specifically the Toronto market. In total, the company owns nearly 10,000 apartments in the province and generates approximately one-third of its net operating income from these assets.

Northview has a market cap of $2 billion and an enterprise value of $4.1 billion. That means the company has $2.1 billion worth of debt and $2 billion worth of equity on a portfolio worth $4.1 billion. This puts the company's debt-to-assets level at an acceptable level of approximately 51%.

Say we get a scenario where Ontario's real estate values fall by 25%, and the rest of the country sees the average price of a house fall 10%. What happens to Northview in that situation?

If one-third of Northview's property falls by 25%, we're looking at a $338 million haircut. A 10% decline in the rest of the portfolio translates into a loss of an additional $270 million. Northview's total portfolio would lose $608 million, dropping the value of its assets to the $3.5 billion range.

$2.1 billion of debt on $3.5 billion in assets increase Northview's debt-to-assets ratio to 60%. That is likely something the company can deal with, but it's not ideal. It would surely stop Northview's expansion plans, since banks would be less likely to lend to a REIT with such a high debt-to-assets ratio. Perhaps the dividend would be slashed to get debt under control, too.

How likely is this?

I'm the first to admit such a scenario is somewhat unlikely. A 25% decline in housing prices in Toronto would be one of the worst bear markets in history. Remember, Calgary's real estate didn't even perform that badly during the big oil crunch over the last few years.

However, it could happen. A combination of rapidly increasing interest rates and banks refusing to lend could have a major impact on the market. Even if such a decline doesn't actually occur, just the thought of it could send the whole REIT sector reeling.

The bottom line? While this is unlikely to play out in a big way, investors must remember REITs are highly exposed to the underlying asset price. Just a small decline could be bad news, which will send the price of their equity reeling. It's best to maintain REITs as part of a diversified portfolio.

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