Income Investors: This 8%-Yielding REIT Is Executing a Turnaround Strategy Now. Time to Invest for Capital Gains?

Description

Cominar REIT (TSX:CUF.UN) equity units have enjoyed a steady 11.4% price recovery since the announcement of its proposed strategic refocusing plan on August 22, and there could be more capital gains after management started implementing the first phase of the new business plan on November 15.

Cominar REIT is currently one of Canada's largest diversified real estate investment trusts (REITs) with a geographically diversified asset portfolio worth about $8.4 billion spread across the retail, industrial, and office clientele bases.

Background

The REIT had lost half its market value during the 12 months from July 2016 to early August 2017, as investors priced in the rising risk of a payout cut when adjusted funds from operations (AFFO) and cash flow payout ratios had ballooned beyond sustainable levels amid continuously depressed occupancy rates below their 94% historical levels.

Equity units in Cominar then traded at an ever-deepening discount to their net asset value, as management instituted a highly dilutive distribution reinvestment plan (DRIP) to preserve cash flow, while keeping the highly unsustainable distribution untouched amid a growing likelihood of a credit-rating downgrade.

However, after DBRS finally downgraded Cominar's unsecured debentures to non-investment grade on August 3, and Cominar announced a 22% distribution cut, while suspending the problematic DRIP on the same day, the units plunged more than 8% and bottomed at $12 on August 9.

The credit-rating downgrade evidently didn't mean doom for Cominar's valuation, as the REIT had some $3.6 billion worth of unencumbered assets in its portfolio that it could mortgage to refinance unsecured debentures, whose maturities were still several months out starting June 2019.

Case for a sustained rebound

Cominar is implementing a new strategic refocus. The REIT has decided to focus on its core market, namely Quebec and Ottawa, and dispose of all assets outside this core market for a probable $1.2 billion in realizable sales proceeds meant to reduce debt.

I discussed the risks and merits of this strategic plan in September, and judging from the steady rise in the market price of Cominar units since August, the market is showing some confidence in the success of the new program.

Cominar has some competitive advantages in its core market. In its third quarter (Q3 2017) earnings release this month, same property net income rose 1.4% from the comparable quarter last year, while the same measure declined 8.4% in the non-core market.

While non-core asset sales are still to launch early 2018, the REIT has already launched the early part of the new plan into motion.

As of November 15, Cominar is repurchasing a significant number of its outstanding units for cancellation.

The REIT is targeting to repurchase up to 9,000,000 units on the open market until it exhausts its $125 million budget for this exercise. This program will remove about 5.11% of Cominar's outstanding units from the float and probably lift the market price as the net asset value per unit increases after the repurchased units are cancelled.

Most noteworthy, this exercise will purchase up to 127,040 units per trading day. At this rate, Cominar will need at least 70 trading days to conclude the unit-repurchase exercise, giving the units some price support throughout the first quarter of 2018.

If Cominar can manage to complete the repurchase program during the first quarter of 2018, investors may continue to see some continued price recovery in its units during this period, booking further capital gains on this income investment.

The current $0.095 per unit monthly payout yields a good 8% at the current price levels of ~$14.26.

A successful execution of the new strategic plan could remove the deep discount that Cominar units trade at today. If the price to net book value of 0.686 improves to 0.9, Cominar investors could book some ~30% capital gains over the next year.

With a lower target debt level of 48%, Cominar's valuation could improve in the long term.

The risk

Cominar has recently managed to register significant success in re-leasing the ex-**Target** space left vacant after the retail giant exited Canada, but, unfortunately, its retail portfolio is taking another hit from the latest Sears Canada demise.

This development amid a slow recovery in occupancy levels across the whole leasing portfolio could slow the recovery process.

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Date
2025/09/08
Date Created
2017/11/27
Author
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