Have Residential Real Estate Investment Trusts Become Overvalued?

Description

As pretty much everyone knows, the real estate industry has been hot in Canada the last number of years, fuelled by strong population growth and low interest rates, which helped bring on a tonne of investment.

While most people will immediately think of the housing market that has boomed in value, it has extended to other areas of the market as well, including real estate investment trusts (REITs).

The REIT industry is hot, with many REITs at all time-highs. This can be attributed to the impressive performance of these companies taking advantage of a booming industry, but it's especially attributable to the increase fear of a recession.

Real estate is one of the top defensive industries to gain exposure to if you're concerned about a potential recession.

So, has an already overheating industry that's now being propped up by the fear of a recession pushed the REITs to a tipping point where they have become overvalued?

Let's look at two top REITs in Canada today: **InterRent REIT** (TSX:IIP.UN) and **Minto Apartment REIT** (TSX:MI.UN).

InterRent

InterRent has been one of the top growth REITs the last five years, but does its past success warrant the valuation that it's getting today?

Over the trailing 12 months, InterRent has an adjusted funds from operations (AFFO) of $0.40 a share. At Tuesday's closing price of $16.19 a share for InterRent, that gives it a more than 40 times price to AFFO ratio, or a 2.47% AFFO yield.

Looking at its share of properties and the markets they operate in, and going by the third quarter

Canadian Cap Rate Report, I estimate InterRent has an average portfolio cap rate of roughly 3.4%, so clearly significantly higher than its current AFFO yield.

InterRent's properties are located in Ontario and Quebec, in regions where the real estate markets have been booming, which has driven down cap rates, so it's understandable that InterRent would have a low AFFO yield.

Plus, the company has proven it can grow its business well over the last half-decade, and its AFFO has grown alongside it.

Investors should be cautioned though that it isn't undervalued by any stretch, so going forward, its share price will probably have limited upside, which would only increase alongside AFFO growth.

On the flip side, if that growth was to slow, InterRent could lose some of the growth that's priced into its stock and see some movement to the downside.

Minto Apartments

Minto Apartments looks a little cheaper relatively speaking, but the stock still does look slightly overvalued.

Minto has trailing 12 months of AFFO per share of roughly $0.73, which, at Tuesday's close would give it a P/AFFO of more than 32 times and a AFFO yield of roughly 3.1%.

While these are cheaper than InterRent, comparatively speaking, Minto owns properties in a wider range of regions that give it a higher average cap rate for its portfolio.

According to my rough calculations, taken the same way I calculated for InterRent, Minto's estimated company-wide cap rate should be roughly 4.1%.

Looking at its total value, it seems as though Minto has about a 23% premium in its stock price, which is slightly cheaper than InterRent, which, by my estimates, has a 26% premium in its share price.

Minto doesn't quite have the same growth history of InterRent, which could be one reason its premium is slightly less than InterRent's, but given that it has a long track record of solid operations, still makes it a high-quality residential REIT to own.

Bottom line

The industry as a whole definitely has significant value, but you could argue that it deserves higher multiples on its valuation metrics, as investor demand for defensive industries stays hot.

Going forward, I don't expect much movement from the stocks to the upside or the downside, with the exception that something negative in the industry, or a slowing of the growth, would result in a large move to the downside, while these stocks got newer and lower valuation metrics.

It's something to be aware of and consider though, if you are thinking of adding a residential REIT to your portfolio, as the yields are mostly small, and there isn't a whole lot of upside potential in the shares.

CATEGORY

1. Dividend Stocks
2. Investing

TICKERS GLOBAL

1. TSX:IIP.UN (InterRent Real Estate Investment Trust)
2. TSX:MI.UN (Minto Apartment Real Estate Investment Trust)

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Date
2025/08/18
Date Created
2019/12/11
Author
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