Choice Properties REIT (TSX:CHP.UN): Is this 5.7% Dividend Stock in Danger?

Description

Real estate investment trusts (REITs) are an excellent source of passive income. However, Canada's real estate sector is one of the most overvalued in the world and is now on the brink of a correction. Does this put residential landlords like **Choice Properties REIT** (TSX:CHP.UN) in peril?

Here's a closer look.

Canada's housing market correction

Canada's housing market has been on an epic rally for several years. Since 2015, home prices have outpaced income growth by 40%, according to a report by the Organisation for Economic Co-operation and Development (OECD). Canadian homes are now the second-most overvalued in the OECD index of nations.

A report by Moody's Analytics found that homes in some parts of Canada were overvalued by as much as 25%. Meanwhile, Toronto was the third most risky property market on the **UBS** Global Real Estate Bubble Index 2021.

Put simply, Canadian homes are overpriced. Much of this was driven by government stimulus. Low interest rates and easy lending standards allowed consumers to overborrow and overpay for real estate. This speculative mania is now ending.

Borrowing costs

High inflation has compelled central banks across the world to raise interest rates. The Bank of Canada has pushed rates up aggressively this year. In fact, rates were bumped up by 75 basis points (0.75%) last week. The policy rate is now 3.25% — significantly higher than the 0.25% rate in 2021.

This sudden tightening of credit is likely to pop the real estate bubble in Canada. Some experts believe home prices could drop by 20% or more. That's bad news for speculators and homeowners. But it could also impact residential landlords like Choice Properties.

Choice Properties's valuation

The impact of higher interest rates is already clear on Choice's balance sheet. In its latest quarterly report, the company wrote down the value of its investment properties by $523.8 million.

Shareholders' equity, or book value, is now roughly $3.6 billion, while the company's market capitalization is $4.6 billion. In other words, the stock is overvalued, considering the recent hit to book value.

Choice may have seen some growth in rents recently. However, its adjusted funds from operations (AFFO) is still roughly $0.90 on an annualized basis. That means the stock trades at 28.6 times AFFO. That's another indication of overvaluation.

Finally, the REIT offers a 5.3% dividend yield, while fixed-income securities like Guaranteed Investment Certificates and Term Deposits offer nearly 5%. The risk-to-reward ratio is simply unattractive.

Bottom line

Choice Properties faces some pressure on its book value and borrowing costs in the year ahead. Meanwhile, the stock is clearly overvalued. Income-seeking investors would be better off investing in GICs or term deposits. Stay away from this REIT for now.

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vraisinghani