3 Things to Look for When Buying a REIT in Canada

Description

Investing in real estate is nothing like investing in stocks. REITs try to financialize real estate investing and make it accessible to stock market investors. Having a REIT in your portfolio has its merits. It protects your investment from inflation and gives regular dividends. REITs are not directly affected by the stock market noise but are sensitive to property prices. This type of investment won't make you rich, but it will give a stable and regular dividend that's much better than bond yield.

Types of REITs

Are all REITs similar? No. Are all REITs low-risk investments? No. REITs are like mutual funds and ETFs that pool your money to buy land and develop income-generating properties. There are three types of REITs: equity, mortgage, and hybrid REITs.

An equity REIT is safer than the other two, as it rents and sells property and gets the full payment. Equity REITs protect themselves from rent default by taking a deposit from the tenant. It can deduct any unpaid rent from this deposit. When property prices stabilize, REITs give you dividends from the rental income. When property prices rise, they give you capital appreciation plus dividends.

Some equity REITs have exposure to a particular type of real estate, like healthcare, industrial, retail, apartment, and logistics warehouses. Each property has different factors driving its rent and prices. You can use REITs to diversify your portfolio across asset classes and properties.

Three things to consider when buying a REIT

How do you identify the right REIT? Look at three aspects:

- Debt on the balance sheet
- Asset profile and its growth potential
- Quality of tenants, lease longevity, and customer diversification

Each of these factors is different for different property types. Hence, also consider factors that affect the prices and rent of the underlying properties.

How much debt is on the balance sheet?

REITs generally carry huge debt, as the business is capital intensive. They have to acquire land and develop the property — for which they use debt financing. You should look at a REIT's debt-to-EBITDA ratio to understand if it has enough operating income to service the debt. Also, look at the debt-to-market cap ratio to ensure debt investing is not overpowering equity investors.

For instance, **Nexus Industrial REIT** has a debt-to-market cap of 126% and a debt-to-EBITDA of 8.5, which is way higher than retail REITs. Its overall debt is high, as it used more mortgage financing than equity financing. Retail REITs like **SmartCentres REIT** (TSX:SRU.UN), **RioCan REIT** (TSX:REI.UN), and **Slate Grocery REIT** have higher equity financing. Among the three retail REITs, SmartCentres has the lowest debt-to-market cap ratio of 85.7%. **Canadian Apartment Properties REIT** has an even lower ratio of 69.6%.

But debt alone doesn't qualify for a good REIT. Lower debt gives a REIT the financial flexibility to acquire and build more properties, increasing their growth opportunity. There are other aspects to consider.

Asset profile and its growth potential

A REIT's ability to invest in more properties and demand higher rent drives growth. CARPEIT is under the government's rent-control directive. But retail and industrial REITs can demand higher rent as commercial properties attract higher rent. Among all the above REITs, SmartCentres is less risky and has good growth options. Moreover, it offers a dividend yield of over 5.6%.

A REIT's performance is determined by its tenants

A REIT is as good as its tenants, for they are the ones that provide the rental income. Hence, when looking at a REIT, look at the top tenants, their creditworthiness, average lease term, and diversification of tenants.

Why is this important?

Diversification can work both ways. In 2015, RioCan REIT fell 18% after its major tenant, **Target**, exited Canada, significantly reducing its occupancy rate and rental income. Target is a big company with good creditworthiness, but high exposure to just one client left RioCan's portfolio vulnerable. SmartCentres faces a similar risk. It earns over 20% rent from **Walmart** and significant rent from Walmart-anchored stores. But high exposure to Walmart helped it earn stable rent during the pandemic when other non-essential stores closed down.

Buy a REIT that outperforms the market, and SmartCentres has outperformed the market.

CATEGORY

1. Dividend Stocks
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TICKERS GLOBAL

1. TSX:REI.UN (RioCan Real Estate Investment Trust)
2. TSX:SRU.UN (SmartCentres Real Estate Investment Trust)

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