Avoid Retail REITs Before it’s Too Late

Description

The retail apocalypse is gaining momentum, challenging the viability of brick-and-mortar retail, especially “big-box” department stores, and hence the survival of shopping malls. Online shopping is easier, typically cheaper, and more convenient, making it the ideal way to shop. The widespread adoption of the ubiquitous smartphone and mobile internet provides customers with the opportunity to make purchases at any time.

By the end of April 2019, over 12 major North American retailers had declared bankruptcy, while one-time leading iconic U.S. retail department store chain Sears filed for bankruptcy in late 2018. This has had a sharp impact on shopping malls, because major department stores were cornerstone tenants that essentially sustained them by generating substantial foot traffic for smaller retailers.

Retail apocalypse impacting grocery chains

The increasingly rapid decline in the outlook for brick-and-mortar retailers challenges the existence of shopping malls and hence retail REITs. While grocery store chains like **Loblaw** have proven resilient to this trend, making them key anchor tenants, they are now under threat from the rapid uptake of e-commerce and online retailing.

According to consultancy McKinsey & Company, “monumental forces are disrupting the industry,” and sales growth among major grocery chains in North America and Europe have only been, on average, 2% over the last decade. Margins for grocery chains also deteriorated significantly, placing greater pressure on management to make productivity gains and lower costs. Groceries and fresh food were once thought to be immune to the havoc being wrought across brick-and-mortar retail by e-commerce, but it is fast being acknowledged that this was a myth. McKinsey believes that if radical changes aren’t made by existing grocery chains, then the industry will lose up to US$700 billion in sales to online retailers by 2026.

That weakness can be attributed to the rapidly expanding popularity of online shopping. Even grocery and department store behemoth **Walmart** has beefed up its online presence, especially for the sale of groceries. For the final quarter of 2018, Walmart experienced a massive 43% surge in the volume of online sales led by a notable increase in the purchase of groceries. This shows that it is finally taking the fight to **Amazon.com**, which has been responsible for the destruction of brick-and-mortar retail.

That highlights the threat posed to shopping malls and retail REITs. Many, like **Slate Retail REIT** (TSX:SRT), have differentiated themselves by focusing on acquiring and developing properties where grocery store chains are the primary anchor tenants. Slate Retail is even more exposed to the ongoing apocalyptic decline of traditional retailing than its Canadian peers because it is focused on U.S., where shopping malls are deteriorating faster.

The REIT owns 84 U.S. properties with almost 11 million square feet of gross leasable area — roughly half of which is occupied by grocery store tenants. Fortunately for Slate Retail, its top tenant by annualized base rent, Walmart, which is responsible for 7.8% of that revenue, has demonstrated considerable resilience in the face of the onslaught from online retailers.

Nonetheless, while grocery occupancy by the end of the first quarter 2019 remained unchanged at 100%, the rate for non-grocery tenants had deteriorated by 1.1% year over year to 87.1%, causing the overall occupancy rate to decline by 0.4% to 93.3%. Slate Retail's earnings took a hit during the first quarter, despite net operating income (NOI) remaining relatively flat year over year at US$24.6 million. Funds from operations (FFO) declined by 12% to US$13 million, while net income of US$1.6 million was a 17th of what it had been a year earlier. Worse still, adjusted funds from operations (AFFO) softened by almost 13% year over year to US$0.21 per unit.

This indicates that Slate Retail's distribution, yielding a juicy 9%, may not be sustainable. With the payout ratio as a function of trailing 12-month AFFO at 104% coupled with the increasingly bleak outlook for U.S. retail REITs, it makes sense for management to cut the distribution to preserve cash flow in a difficult operating environment.

Foolish takeaway

The outlook for retail REITs remains poor and likely will worsen before it improves, making them unattractive investments. For the reasons discussed, it isn't unreasonable for Slate Retail to reduce its distribution in coming months as it prepares for the storm ahead.

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