Dividend Investors: Is This 12% Payout Safe?

Description

After months of speculation and calls from pundits that the dividend was unsustainable (including myself, who predicted a cut approximately a month ago), two weeks ago, **Slate Office REIT** (TSX:SOT.UN) finally did the inevitable and slashed its monthly dividend.

The new annual payout will be $0.40 per share, versus the previous distribution of $0.75. Slate's management team did this to pay off debt and help free up capital to make upcoming acquisitions. The company also sold a 25% stake in some of its finest assets to an unnamed private investor — a move that will give the company some $527 million in cash.

Slate's new distribution yield is approximately 6.5%, which puts at a similar level to its peers. The old payout ratio was approximately 125% of the REIT's adjusted funds from operations, which is never sustainable. Now the stock will be able to balance debt repayment with growing its portfolio, specifically in the United States. Management is pleased with how buildings located in Chicago have performed after being recently acquired.

But there's another 12%+ dividend out there — one that I think may end up having the same fate as Slate's once generous payout.

Enter American Hotel Properties

On the surface, **American Hotel Properties REIT** (TSX:HOT.UN) isn't in quite as dire of shape as Slate Office REIT was. When I last wrote about it in February, I noted the owner of 112 hotels across the United States could still afford its dividend based on trailing adjusted funds from operations, although only barely. The stock needed to post a good quarter to help ease investor concerns.

Unfortunately, that didn't happen. Fourth-quarter revenues dipped more than 3% versus the same quarter last year, driven down by hotel renovations and a particularly strong quarter in Florida the year before. The bottom line showed just how dependent the hotel business is on good revenues; even though revenue just dipped slightly, adjusted funds from operations decreased some 25% in thequarter to US$0.12 per share.

Full-year results weren't quite as bad, but overall don't really inspire a lot of confidence for investors seeking a secure distribution. Adjusted funds from operations came in at US$0.65 per share, compared to US$0.74 the year before. The annual dividend is also US$0.65 per share, which puts the payout ratio at exactly 100%.

The company is confident the payout ratio will improve in 2019 now that certain marquee properties have completed their renovation programs. Management projects a payout ratio going forward in the 85% range. 2018 saw good results from its budget properties after many converted to more recognizable brand names. Premium hotel results were driven down from so many properties being renovated. These numbers should improve in 2019.

But there's also risk here. The hotel business is economically sensitive and the United States is due for a recession. A premium hotel operator would get hit hard in any economic slowdown. And although the balance sheet is somewhat improved, American Hotel Properties still has a debt-to-assets ratio above 50%, which is above what I like to see.

Is the payout safe?

I think it's definitely possible the company weathers this storm and can maintain its generous 12% yield. 2019's results will have to be better than last year's to avoid such a fate, but the lack of renovations should immediately improve both the top and bottom lines.

But at the same time, I can see why investors are skeptical. American Hotel Properties needs to put up a couple of good quarters to quiet the naysayers. Until then, investors will rightfully treat this generous dividend as risky.

Don't buy this stock if you're looking for a secure payout. It's a high risk/massive reward stock. If management can turn it around, shares can easily be 50% higher a year from now. If the turnaround plan fails and the dividend is cut, who knows how far the company could fall.

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