Canadian Retail REITs Will Feel the Impact of Coronavirus

Description

Canadian retail REITs are facing considerable headwinds. You see, retailers, particularly those selling non-essential products, have been hit hard by the coronavirus. North American retailers are under considerable pressure from the rise of online shopping and e-commerce. **Amazon.com's** stratospheric rise and rapidly expanding online retailing is challenging the viability of traditional brick-and-mortar retailers. It triggered a secular shift in consumer behaviour, sparking the retail apocalypse and rising number of bankruptcies, which are shaking the industry and retail REITs to the core.

Bankruptcies ahead

Since 2015 there have been over 82 major North American retail bankruptcies, including some notable companies that were once believed to be too big to fail. This includes department store behemoth **Sears**, once the largest retailer in the world, as well as 90s household names RadioShack and Toys"R"Us. The latest major victim, **J.C. Penney**, filed for bankruptcy last Friday, even after earning almost US$11 billion of sales for 2019.

Canadian retailers have fared better than their U.S. counterparts, but this won't last, with worse to come.

Coronavirus accelerating the apocalypse

The measures taken by governments around the world to contain the coronavirus have had a devastating impact on many economies and industries. The shuttering of non-essential businesses, travel bans, and social distancing have weighed heavily on the economy.

The IMF predicts that Canada's 2020 gross domestic product will contract by 6.2%, and we have already witnessed the worst job numbers on record for April, which caused the unemployment rate to spike to a worrying 13%. When coupled with Canada's heavily leveraged households, which are some of the most indebted in the world, there can only be a sharp decline in consumption.

Canadian retailers will be sharply impacted. Among the most vulnerable is iconic Hudson's Bay, which went private earlier this year to avoid the pressures being felt by publicly listed retailers.

Online shopping is expanding

A key risk for many Canadian retailers and REITs is the sharp uptick in online shopping that has occurred since the pandemic began. Amazon reported that sales are booming, forcing it to hire more staff to meet operational demands. For the three months through to March, Amazon reported a massive 26% year-over-year increase in sales.

As if this doesn't pose enough of a threat, stay-at-home orders and the closure of non-essential businesses has triggered a sharp spike in online grocery and fresh food sales. This has long been considered an industry segment immune to the depredations of online retail. Amazon's foray into groceries and fresh food sales through the 2017 US$13 billion purchase of upscale grocery chain Whole Foods initially proved disastrous.

Nonetheless, before the coronavirus pandemic hit, Amazon was gaining traction and experiencing a surge in online grocery sales. The pandemic appears to have been the catalyst needed to convince consumers that it is more convenient to buy groceries, fresh produce, and other consumer staples online. Online grocery sales are growing so fast that Amazon bolstered its online grocery order capacity by 60%.

This will lead to a permanent consumer purchasing shift, where the adoption of online grocery shopping will accelerate. Analysts believe Amazon's grocery sales between 2019 and 2023 will grow around three times to be worth a whopping US$70 billion.

Canadian retail REITs are a risky investment

These events are challenging the existence of shopping malls, boding poorly for Canadian retail REITs as long-term investments. **Slate Retail REIT** (TSX:SRT,UN), which owns 72 U.S. grocery-anchored retail properties, is vulnerable to the secular headwinds triggered by the expansion of internet retailing.

The impact can be seen from Slate's first-quarter 2020 results. Despite downsizing its property portfolio, Slate's all-important occupancy rate deteriorated. Overall occupancy rate declined by 0.5% year over year to 92.8%, and its grocery-anchor occupancy fell from 100% to a worrying 97.3%.

As a result, Slate Retail's rental income fell 12% compared to a year earlier, while net operating income was 19% lower and adjusted funds from operations (AFFO) decreased by 4%. The decline in AFFO is the most worrying aspect, because this is a key measure of a REIT's ability to generate cash flow from its assets.

Slate Retail's distribution yielding a whopping 15% is under threat. An AFFO payout ratio of 104% coupled with declining rental income isn't sustainable. Those numbers will only weaken, as the economic fallout from the coronavirus impacts retailers.

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Date
2025/08/25
Date Created
2020/05/18
Author
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