Want to Buy Real Estate Stocks? Here Are 3 Crucial Metrics to Know!

Description

Real estate is one of the most popular industries to invest in. In addition to buying a rental property, there are tonnes of high-quality real estate stocks you can buy.

This is advantageous for investors, because not everyone has cash for a down payment. But as long as you have some cash to invest, you can gain exposure to the high-potential real estate industry.

In Canada, there are many real estate investments trusts (REITs) to buy. These are stocks that you can have confidence owning for the long haul. And because there is so much choice, they offer exposure to several different assets, whether it's residential properties, retail, offices, senior homes, or more.

But in order to invest in real estate, it's crucial to understand the investment. And there are certain metrics used in the industry that will help you to compare different REITs to help figure out which real estate stocks are the best to buy.

If you're interested in finding the best real estate stocks to buy for your portfolio, here are three key industry metrics to know.

The capitalization rate tells investors how much yield a property generates

The capitalization rate is generally calculated as the ratio between the annual rental income produced by an asset and its current market value.

If you have a house that has a market value of $1,000,000, and it can generate $36,000 in rental income ($3,000 a month), the cap rate of that property would be 3.6%.

Understanding the cap rate is crucial, because it helps investors to compare the value of different real estate assets. In addition, it can also help you to determine the market environment in different regions or over several years.

For example, in recent years, housing prices in Toronto have increased much faster than somewhere like Calgary. According to the CBRE, the cap rate for residential real estate in Toronto has declined from 6.5% in 2009 to roughly 3.5% in 2021. Meanwhile, Calgary's cap rate has declined from roughly 6.25% to about 5.25% over that same period.

So, we can see from the cap rate that not only has Toronto gotten more expensive quicker, but it's also quite a bit more expensive today.

If you want to buy real estate stocks, it's crucial to understand net operating income

While the cap rate is used mostly to look at the value of investments and compare them, the net operating income (NOI) is used to assess a property or entire fund's profitability.

NOI is one of the most commonly used figures in real estate and is found by taking a property or fund's gross operating income and subtracting its operating expenses. This way, investors can analyze how profitable the investment is and whether or not the real estate stocks are worth a buy.

In addition to NOI, you'll also likely see SPNOI (same property net operating income). When funds grow their portfolios through acquisition, it can impact the numbers from period to period. So, SPNOI is a simple calculation used by investors to assess the organic growth of certain properties.

Profitability is important, but so is operating performance

While NOI is one of the most important metrics used to assess real estate stocks before you buy them, the most important metric might just be funds from operations (FFO).

FFO is mostly used in the real estate industry and is used to refer to the cash flow that a property or fund generates. To get the FFO, you typically take the earnings and then add back any non-cash expenses such as depreciation, amortization, and one-time gains or losses on the sales of assets.

The reason the FFO is so important is that it's used to show the operating performance of a property or fund rather than its total profitability. In addition, most REITs base their dividends on their FFO rather than their income.

So, the next time you're looking to buy high-quality real estate stocks, these three metrics will be some of the most useful to use.

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2025/08/21
Date Created
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