What Would a Real Estate Crash Do to REITs?

Description

The aggressive rate-hike campaign by the Bank of Canada in 2022 appears to be effective in cooling the housing market. **RBC** Economics' recent report projects a 12% price correction from February this year come winter. While some industry analysts advise people to accept the correction, homeowners and sellers fear the drop in the value of their priced possession or investments.

For others, the deepest fear is a collapse or crash of the market. According to RBC, a housing correction favours homebuyers, because sellers could sell their properties below the real intrinsic values. From an investment perspective, a real estate market crash could have an impact on real estate investment trusts (REITs).

Notion on REITs

The appeal of REITs to investors has risen tremendously over the past two decades. Apart from lower cash outlays and high dividend yields, the asset class can be a hedge against inflation. While rising interest rates affect real estate values, there's a notion that REITs underperform during inflationary periods.

Real estate (-18.5%), where REITs belong, is the third-worst-performing sector of the TSX year to date after healthcare (-51.17%) and technology (-32.43%). There's no doubt that rising interest rates pose a challenge for the large landlords. The threats are higher borrowing costs and decrease in property values.

Sharp declines in share prices could also occur due to heightened volatility. Nonetheless, REITs with strong fundamentals can negate or overcome the impact of rising rates.

Residential REIT

Morguard North American Residential (TSX:MRG.UN) is a solid pick if you want exposure to the residential sub-sector. The $967.47 million REIT owns and operates high-quality, multi-suite residential properties. As of July 26, 2022, the portfolio consists of 12,983 residential suites in 42 properties. The locations are in Alberta, Ontario, and nine major markets in the United States.

In the second quarter (Q2) 2022, net income and net operating income (NOI) increased 724.3% and 13.6%, respectively, versus Q2 2021. Morguard's basic funds from operations rose 23% year over year to $19.8 million. At the quarter's end, the occupancy rates in Canada and the U.S. were 95.2% and 96.4%, respectively.

Also, during the quarter, the average monthly rent (AMR) per suite in Canada and the U.S. increased by 3% and 13% compared to the same period in Q2 2021. At $16.94 per share, Morguard is down by only 2.1% year to date. The 4.13% dividend yield can compensate for the temporary retreat of the stock price.

Grocery-anchored REIT

Slate Grocery (TSX:SGR.U) pays an over-the-top dividend yield of 7.64%. At $11.40 per share, the year-to-date gain is 3.5%. This $675.97 million REIT owns and operates grocery-anchored real estate in major U.S. metro markets. Its chief executive officer (CEO) Blair Welch said the defensive nature of the REIT assure investors of long-term, stable income.

Since 97% of its portfolio is secured by net leases, Slate Grocery has protection in an inflationary market. Welch added that the REIT plays a critical role today, because in facilitates the last mile of food logistics in timely and cost-efficient ways. Management will continue to focus on organic growth and accretive investment opportunities.

Steady performers

Rising interest rates could have a negative impact on REITs in some sub-sectors. However, it doesn't hold true for Morguard and Slate Grocery thus far in 2022.

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