Could This Major REIT Get a Credit-Rating Downgrade Next Month?

Description

Cominar REIT (TSX:CUF.UN) could be facing a potential credit-rating downgrade by August 2017 after failing to meet some of the requirements of its credit-rating agency DBRS during the past 12 months.

Management revealed during the first-quarter (Q1 2017) earnings conference call in May that they would be meeting with representatives from the credit rating agency DBRS in June for a scheduled review of Cominar's credit rating.

DBRS warned in August 2016 that the real estate investment trust (REIT) could face a rating downgrade if it failed to comply with the rating parameters of its rating category relating to its debt metrics or leverage ratios.

Since then, Cominar REIT has made some frantic efforts to comply with the rating agency's recommendations by selling some assets to pay down debt. The REIT has achieved some, but not all the parameters of DBRS's BBB credit-rating grade.

Cominar REIT's senior unsecured debentures are currently rated BBB by DBRS, with an assigned trend of "negative" in the rating agency's August 18, 2016, report on the REIT.

The BBB category is just a notch above the speculative (junk) rating grade for an issuer, and any slight downgrade for Cominar would mean that the REIT would struggle to get more debt financing for its operations, and that it would begin to pay higher interest rates to lenders.

Cominar's current status

As of the REIT's Q1 2017 financial statements, Cominar has managed to reduce its outstanding debt to 52% of assets, right below the 53% threshold for DBRS's BBB category.

However, the REIT's total debt to operating earnings (EBITDA) ratio still stands at 9.9 times, way higher than the DBRS required low nine times range.

Potential for a downgrade

Cominar has failed to get to the low nine times range for the debt-to-EBITDA range, which is in line with the DBRS's BBB rating category since August 2016.

Furthermore, Cominar continues to suffer from lower average occupancy levels on its properties. The DBRS was hoping Cominar would show significant progress towards increasing its occupancy rates towards the 94% historical average levels.

The REIT's sustained, high monthly payout of $0.123 per unit does not help its cash low and payout ratios either, as the AFFO payout ratio ballooned beyond 125% in the last quarter.

So, as a worst-case scenario, DBRS could easily decide to downgrade Cominar's credit rating to below investment grade by August 2017.

Case for a maintained rating

Cominar has already complied with one of DBRS's major requirements by reducing total the debt level below 53% of capital. The REIT also stated that it had signed new contracts with new tenants for about 1,700,000 square feet, and these tenants would start rental payments over the next five quarters, beginning in the current quarter.

Moreover, the REIT's re-instituted distribution-reinvestment plan (DRIP) is currently preserving cash, while Cominar is aggressively seeking new tenants and developing new properties with higher rental potential.

The REIT's fortunes have the potential for improvement in the near term as Canada's economy continues to grow.

Since the prior negative trend has turned, and it's not surprising that Cominar's rating trend could be upgraded back to stable.

Foolish bottom line

It's highly unlikely that DBRS will downgrade Cominar REIT's credit rating to below investment grade as the REIT has shown evidence of its willingness and ability to comply with the rating agency's requirements.

Although anything could still happen since other important ratios haven't been met yet, Cominar's cash flow prospects seem likely to improve going forward.

Investors, be aware that a credit-rating downgrade would seriously hurt Cominar cash flows and would mean a distribution cut as the REIT faces higher borrowing costs. Investors could suffer some further capital losses too.

If no downgrade happens, and the REIT maintains its distribution through the next two to three quarters while improving occupancy levels, then current investors would do great.

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