Retail REIT Investors: Beware the Downside

Description

Who isn't going bankrupt in retail these days? It seems like there's a weekly death notice as brick-and-mortar retail sorts out its inventory problem. There's just too darn much retail square footage in both the U.S. and Canada.

You might think your investment in **RioCan Real Estate Investment Trust** (TSX:REI.UN) is safe because it is Canada's largest REIT with a roster of quality retail tenants such as **Canadian Tire Corporation Limited** and **Loblaw Companies Limited**, which are second to none.

Fool.ca contributor Andrew Walker recently suggested income investors looking for above-average yield — its current dividend yield is 5.4% — consider taking a small position in RioCan because it provides a reliable income stream and has some attractive residential opportunities at 50 of its properties in different parts of the country.

On April 24, RioCan announced a 50/50 joint venture partnership with **Killam Apartment REIT** (TSX:KMP.UN) — a REIT I recently recommended — that will see the two companies develop a 7.1-acre site in Ottawa. By the time it's built, there will be 840 rental units on the property.

Examples such as the one above are the kinds of diversification should excite RioCan investors, because these deals reduce its reliance on retail.

But before you plunk down your hard-earned dollars, you might want to consider the downside lurking in retail that investors aren't talking about: triple-net leases.

A story hit my news feed recently that caught my attention. Apparently, independent retail businesses in Vancouver are getting crushed by the rising property taxes they're forced to pay under these triple-net leases. A triple-net lease requires tenants to pay rent, maintenance, and property taxes on a property.

Real estate owners love them because it puts the onus back on the tenant to cover all of the costs of retail space. That's fine when property values are rising modestly.

However, as is the case Vancouver, small retailers are forced to cover massive year-over-year property tax increases. In one example in *The Globe and Mail* from early January, a restaurant saw property taxes increase 268% in 2016 to $614,000 from $229,000 a year earlier. That's an additional $8,000 a week the restaurant has to come up with to meet its obligations under the triple-net lease.

I know what you're thinking.

Big retailers like Canadian Tire who generate billions in revenue each year aren't affected by this. Maybe RioCan isn't worried, but the last time I checked, most of its retail leases were triple net. If property taxes in Toronto grow at the rate seen in Vancouver, that's two cities where retailers of all sizes are paying through the nose to keep the lights on.

Eventually, like the independent retailers in Vancouver who are fuming over this situation, big retailers are going to ask to renegotiate the terms and conditions of their leases to share some of the increase. It's inevitable. Alternatively, when their kick-out clause takes effect, they'll walk.

Now, RioCan has specifically targeted big companies like Canadian Tire which can absorb these increases, but it's something to think about if you own RioCan stock or are considering buying.

At the end of the day, triple-net leases are a double-edged sword that could end up affecting the size of your monthly REIT distribution.

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