Risky REITs: 1 to Buy for +50% Upside and 1 to Avoid

Description

If you've been following the stock price movements of real estate investment trusts (REITs), you can more or less list the different types of REITs from riskiest to safest on a spectrum.

Industrial REITs have been outperforming. Office and multifamily REITs have been holding their own. Retail and hotel REITs are faring the worst, but how bad are they?

Hotel and retail REITs are hit the hardest

The delinquency rate is the percentage of loans that are past due. It indicates the quality of a loan portfolio.

Trepp, LLC found that 24.3% of loans backed by U.S. hotels in commercial mortgage-backed securities (CMBS) were at least 30 days delinquent in June, up from 2.71% in April.

The CMBS delinquency rate for retail properties was 18.07% in June, up from 3.67% in April.

The rates are expected to worsen for July.

Hotel REIT example

The situation is so bad for hotels that it's no wonder **American Hotel** (TSX:HOT.UN) has suspended its monthly cash distribution since April. It's temporarily suspending the cash distribution "until economic conditions improve and COVID-19 issues abate."

American Hotel invests in premium branded hotel properties primarily in relatively large secondary markets across the U.S. Its current portfolio comprises 79 hotels across 22 states and 51 cities.

The stock has fallen from grace, down 64% from pre-COVID-19 levels. However, if it survives, the hotel stock can double investors' money in a couple of years from the recent quotation of $2.51 per unit even with a new normal that dictates lower cash flow generation compared to its 2019 levels.

Retail REITs are lower risk

Retail properties are faring better than hotels. The CMBS delinquency rate for retail properties spiked but was still meaningfully (i.e., 25%) lower than hotel's rate in June.

Particularly, retail REITs with grocery-store or pharmacy anchors should be more resilient as these essential businesses remain open through the pandemic.

SmartCentres REIT (TSX:SRU.UN) owns 166 properties across Canada with an industry-leading occupancy rate of 98%. About 73% of these properties are anchored by **Walmart**, which contributes to more than 25% of its revenues.

Its Q1 funds from operations (FFO) per unit rose 7.7% year over year to $0.56. Q2 results will reveal the near-term impacts of COVID-19.

The REIT noted that 60% of its tenants are essential services that remain open. Its unenclosed retail assets has performed the best with April rent collections of about 70%. 96% of its portfolio is open-air retail, which benefits first from the phased re-opening of "non-essential" retail in May and June.

The retail REIT has maintained its high cash distribution so far with a current yield of 9.2%. Its normalized FFO payout ratio is about 83%.

SmartCentres stock can appreciate more than 50% from the current $20 per share level in a normalized economy.

The Foolish takeaway

Hotel and retail REITs offer some of the best upside potential for the greater risks that investors are taking on due to near-term COVID-19 impacts. Hotel REITs offer the greatest upside potential but are also the riskiest.

Retail REITs, especially for those with grocery-store and pharmacy anchors, are less risky. Therefore, investors are best to avoid hotel REITs at this time. Instead, consider quality retail REITs, such as SmartCentres, which still offer juicy income and substantial upside.

CATEGORY

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TICKERS GLOBAL

1. TSX:HOT.UN (American Hotel Income Properties REIT LP)
2. TSX:SRU.UN (SmartCentres Real Estate Investment Trust)

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