Why I'm Skipping This Succulent 10% Yield

Description

I'm the first to admit it: I'm a sucker for a succulent yield.

Here's the way I look at it.

Normal stocks pay dividends of 3% or 4%. Stocks that pay 8%, 9%, or even 10% clearly have something major wrong with them. Much of the time, the discount is warranted. There are major warts that I don't want to deal with.

Upon digging deeper, I surprisingly often find a very compelling bull case. Sometimes earnings are depressed because of one-time items. Other times, sentiment plays a major role. Investors also have a way of freaking out over things with a small probability of happening too.

If I can find a stock that is yielding 9%, all I need is minimal capital gains to generate a very reasonable return going forward. If I can limit my selections to stocks with generous dividends plus capital gains potential, I can get the best of both worlds. I get a terrific dividend to wait with the potential for outsized capital gains in the future.

On the surface, **Cominar REIT** (TSX:CUF.UN) looks exactly like the kind of stock I'd be interested in. Unfortunately, I'm not. Here's why.

Risk of a dividend cut

You'd be amazed at how many stocks yielding between 8% and 10% can easily afford their dividends.

Cominar REIT is not in that club.

Cominar recently announced its 2016 results. Adjusted funds from operations (AFFO) came in at $239 million, or $1.39 per share. That was down significantly versus 2015, when the company delivered $262 million in AFFO.

A number of things weighed on results. Occupancy dropped to just over 92%. The company's debt-to-assets ratio spent much of the year close to 55%, although that dropped as the year progressed thanks to some asset sales. Quebec's tepid economy didn't help either.

Cominar currently pays $1.47 per share each year to investors. That gives it a payout ratio of 106%. This isn't good, but if AFFO go up in 2017, then it isn't an issue.

Unfortunately, I don't see that happening. Cominar sold $115 million worth of property in 2016 and wants to dispose of $143 million more. Now, $258 million worth of properties isn't much for a company the size of Cominar — it has $8.3 billion in assets — but it's hard to increase earnings when income-producing assets are eliminated.

In addition, the Quebec office market continues to be soft. Occupancy in that part of Cominar's portfolio was 90.3% at the end of 2015. It slipped to 89.6% at the end of 2016.

Valuation

Investors should be willing to risk a dividend cut if they're getting assets cheaply enough.

Cominar shares trade hands at $14.62 each as I write this. The company generated $1.39 per share in AFFO in 2016. That puts shares at 10.5 times AFFO, which is a reasonable valuation. In addition, shares trade for about 70% of book value. Both of these metrics are a good value when compared to most other REITs.

Ultimately, I believe it's the risk of a dividend cut that is weighing down the stock. If Cominar paid out $1 per share — for a yield of 6.8% — it would allow investors to focus on the valuation rather than the dividend.

There are also other REITs that trade at a similar valuation to Cominar that don't pay out more than 100% of their AFFO in distributions. An investor can choose one of them instead without the dividend cut overhang.

The bottom line

There's certainly the chance Cominar will get through this rough patch without cutting the dividend. The company offers a compelling valuation as well, which is music to any value investor's ears. But at the end of the day, I just don't see the capital gains potential while the dividend issue overhangs the stock. For those reasons, I'll choose to get my income from other REITs.

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nelsonpsmith