There May Be Opportunity in This Dividend Cut

Description

Have you experienced dividend cuts? They sure are a pain!

Thankfully, not all dividend cuts are bad. It's true that they often come with hefty stock price cuts. However, opportunities can lie in the reduced stock price that's depressed from the negative sentiment around the stock.

Here's an example with **Slate Office REIT** (TSX: SOT.UN) to illustrate the point.

This REIT recently cut its dividend

Slate Office has maintained a funds-from-operations (FFO) payout ratio of about 100% for a couple of years. Essentially, it pretty much left no margin for error before it cut its dividend.

Slate Office reported its fourth-quarter and full-year results on Monday. Unfortunately for income investors, it also announced a dividend cut — slashing its annualized cash distribution by nearly 47% from $0.75 to $0.40 per unit.

Here’s why the dividend cut may be a good thing

The real estate investment trust (REIT) is a pure-play on office properties. It advertises itself as a value investor with an entrepreneurial culture.

The REIT has a recent history of generating strong returns. Since 2015, Slate Office has generated returns on equity of about 12-14%. As well, its returns on assets have been stable at about 4% for each of those years.

Here’s a more concrete example. Slate Office recently sold its Greater Toronto Area joint venture portfolio for a rate of return of 19%.

The dividend cut frees up $26 million of capital each year. This capital can be used for deleveraging the balance sheet or to grow the portfolio. The cut also implies a much safer FFO payout ratio of about 56% compared to the ratio of more than 100% before the cut.

Slate Office’s debt-to-asset ratio increased from 58% at the end of 2017 to 63% at the end of 2018. And its interest coverage ratio declined from 2.7 times to 2.3 times.

Investor takeaway

When stocks cut their dividends, usually the market sells first and asks questions later. Since the Q4 and full-year results and the news of the dividend cut came out, Slate Office stock has fallen about 10% as of writing.

The amount of the decline is worth about a full year’s dividend before the stock price drop. This goes to show that investors should prioritize researching business fundamentals, valuations, and growth prospects before considering the income potential of a stock.

If Slate Office can continue generating double-digit rates of returns on its office portfolio transactions, the shaved off stock price could be an excellent entry point for outsized returns. At $6.08 per unit as of writing, the revised cash distribution represents a yield of nearly 6.5%.

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