Real Estate Investing: Good Debt vs. Bad Debt

Description

CTV News reported on Statistics Canada saying that the ratio of household debt to disposable income hit a record level in the fourth quarter, as mortgage borrowing rose and disposable income fell. Specifically, Canadian households had $1.86 of debt to $1.00 of disposable income. Much of the debt is mortgages. With rising interest rates from the Bank of Canada that are leading to other interest rates (including mortgage rates) rising as well, it's the perfect time to discuss good debt vs. bad debt in real estate investing.

In *Rich Dad, Poor Dad*, American businessman and author Robert Kiyosaki noted that good debt is used to buy assets that generate income, while bad debt is spent on things that essentially don't generate income.

In the case of real estate investing, it follows that a mortgage is bad debt if you're buying a property to live in. However, the mortgage would quickly turn into good debt if you rent out a room or basement to generate rental income. Needless to say, a mortgage for a rental property is good debt. Real estate is a special kind of investment, though, because we get to live in it and real estate values are expected to rise in the long run.

In any case, mortgage rates are relatively low compared to other kinds of debt. Canadians should pay more attention to high-interest rate debt. For example, many people do not pay in full every month for the amount borrowed on their credit cards. Credit cards are some of the highest interest rate loans. So, people should strive to pay those off in full each month to avoid high-interest expenses. Always pay off high-interest debt before lower-interest debt whenever possible.

Is it bad to borrow to invest in Canadian REITs?

Many Canadian REITs offer juicy monthly cash distributions, especially after the recent market correction. Expanding from what we discussed earlier about good and bad debt, if you're able to borrow at a lower interest rate for a higher yield in REITs, the loan is considered good debt. That said, REITs are already leveraged. So, retail investors don't necessarily need to borrow.

Ultimately, REIT investors should pick quality REITs that pay safe yields and buy when the underlying stock is at a good valuation. Inevitably, REITs have large amounts of debt (in the form of mortgages) on their balance sheet. Therefore, their borrowing costs are increasing. As interest rates rise, REIT valuations are being re-rated, which is why REITs have been participating in this market correction. Income investors should take this market downturn as an opportunity to buy REITs for attractive passive income at cheap prices.

In the REIT sell-off so far, **NorthWest Healthcare Properties REIT** (TSX:NWH.UN) has held up relatively well. Perhaps it's because it's in a defensive asset class and enjoys a low weighted interest rate from its global real estate portfolio. Its cash flows generated from hospitals, medical office buildings, and other medical facilities are reliable with the support of long-term contracts. Its weighted average face interest rate on debt, including the impact of cross-currency rate swaps, was only 0.85% in the first quarter.

So far, the healthcare REIT has fallen 17% from its 52-week high and is trading at its 52-week low. At $11.91 per unit at writing, it offers a compelling yield of 6.7%. Furthermore, analysts think the value stock is discounted by about 22%. Interested investors should watch for an entry point to lock in juicy monthly cash distributions.

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