Canadian REITs: A Ridiculously Easy Way to Increase Your Passive Income

Description

The real estate industry suffered a setback in 2022 as interest rate hikes began. Most REITs use debt to develop investment properties. Thus, a higher interest rate increases their interest expense. Moreover, mortgage rates impact property prices.

During the pandemic, interest rates fell to near zero, which triggered property buying and pushed real estate prices to a new high. Property prices fell when the Bank of Canada started increasing interest rates in March. As REITs took secured debt against their properties, a decline in the fair market value of properties impacted their debt ratios.

Why invest in Canadian REITs now?

Despite the sector's weakness, REITs are a good way to earn monthly passive income. As REITs enjoy the tax benefit of a trust, they have to distribute a significant portion of their rental income to shareholders. A 65-75% payout ratio is healthy and can give you passive income even in a recession.

Almost all Canadian REITs saw an 18-25% stock price dip this year when the interest rate hike began. A decline in stock prices inflated the distribution yield. A 2023 recession could keep real estate stocks in a bearish zone, but they could revive once inflation eases and interest rate hikes slow.

A glimpse of the recovery rally was seen in October when the Bank of Canada slowed rate hikes from 75 basis points (bps) to 50 bps. The **iShares S&P/TSX Capped REIT Index ETF** has surged 11% since October 20 after falling 28% between March and October.

A ridiculously easy way to earn passive income

If you are building a REIT portfolio in your Tax-Free Savings Account (TFSA), I have identified two commercial REITs that can give you good passive income.

Slate Office REIT

Slate Office REIT (TSX:SOT.UN) is a small-cap stock with a $390.5 million market cap. It has a total of 53 properties in its portfolio, with an occupancy rate of 81.9% as of September 30. The REIT is using falling property prices as an opportunity to dispose of low-yielding assets and acquire high-yielding ones. Slate Office REIT's distribution payout ratio increased to 75.9% in the third quarter from 66.1% in the previous year's quarter due to higher interest expenses. But this payout ratio is healthy, and the REIT can continue paying a distribution of $0.40 per share.

SOT.UN stock is trading at a 13.6% discount from its average trading price, which has inflated its distribution yield to 8.7%. The REIT has high risk as only 65% of its tenant base is government and high credit ranking companies. Currently, its trading volume is way below (53,750) that of other REITs. I suggest you invest a smaller portion of your REIT portfolio in Slate Office. The main reason to buy this REIT is to lock in a ridiculously high distribution yield for a slightly higher risk.

You can balance out the risk from Slate Office by investing a larger portion of your portfolio in Allied Properties.

Allied Properties REIT

With a market cap of $3.3 billion and an average trading volume of 480,000, **Allied Properties REIT** (TSX:AP.UN) has a lower risk than Slate Office in terms of liquidity. Allied Properties has 202 rental properties worth $9.4 billion and a well-diversified tenant base, with the top 10 tenants accounting for less than 20% of rental income.

The REIT is one of the oldest stocks on the TSX. It has been growing distributions annually since 2004, except during the financial crisis (2008–2012), when it maintained its distribution at $1.32 a share. Allied resumed distribution growth from 2013 onwards. So far, the company has an occupancy ratio of 89.6%. Properties under development could add $82 million in net operating income by 2026.

The REIT's distribution payout ratio increased to 83.2% in the third quarter from 81.8% in the previous year's quarter. This ratio is still sustainable. In the worst-case scenario, the REIT might pause its distribution growth and maintain payouts at $1.75 per share.

But the market bearishness has pulled the stock price down 47%, inflating the distribution yield to 6.75%. Now is the time to lock in higher passive income and a chance to ride the recovery rally of over 70%.

CATEGORY

1. Dividend Stocks
2. Investing

TICKERS GLOBAL

1. TSX:AP.UN (Allied Properties Real Estate Investment Trust)
2. TSX:RPR.UN (Ravelin Properties REIT)

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