Warning: House Prices Could Drop 18% – and These REITs Could Drop Further

Description

Canada's housing market is a national sport. House prices have been relentlessly surging for over a decade. Now, with unemployment at a record high and an ongoing pandemic, Canada's housing market could finally deflate.

The Canadian Mortgage and Housing Corporation (CMHC) has forecast falling home prices of to 18 per cent in the 12 months ahead. That's the worst-case scenario. CMHC's base case forecast was a 9% drop.

It's also worth noting that these forecasts are for average prices across the country. Expensive markets such as Toronto or Vancouver could experience deeper declines in value. That, of course, is bad news for homeowners and real estate investors. However, it also impacts dividend investors who rely on real estate investment trusts (REITs).

REITs are tax-advantaged structures for rental income. These listed securities can offer better dividends than traditional stocks because they can access more leverage and extract more free cash flow from rents. If the housing market collapses, leverage tightens and rental income is squeezed.

Residential REITs with higher leverage or more exposure to major cities could be at the most risk. Here are two REITs that could probably decline faster than the national housing market.

Northview Apartment REIT

Northview Apartment REIT (TSX:NVU.UN) stock dipped when the COVID-19n outbreak began, but has since recovered all its lost value. In fact, the stock is now 13% higher than at the start of the year. Investors seem to be optimistic that the housing market will hold up better than expected.

However, Northview's portfolio looks overexposed to some vulnerable markets. More than a third of its multifamily units are located in Ontario. Nearly 10% are in Toronto and its surrounding areas, which are at the apex of the housing market crisis. However, several thousand units are in what I would call university towns.

The housing markets in Guelph, Kitchener and Hamilton, hinge on the arrival of university students. This year, of course, universities have switched to virtual classes, which means student arrivals will plunge. International student arrivals could disappear altogether, putting pressure on these overvalued housing markets.

Northview also has a sizable debt burden. Net debt to earnings before interest, taxes, depreciation and amortization (EBITDA) was as high as 10.1. While the debt coverage ratio was 1.60. These risks don't seem to be priced into the REIT's elevated stock price.

InteRent REIT

InterRent REIT is similarly exposed to vulnerable markets. Two-thirds of its portfolio is concentrated in the Greater Toronto Area or Montreal. While Montreal's housing market isn't as overheated as Vancouver or Toronto, it's relatively overvalued.

Rents in Montreal's downtown are dropping faster than anywhere else in Canada. Average one- and two-bedroom apartment rents declined 5.2% and 2.6%, respectively, in April. The flood of Airbnb units entering the long-term rental market is the prime reason for this plunge in tourist-heavy Montreal.

The stock price has recovered its losses and is flat year to date. However, a housing market crash focused on Canada's largest cities could be detrimental to InterRent's book value and rental income.

Bottom line

The housing market is due for a correction, and prices in Toronto and Vancouver could face steeper declines. REITs focused on major cities or with too much debt could magnify the incoming crash.

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