3 Biggest Risks Canadian REITs Face During the COVID-19 Financial Crisis

Description

They usually enjoy bond-like income protection from their long-term lease portfolios, but Canadian real estate investment trusts (REITs) aren't exactly immune to the challenges posed by the devastating COVID-19 pandemic in 2020.

Three risks stand out today. REIT investors should closely evaluate their holdings for their impacts on both future income and capital gains.

There's the potential for a 75% cut to monthly gross rental income. There's the risk of opportunistic tenants who will negotiate rent deferrals even if they are liquid and well capitalized. On top of these, there's an evolving but elevated preference for perpetual work-from-home arrangements that threatens office REIT occupancy levels.

A 75% hit on rental income!

The Government of Canada announced the Canada Emergency Commercial Rent Assistance (CECRA) program on April 24. The program aims to cushion small businesses that were heavily affected by the COVID-19 pandemic and associated lockdowns.

Landlords can be awarded forgivable loans in exchange for lowering their rents by 75% to eligible small businesses. Qualifying small businesses are those that pay less than $50,000 in gross monthly rent, generate less than $20 million in annual revenue, and have seen their revenues decline by over 70% during the pandemic.

The program will cover rentals for April, May, and June 2020. In other words, it covers the whole second quarter of this year.

A Canadian REIT that has tenants who are eligible for the CECRA program could end up collectingonly a quarter of its usual monthly gross rental income for three months. There won't be any recoverieson a full quarter's unpaid rent, so you should find out whether your REIT has significant exposure tothe small business category.

Enclosed shopping malls are the worst hit properties. Some mall retail REITs could be forced to announce distribution cuts at some point if the pandemic remains uncontained.

Cominar REIT could take a significant hit in its mall real estate assets segment. Fortunately, though, the trust's total portfolio is diversified into the office and industrial property segments.

Earlier diversifying moves into mixed-use properties have cushioned other big-name Canadian retail REITs. However, there's a need to closely monitor how portfolios are performing into May as tenants increasingly take up the government CECRA aid package.

A vigorous work-from-home trend

A number of companies are suddenly realizing that employees can still work productively from their homes, and more so after a majority of Canadians worked from home during the COVID-19 pandemic.

This is a compelling incentive for companies to cut down on office rent and related corporate expenses and improve their profit margins.

A perpetual work-from-home arrangement recently became a reality for many **Open Text** employees. This could happen to **Twitter** employees after lockdowns too. Demand for office space could be impacted if this trend is sustained beyond the pandemic, especially if many other firms increasingly warm up to the work-from-home idea.

However, as I recently pointed out, it appears that this trend is being prevalent in the technology industry, and many office REITs don't have much exposure to this industry tenant group. Rather, tech firms usually develop and own their own lavish office campuses.

Rent deferrals and collection challenges during the pandemic

Some commercial property landlords have faced significant rent collection challenges during lockdowns. Capable tenants may simply take advantage of the pandemic crisis and try to save on rent obligations or defer the expense to later periods, which hurts REIT cash flows.

I learned during a conference call hosted by **Dream Office REIT** in April that some tenants may request rent deferrals claiming to have taken cash flow hits, yet their businesses continued to operate online during the pandemic.

This is a character issue in credit management, and the process to collect the due amounts could become unnecessarily expensive.

I hope this matter isn't prevalent across the REIT industry today. However, it's important that REIT investors continue to closely monitor rent deferral developments in company business updates going forward.

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Date
2025/08/24
Date Created
2020/05/18
Author
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