Income Lovers: This 12.8% Dividend Just Got More Secure

Description

Much has been written about **American Hotel Properties REIT** (TSX:HOT.UN), especially focusing on the company's succulent 12.8% yield. Who wouldn't get excited about that?

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Although I'm a big long-term fan of the trust's portfolio — which currently includes 112 hotels spanning 32 states and 89 cities for a total of 11,524 guestrooms — the company has a little more debt than I'd like to see. It's also in the middle of a big renovation program, which is impacting the bottom line.

These extra costs have pushed the company's payout ratio to 100% of trailing adjusted funds from operations, which investors never like to see. The whole reason why the stock is offering such an attractive yield is because the market perceives the payout to be at risk.

The good news is, the company just announced a major change — something that could lead to a much more sustainable payout. Let's take a closer look.

Moving forward

American Hotel Properties got its start by owning budget hotels that catered to rail workers before expanding the portfolio into mid-range and upscale properties. Now the company has come full circle and announced it will sell the budget hotel business to Vukota Capital Management for US$215.5 million. Once closing costs and debt repayment are accounted for, American Hotel Properties will walk away from the transaction with a little over US$90 million.

The company intends to use these proceeds to expand further into the upscale hotel business, focusing more on what it calls "secondary metropolitan markets" across the United States, featuring cities like Cincinnati, Columbus, or Baltimore. These are larger population centres that offer plenty of steady demand for hotel rooms.

These hotels also offer more appeal to business travelers, who are less likely to use other cheaper options. And, most importantly, they can be acquired for a similar cap rate when compared to economy hotels while offering more robust nightly average room rates.

What this means for the dividend

American Hotel Properties pays approximately US$51 million per year in dividends. Over the last 12 months, it has earned approximately US$51 million in adjusted funds from operations, which gives it a payout ratio of approximately 100%.

The cash infusion from the sale of the economy hotel business will ensure the dividend is secure. If the payout ratio creeps up to 105% or even 110% over the near term, there's plenty of cash to cover it.

The US$90 million in proceeds from the sale will also be put back to work in new acquisitions, which should be focused in western markets, where it doesn't have much exposure. These will add to the bottom line, helping the dividend become more affordable.

And remember, the company is in the middle of spending millions on a renovation program. It expects to spend US$25 million on renovations in 2019 after spending US$14 million in 2018. Renovated hotels then enjoy higher room rates, leading to a nice return on investment.

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In short, I'd expect the 100% payout ratio to normalize in the 85% range going forward, further securing the payout. The company must still do a good job acquiring new assets, but it looks poised to do so.

The bottom line

I was a little wary about American Hotel Properties's dividend a few weeks ago, but this major announcement should be good news going forward. Earnings should normalize at a higher level, which would mean the 12.8% dividend would be sustainable. If that happens, look for this very cheap stock to rebound nicely higher.

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