2 Cheap REITs: Value Investors' Dream or Value Trap?

Description

Since practically everyone has stopped going to work, ceased shopping, stopped going out for entertainment, REITs are suffering. Rents have been paused in an attempt to stabilize the economy. Unit prices of formerly popular names like **H&R REIT** (TSX:HR.UN) and **RioCan REIT** (TSX:REI.UN) are trading around or below their book values.

Are they a value investor's dream?

If you like sniffing around for deals, Canadian REITs are likely to be a sector that will grab your attention. H&R and RioCan look pretty tempting at these levels. They have been absolutely slaughtered and have not recovered as quickly as other stocks.

Right now, H&R is trading at around $10, a far cry from its previously stable price of just over $20 a share. RioCan is not doing a whole lot better, currently trading at around $16 a share after having fallen from its relatively stable price of around $25 a share.

I'm going to skip price-to-earnings multiples at the moment, since it is pretty certain that earnings are going to fall into the toilet. I'll instead focus on book value, which is a much more pertinent number at the moment considering much of the value of these companies comes from their intrinsic land values.

Currently, both companies are trading at huge discounts to their stated book values. RioCan trades at about 0.62 times its stated book value. H&R has an even more drastic discount, trading at about 0.42, or less than half, of its stated book value. These stocks are cheap according to this metric; there is no doubt.

Where's the risk?

Much of the risk, in my opinion, comes from the book value itself. Earnings losses and the effect of a recession in Canada have been largely priced in already, so it is the value of the company's assets that are in question.

Luckily, the good news is that many of the properties that the companies own are in large, urban centres such as Toronto. It is highly probable that these properties have a better chance to retain value over time. They also benefit from the fact that interest rates are likely to remain low, which lowers the cost of financing and might generally support real estate as an asset.

The problem is, what if real estate does fall sharply in the coming months and years? What if the global debt load, irrespective of insanely low interest rates, becomes unsustainable? The resulting cascade of debt defaults might push asset prices, including real estate values, lower. The book value of these companies could collapse with earnings, driving their stock prices even lower.

Distribution yield

One of the main reasons people buy REITs is for the steady income these companies generally provide. These companies are no exception, with current yields of 13.4% for H&R and 8.69% for RioCan. The yields are generous, but they are also more at risk of a cut than they ever have been before.

The pandemic is pretty much the worst thing that could have happened to these REITs. Even in a financial crisis, people can still go to buy things at a store. Right now, the doors are shuttered and offices are closed. There is literally no way to go out and buy much of anything, and the choice to go to work has been forcibly taken away.

Furthermore, after the crisis ends, who knows how much of the work-from-home mentality will remain. Maybe it will never return to pre-pandemic levels, leaving some offices shuttered for good.

The Foolish takeaway

In this article, I am neither recommending buying or staying away from these stocks. This is a bipolar choice, depending on your view of real estate and the economy going forwards. If you think real estate will hold its value over the next several years and possibly go up, these are screaming buys today. If you think real estate will go down and that there will be a permanent change in the working environment going forward, stay away.

Do not buy these as income stocks at this point in time. The dividends could stay in place or be cut. If you do buy, think of the yield as a bonus to a potential capital gain while you wait for a recovery.

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