Can RioCan REIT (TSX:REI.UN) Sustain its 10% Dividend Yield?

Description

Canada's largest real estate investment trust, **RioCan REIT** (TSX:REI.UN) has always been a lucrative dividend passive-income stock. However, the stock price has plunged over 50% since the COVID-19 outbreak. Now, it offers an unbelievable 10.5% dividend yield.

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Is this double-digit too good to be true or is it the passive-income opportunity of a lifetime? Here's a closer look.

Real estate risks

RioCan's sudden decline in market value isn't unjustified. Investors have noticed plenty of risks for Canada's real estate sector over the horizon.

Commercial real estate is at the epicentre of the storm. With everyone confined to their homes, retail malls and office buildings have been deserted since March. RioCan relies on rental income from tenants who've seen their income entirely vanish.

RioCan said it has collected just 66% of gross rent for April, and investors expect further declines in May.

The portfolio also includes residential properties where rental income has been supported by government stimulus measures. However, Canadian households are overleveraged, and the residential market is overvalued. With record-high unemployment, rental income from residential properties could steadily decline when stimulus measures recede.

In other words, RioCan's income is under enormous pressure. This could make the current dividend payout unsustainable.

Passive-income support

However, RioCan's chief executive officer Ed Sonshine recently said that the distribution is guaranteed. Sonshine's optimism stems from the underlying quality of RioCan's portfolio and the government's numerous stimulus measures that have supported businesses of all sizes.

"Our portfolio is the best it's ever been in history," he told *BNN Bloomberg.* That portfolio is currently worth $25.92 per share, while the trust's shares trade at $13.5. In other words, RioCan is undervalued, even if you account for a correction in property values.

As for the payout, I believe RioCan can easily support it with borrowed capital for the foreseeable future. The trust's debt-to-equity ratio is just 81%, lower than the industry average. Borrowing $1 billion could support the current dividend for two to three years, while only pushing the debt-to-equity ratio to 93%.

"Money's free. So if money's free, you can make your distributions," said Michael Cooper, CEO of RioCan's rival **Dream Office REIT**. If REITs borrow to sustain dividends, investors could directly benefit from this "free money" while waiting for the real estate market to eventually recover.

Real estate is more resilient than most other industries. There is no doubt that demand for office and mall space could be subdued for years. However, converting these units to productive spaces for residential or industrial tenants could put a floor on their value. Also, the underlying properties should see their value appreciate over the long term. Canada's income and population growth support long-term price appreciation.

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Bottom line

Real estate firms like RioCan are in a precarious position. Rent collections have already declined, and there could be plenty of pain ahead. However, investors seem too pessimistic about RioCan's outlook. The stock is trading for less than half of book value, and the team has enough room to borrow and sustain the dividend for years.

Betting on commercial real estate isn't an easy call to make in 2020. However, for contrarian investors with an appetite for risk, RioCan could be an excellent opportunity for wealth creation.

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