What RioCan's (TSX:REI.UN) Transformation Means for Investors

Description

Based on its $14 billion market cap, **RioCan REIT** (TSX:REI.UN) is the largest real estate investment trust (REIT) in the country. It's also heavily exposed to one of Canada's least-loved industries at the moment: retail.

RioCan CEO Edward Sonshine himself admitted that demand for retail space is unlikely to rise over the next 10 years. Instead, as the in-store experience falls out of favour, malls and retail spaces may be on the decline.

The recent expansion of **Amazon** and changing customer preferences across Canada are weighing down mall and supermarket landlords like RioCan and **Choice Properties**.

While Choice Properties is backed by a financially stable conglomerate, RioCan must rely on its own resources to transform the business model and diversify its portfolio. The firm has already shifted its focus away from malls and secondary markets to condos and mixed-use properties in Canada's major markets, including Toronto, Ottawa, Montreal, Vancouver, etc.

This plan involves selling off one-third of the trust's total assets (100 properties out of nearly 300), which will unlock $2 billion (US$1.6 billion) in cash. That chunk of liquidity can be deployed in diversification projects like "RioCan Living" and "ePlace."

ePlace is RioCan's flagship mixed-use project in midtown Toronto, a city where the number of houses on sale has reduced by half between October 2000 and 2015, and the average house price is up 40% over the past three years. In other words, it's a feeding supply to Canada's second most constrained housing market.

About a fifth of the ePlace plot will be retail space of some of its other malls, with offices and 1,100 condominiums and apartments covering the rest. The first batch of 466 rental apartments are expected to be completed by early 2019, but all these have been sold already.

The ePlace units are a small part of the ambitious RioCan Living project, which may add over 10,000 residential units across 50 properties by the year 2025 to the firm’s portfolio.

The current divestiture schedule coupled with the RioCan Living program will make half the portfolio residential within the next decade. By that time, all the company’s retail properties will be in Canada’s prime markets where major retailers like **Wal-Mart**, Safeway, **Home Depot** cannot ignore rising incomes and a growing population.

The risk, of course, is that the retail sector declines faster than RioCan can shift to residential. However, the stock is undervalued enough to compensate investors for that risk.

RioCan currently trades at 94.8% of its book value and offers a 6.1% dividend yield. The price-to-funds-from-operations ratio is attractive at just 12.62. This makes the stock an undervalued contrarian bet for income-seeking investors.

Bottom line

It’s impossible to disagree with RioCan’s restructuring and diversification strategy. However, this plan will take nearly a decade to yield results for investors. A lot can happen over that period, including a recession, housing market slowdown and retail market collapse.

I believe investors who can stomach the risk will have ample opportunities to accumulate the stock over the next 10 years.

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