Passive Income Based on Real Estate Could Be in Danger

Description

Being able to live off passive income is the ultimate goal of every investor. Over the past decade, countless savers and investors have reached this ambitious goal by maximizing savings and returns on investment. However, the return side of that equation could be in peril.

Most passive-income strategies assume sizable and consistent rental or dividend yields. Since the previous financial crisis, rental income from properties and dividend income from real estate investment trusts (REITs) have greatly appreciated. However, the real estate sector now faces the perfect storm that could squeeze income just when investors need it most.

Passive-income squeeze

The global rental market has been squeezed like never before. About one-third of Canada’s workforce has lost employment since the COVID-19 pandemic erupted. Meanwhile, malls and restaurants have been forced to shut, which has made it impossible for small businesses to afford rent.

RioCan Real Estate Investment Trust, for instance, collected just 55% of the rent it was owed in the first quarter of this year. The trust has suspended future developments to conserve cash. However, if the shutdown persists, its 9.7% dividend yield could be cut as well. Landlords face a hefty fixed cost (mortgage repayments) while their income is now highly vulnerable. That could lead to some difficult choices.

Nearly every other REIT faces a similar dilemma. That means passive-income investors simply have no clue how much cash flow they can expect in 2020 and beyond. If there’s a second wave of the pandemic, or if the economy takes too long to recover, real estate prices could drop. This magnifies the peril for REITs across the board.

Limited alternatives

Certain sectors of the real estate sector could hold up better than others. Healthcare-related properties, for example, shouldn’t face the same pressure as the rest of the property sector. **NorthWest Health Properties REIT** is a clear proxy for this segment.

Similarly, industrial properties such as warehouses should see a surge in demand as online shopping expands. **WPT Industrial REIT** and **Dream Industrial REIT** could be in a better position to survive this crisis than residential or commercial landlords.

It seems likely that demand for online goods could drive the need for storage space. Meanwhile, healthcare properties are untethered to the economy. The tenants of these properties tend to be multinational e-commerce giants or healthcare chains backed by private equity. In other words, they're less likely to default on their rents.

Investors could rely on these alternatives for sustainable passive income. Robust cash flows are much more valuable in a post-crisis world.

Foolish takeaway

Retirement strategies based on real estate have had an incredible run. For over a decade, the price appreciation and rental income from real estate has covered living expenses for millions of landlords across Canada.

However, this sector now faces the perfect storm. The economic downturn, extended lockdown, spiking unemployment, and squeezed liquidity could permanently dent rental income. This will certainly be reflected in passive investors' portfolios. However, essential properties could serve as a safe haven for investors who rely on rental income.

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