Canadian REIT Investors: Check This Rating When Buying the Yield

Description

Compared to valuation computations, yield and payout sustainability analysis and growth potential evaluations, it's less time-consuming yet still sensible to consider credit ratings as another starting point metric when selecting investment candidates for a reliable monthly income-generating portfolio.

While the purpose of credit ratings from agencies, including DBRS Morningstar, **Moody's**, **Standard & Poor's (S&P)** and Fitch Ratings is usually meant to show a debtor's ability to repay loans in a timely manner and its potential to default, the ratings aren't exclusive to debt investors only. Indeed, equity investors can use them too — more so if the prime goal is dividend or income investing. But more on this in a moment.

Due to record low interest rates on traditional bonds and GICs, income investors are flocking into higher yield dividend options to augment monthly payouts.

Real Estate Investment Trusts (REITs) are one lucrative asset class created to allow investors to pool funds together to invest in real estate assets and receive almost all the generated net income back in regular (usually monthly) distributions.

REIT yields in Canada remain decent, and income investors who may have been more comfortable receiving safer bond coupons may still be interested in using the age-old risk assessment approaches to their monthly cash flows if they're going to depend on the monthly distributions for income needs.

Check credit ratings

Credit ratings on REITs are usually based on the trust's inherent business risk of its operations, which affects the stability and sustainability of the income from its properties and the trust's balance sheet strength, including the liquidity profile and extent of leverage.

These ratings have been historically a good indication of the risk on an issuer's unsecured notes, as they measure ability to generate enough and timely cash flows to meet maturing obligations.

Now that equity units investors rank lower than unsecured lenders, it's only logical to conclude that a trust with a very low credit rating might also have a very high chance of cutting or suspending its monthly payouts as it tries to pay unsecured debenture holders first.

Conversely, a trust with very high corporate credit rating may also have a very healthy distributable cash flow profile.

Thus, evaluating the trust's issuer credit rating can be a quick way to sift through potentially reliable income distributors to stash in a retirement portfolio.

Further, those trusts with higher credit ratings can usually raise new debt at lower interest rates because of their perceived lower credit risk), and can therefore can grow their property portfolios much faster than lowly rated peers, all else being equal.

Given that leverage is a key source of capital for REIT, as they are required to pay out around 90% of earnings to investors, obtaining a high credit rating is a key asset for growth.

Look out for downgrades

While defaults are rare, even on lowly rated issuers, distribution cuts have happened several times after periods of weaker cash flows and some of these cuts have at times coincided with credit rating downgrades.

Such was the case in 2017, when **Cominar Real Estate Investment Trust** (TSX:CUF.UN), one of Canada's largest diversified REITs, suffered a rating downgrade on its unsecured debentures from investment grade (BBB(low) with Negative trend) to speculative grade (BB(high) from DBRS after a long period of poor portfolio performance and an unsustainable pay-out rate. The trust announced a massive distribution on the same day and made another cut in the following year.

Cominar's rating trend had deteriorated to negative in prior reviews, and investors DBRS could have spared Cominar the embarrassment of a credit rating downgrade had management been willing to significantly reduce its unsustainable payout to equity investors.

With the Cominar case in hindsight, maybe it's worthwhile to take note of the rating and trend changes such as the recent one on **Artis REIT,** whose trend changed from stable to negative late last year.

Ironically, the trust was blamed for favouring its unit holders at the expense of its creditors. Its rating sits right at the borderline between investment grade and speculative grade.

Take note, however — an issuer may still cut its distribution to maintain its current rating, so deeper analysis is required when sifting through these investments.

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