Are REITs Now Oversold?

Description

Canadian REITs are getting hammered, and income investors are wondering if this is a good time to buy the real estate names for their portfolios.

Interest rate risks

The U.S. Federal Reserve and the Bank of Canada are increasing interest rates to fight inflation. The process is expected to continue until the central banks can get inflation down to at least 3%. That might take more time than initially expected, with inflation in March hitting 8.5% in the U.S. and 6.7% in Canada.

As interest rates increase, bond prices tend to fall, driving up bond yields. This pushes up mortgage rates, making it more expensive to finance property purchases or to renew loans on existing buildings.

It is the renewal part that might have investors concerned. REITs carry a lot of debt that is taken on to build or buy buildings. When bonds or mortgages need to be repaid these companies have to issue new debt or renew the loans. As borrowing costs rise, the amount of cash flow that is available for distributions to shareholders can get squeezed.

When revenue doesn't rise fast enough, or if payouts are already too high based on current cash flow, the distributions could get cut or even shelved. If that happens, the unit prices can go into a steep decline.

Not all REITs have the same level of borrowing risks or exposure to rising rates, so investors need to do their homework and decide which type of property they want to hold through the REIT investments.

Let's take a look at one REIT that has seen its unit price recently pull back but has outperformed its peers.

RioCan

RioCan (TSX:REI.UN) trades for $23 right now compared to $26 in March. The price is still way above the 2020 lows around $14 when pandemic lockdowns shut the doors on all of RioCan's shopping malls. For 2022, RioCan's unit price is pretty much flat. This compares with drops of 10% to 25% for several other popular Canadian REITs.

It is unlikely another COVID-19 lowdown will occur, and government assistance helped most of RioCan's customers get through the pandemic. The company's retail space remains in strong demand, and RioCan can charge higher rent each time a tenant vacates a building. RioCan has a solid balance sheet and can borrow at attractive rates, but its debt costs will nonetheless increase.

The construction of new mixed-use properties should help mitigate the pain. RioCan is building properties with rental units above the retail space. Rising home and condo prices combined with higher mortgage costs will push more people into rental units. RioCan's new mixed-use buildings are in strategic locations along public transit routes in Canada's largest cities. These units should rent for premium prices in the coming years.

RioCan slashed the distribution from $0.12 per month to $0.08 during the pandemic but started to increase it again this year. The current monthly payout of $0.085 per trust unit provides a 4.4% yield. It is unlikely the payout will get cut again, but the pace of increases might slow down if borrowing costs continue to climb and remain elevated for an extended period of time.

Should you buy REITs now?

RioCan and several other REITs looks more attractive today than they did in March, but I would stay on the sidelines until it becomes clear how rising borrowing costs will ultimately impact the sector. A five-year GIC now pays close to 4%, so income investors have a safer option without giving up much on the return they would get from RioCan today.

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