Can This Monster 8.5% Yield Survive or Is a Distribution Cut Looming?

Description

High yields among dividend-paying stocks continue to attract considerable scrutiny from income-hungry investors, as nearly historically low interest rates makes traditional income-producing assets such as bonds unattractive investments. One such stock that is attracting significant attention because of its 8.5% yield is **Slate Retail REIT** (TSX:SRT.UN). The REIT, which is due to release its second-quarter 2019 results tomorrow, has so far weathered the retail apocalypse in relatively good shape, but there are signs that the operating environment is due to become more difficult.

Retail apocalypse

Slate Retail owns a portfolio comprised of 84 retail properties all located in the U.S. with 10.7 million square feet of gross leasable area. Importantly, all locations possess grocery store anchor tenants. It is that last attribute that has been responsible for shielding the REIT from the fallout from the retail apocalypse and near failure of many tier-two and -three shopping malls caused by the bankruptcy and decline of major department stores.

Nonetheless, Slate Retail is facing a major threat, as online retailers expand into grocery sales. It is anticipated that online grocery sales will be worth US$27 billion by 2025, as technological innovations makes it more attractive for consumers, especially millennials, to buy fresh food, groceries, and other necessity-based products online. This makes it likely that grocery chains will no longer be as immune to the transformation of brick-and-mortar retail as once believed, placing further pressure on already troubled retail REITs.

Weak results

Slate Retail's first-quarter 2019 results indicate that occupancy rates are falling. It reported an overall occupancy rate of 93.3% for the period, which was 0.4% lower year over year, and that non-anchor occupancy had dropped by 0.9% to 87.1%. Revenue was flat year over year, while funds from operations (FFO) plunged by 12% to US$13.4 million and adjusted funds from operations (AFFO) declined by almost 17% to US$9.1 million.

This has sparked considerable speculation that Slate Retail's distribution and that monster 8.5% yield is under threat.

You see, AFFO is an important measure of the funds available to a REIT and is a superior means of measuring performance because net income includes a range of non-cash charges which don't fully portray the businesses financial state. Slate Retail's AFFO will likely soften further because of its decision to sell two properties for US$24 million in early March 2019.

Weaker AFFO combined with the distribution having a trailing 12-month (TTM) payout ratio of 104% highlights that the payment is unsustainable over the long term. That is further exacerbated by Slate Retail's high debt-to-gross-book-value ratio of 61%, highlighting that the REIT is heavily levered and needs to reduce the level of debt in proportion to the value of its property portfolio.

Foolish takeaway

Even if Slate Retail slashed its distribution by 40% to US$0.51 annually, it would still yield in excess of a juicy 5%, making it an attractive investment. The additional cash flow saved could be directed to reducing debt and redeveloping exist properties to improve their attractiveness for shoppers and tenants, bolstering their resilience to the transformation of the retail sector. Any distribution cut will likely cause Slate Retail's stock to decline sharply in value, despite it being a positive long-term move for the REIT.

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