Canadian Apartment REITs Fall While House Prices Rise: Why?

Description

Canada is a hot property market, as prolonged low interest rates and strong employment kept house buying active. In fact, house buying accelerated during the pandemic, as the government released stimulus checks and reduced interest rates to near zero. Apartment REITs surged 40-60% between October 2020 and August 2021 on the back of the house price rally. But in August 2021, Justin Trudeau's government pledged to introduce policy changes to control house prices, pulling down prices of apartment REITs.

Is it a good time to buy apartment REITs? Let's see.

So many vacant houses, yet Canada faces a housing crisis

According to the Canadian Real Estate Association (CREA), Canada's average home price surged 20.8% year over year in February due to a 23.7% increase in new listings. Canada is suffering from a housing crisis due to the lack of affordable housing. This supply crunch has sent house prices to a level that is 19% above the borrowing capacity of median-income households as of late 2021.

Some economists blame the speculators for artificially inflating house prices. Speculators buy a house for investment purposes and leave it vacant. Their objective is not to live in the house but to speculate — to buy low and sell high. Hence, the government has introduced a 1% tax on foreign-owned, vacant, or underused real estate to curb speculative buying.

Economists give mixed forecasts for house prices

Many economists have warned of a housing bubble. Three factors could burst this bubble: rising interest rates, government policies on controlling house prices, and lack of affordability. Any bubble bursts when rising prices dry up liquidity. Capital Economics economist Stephen Brown forecasts Canadian house prices to fall around 25% if interest rates rise to the pre-pandemic level. Oxford Economics warns that if house prices continue to rise, even after the interest rate hike, a crash (home prices fall by 40% or more) could be possible.

But some economists expect house prices to continue rising at a slower rate. RBC Economics expects prices to grow by 6.2% in 2022, slower from a 17.8% gain in 2021 (based on house price data from RPS). The CREA expects the annual average sale price to increase 14.3% in 2022 and 3.2% in 2023. The basis of this forecast is there is too much demand in the housing market.

Canadian Apartment REITs fall while house prices rise

While house prices surge, apartment REITs are underperforming due to Justin Trudeau's pledge to change the tax treatment of apartment REITs.

Canadian Apartment Properties REIT (TSX:CAR.UN) and **InterRent REIT** (TSX:IIP.UN) fell 15% and 12%, respectively, since August 2021. They underperformed the S&P/TSX Capped REIT Index, which was almost unchanged. The two apartment REITs fell 4-6% in the last two weeks, as Justin Trudeau signed a power-sharing agreement with the opposition party. As part of the agreement, he pledged to change the tax treatment of apartment REITs.

At present, Canadian REITs pay little or no corporate tax. They are treated as income trusts, as they

- Hold only "qualified REIT properties" any time during a tax year;
- Have at least 75% of their portfolios (by fair market value) in Canada; and
- Earn minimum 75% revenue from rent or mortgage interest from Canadian properties and capital gains from the sale of such properties.

REITs transfer a significant portion of their income to investors as dividends. The dividend income is taxable in the hands of shareholders and not in the hands of REIT. Any change in this tax structure could significantly impact a REIT's income and dividend.

Other than policy changes, the house price rally will end someday when the bubble bursts. This uncertainty makes apartment REITs riskier. Moreover, apartment REITs face a capping on the rent they can charge.

Should you invest in apartment REITs?

Two reasons to buy REIT are to hedge against inflation and earn dividends. When inflation rises, rent and property prices rise, driving REIT prices. That was the case for apartment REITs before August. Moreover, their dividend yield is less than 2.5% because of rent control.

There are better retail REITs, such as **Slate Grocery** and **SmartCentres REIT**, offering over 6% dividend yield, as they enjoy high rent.

CATEGORY

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