How Does RioCan Real Estate Investment Trust's U.S.-Portfolio Sale Impact it?

Description

RioCan Real Estate Investment Trust (TSX:REI.UN) is known for its size, scale, and leadership as Canada's largest retail real estate investment trust (REIT).

RioCan has about 300 Canadian properties across 64 million square feet, of which 46 million is owned by the REIT. RioCan also had about 6,500 tenants and generated roughly 84% of its revenue from national and anchor tenants.

Key strengths

One of RioCan's key strengths is that it earns a total of 75.2% of its annual rental revenue from Ontario (67.5%) and British Columbia (7.7%). Economically, these are the most stable provinces in Canada.

The REIT also earns 13.4% of its rental revenue from Alberta, 8.9% from Quebec, 1.5% from eastern Canada, and 1% from Manitoba and Saskatchewan.

RioCan's second key strength is that it's focused on the key markets in each of the listed provinces and earns 75% of its annual rental revenue from the key cities.

Specifically, it earns 4.7% of its annual rental revenue from Vancouver, B.C., 7.1% from Calgary, Alberta, 4.5% from Edmonton, Alberta, 41.9% from Toronto, Ontario, 11.3% from Ottawa, Ontario, and 5.5% from Montreal, Quebec.

Additionally, RioCan earns about 35.4% of rental revenue from its top 10 tenants. They're quality tenants, including companies such as **Loblaws**, **Canadian Tire**, **Wal-Mart**, **Cineplex**, **Metro**, and **Empire**, which is the parent company of Sobeys.

Impact of the U.S.-portfolio sale

In December last year, RioCan announced the sale of its U.S. portfolio of 49 properties. The sale net proceeds are $1.2 billion (net of outstanding mortgages payable, transaction costs, and taxes). Thanks partly to a stronger U.S. dollar, RioCan will pocket gains with a rate of return of 16%.

The proceeds will be used to repay debt and strengthen the REIT's balance sheet. RioCan's debt-to-total-assets ratio is expected to fall from the first quarter's 45.6% to 39% as a result.

After the sale, RioCan will be able to focus on its Canadian growth strategy and development pipeline with enhanced liquidity.

Is RioCan's distribution safe?

Since 1996 RioCan has maintained a high portfolio occupancy of 94-98%. This doesn't come as a surprise given the REIT's key strengths previously discussed. In the first quarter the REIT's portfolio occupancy was 94.8%.

RioCan's EBITDA interest coverage of 3.11 times is the highest it has been since 2000. Similarly, its debt-to-total-assets ratio of 45.6% is at the low end over that period. Using its enhanced liquidity from the U.S.-portfolio sale, RioCan anticipates that its debt-to-total-assets ratio will fall to 39%, which will be the lowest it has ever been within the period."

The U.S. portfolio sale will reduce RioCan's operating funds from operations (OFFO) temporarily. However, the REIT has been steadily mitigating that effect via acquisitions. In December 2015 RioCan paid $774 million to acquire Kimco's interests in 23 properties.

Last week, RioCan entered an agreement to pay $352 million for the 50% interest in four properties, which the Canada Pension Plan Investment Board holds. RioCan has also entered into agreements on two other acquisitions.

The Kimco acquisition is expected to replenish about 36% of the lost OFFO. Additionally, the four properties, which are diversified across four different cities in three different provinces, are immediately accretive.

Based on RioCan's OFFO per unit generated in the first quarter, its payout ratio was 76.6%. Excluding the U.S. discontinued operations, its payout ratio would have been 97.4%.

With RioCan's recent acquisition activities and enhanced liquidity, the REIT should be able to continue paying its monthly distribution that equates to a 4.8% yield at about $29.20 per unit. RioCan has shown its commitment to paying its distribution by maintaining or increasing it for the 24th year.

Valuation

My biggest concern is that after appreciating about 27% from the low in December when it announced the sale of its U.S. portfolio, RioCan now trades at a pricey P/FFO of 17.1, which is at the high end historically. If RioCan falls to about $25 or lower at a P/FFO of 15 or lower, it'll be a more fair entry point.

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1. TSX:REI.UN (RioCan Real Estate Investment Trust)

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