Why residential REITs could see a rebound in 2023

written by InvestorNews | January 10, 2023

Timing is everything. If I had written this article last week, like I intended to do but got distracted, I would already look like a hero. Several of the examples I will provide below are up 3-4% in just the last couple of days as the overall market is speculating on whether there will be an interest rate policy shift by the U.S. Federal Reserve. Or perhaps the markets are also seeing a late Santa Claus rally as tax loss selling seemed to carry on until very late in December. Maybe it's just the random walk of the market that is up for the last few days but might be down the next few. Regardless, whatever is causing this latest (temporary?) positive market momentum is somewhat irrelevant to today's investing theme because I'm looking out for weeks and months, not just the first few days of the year.

As the title suggests, today's theme is Real Estate Investment Trusts, but not all REITs. For those not familiar with this sector, there are many categories and even more individual names which cover a very broad spectrum when it comes to real estate. Generally speaking, REITs are categorized into Office (places where companies host employees that aren't working from home), Retail (shopping malls, strip malls, grocery stores, wherever you go to buy retail goods that aren't on-line), Industrial (typically warehouses, but can also house more service oriented businesses that don't have people coming into browse for goods), Residential or Multifamily (houses, apartments, condos, or anywhere an individual or family can live) and Specialty (everything else including a fairly unique name like American Tower Corporation (NYSE: AMT) which owns cellular towers and leases space to Telcos). There are a few other minor categories or sub-categories but I think you get the picture.

Today I’m going to single out the Residential segment, also commonly referred to as Multifamily, as a potential opportunity for investors in 2023. The premise is pretty simple – you gotta live somewhere. But before you roll your eyes and make a comment like “no sh*t Sherlock”, hear me out as there is a little more to it than that.

There is a lot of jargon in the REIT analysis sector, like cap rates, AFFO, FFO, discount to NAV, all of which can be useful metrics, especially when comparing peers, but I’m looking at something a little more macro and a little simpler than what you might find in an Investment Advisor’s research report. To expand on my “you gotta live somewhere” comment, I’m looking at the fact that mortgage rates have increased dramatically in the last 6 months. The U.S. Federal Reserve raised its Federal Funds Rate from 1% to 4.5% from June to December. Obviously, mortgage rates have followed suit, with the average 30-year fixed rate mortgage in the U.S. rising from roughly 3.0% in June to about 6.5% today. That has a material impact on how much house you can afford. Combine that with the fact that housing prices rallied substantially during the heart of the pandemic, as many people wanted a nicer space to work from home, and you have a situation where, in a very short period of time, a lot of people got priced out of home ownership.

Home prices have started to flatline or possibly even started to fall in some locations but not nearly enough to compensate for those much higher interest rates. Correspondingly, we’ve seen the impact of this over the last few weeks as one of the key drivers of inflation have been rising rental rates. Seems like all should be good for the residential REIT sector with all those rental properties available for those who can’t afford to buy their own home. One could argue they should be at or near

52-week highs in a market that is supposed to be looking forward 6 months. Not even close. Most are at or near their 52-week lows, some are even at multi-year lows.

Why? One reason is that those pesky interest rates can be a bit of a double edged sword. As noted earlier, the “cap rate” is an important metric for REIT valuations. The capitalization rate, or cap rate, of a property, is the amount of money you can expect to get from a property compared to its value or price per year. This includes all the expenses of operating the property but does not include the costs of buying, selling, or financing the property. In Canada, the national average cap rate rose 39 bps from 5.42% at the beginning of 2022 to 5.81% as of Q3/22. A high interest savings account has gone from virtually nothing to over 4% during that same period. Naturally, you aren’t going to pay as much of a premium for the earning potential of a REIT when you can find something competitive in the form of a risk free investment.

This all sets the stage for why I think residential REITs could see a rebound in 2023. With strong demand for rental properties due to a combination of immigration and lack of housing affordability, you could see rental rates continue to rise as contracts are renewed. That implies that in 2023, cap rates should rise faster than competing investment alternatives like bonds or GICs/CDs. As long as the U.S. Federal Reserve doesn’t get carried away and we only see one or two more small rate increases with the potential for them to pivot later in the year, what was a headwind for the residential REIT sector in 2022, could become a tailwind for 2023. Not only do most of these REITs have monthly or quarterly distributions that range from 2% – 5% on an annual yield basis, but many are trading between 35% and 50% below their 52-week highs.

There’s more to my thesis than this, but if I’ve managed to keep your attention this far, I won't push my luck trying to keep it any longer. Instead, I will simply throw out some ideas that you can consider if you see any merit to my 2023 investing theme.

Company Name	Ticker	Market Cap	Annual Yield	Primary Location(s)
Equity Residential Property Trust	NYSE: EQR	US$ 21.7 B	4.20%	Boston, New York, Washington, D.C., Seattle, San Francisco and S. California
Avalonbay Communities	NYSE: AVB	US$ 22.1 B	3.90%	New England, New York/New Jersey metro area, Mid-Atlantic
Tricon Residential	NYSE: TCN TSX: TCN	C$ 2.9 B	3.00%	Orange County, California, as well as focus in the U.S. Sun Belt
Canadian Apartment Properties REIT	TSX: CAR.un	C$ 7.7 B	3.30%	Major urban centres across Canada
Killam Apartment REIT	TSX: KMP.un	C$ 1.9 B	4.20%	Atlantic Canada, Ontario, Alberta and British Columbia