2 REITs You Should Avoid As Bond Yields Spike

Description

Preference for bonds was high before because the low-risk, fixed-income instrument offered healthy returns. In a low-interest-rate environment, most yield-hungry investors would instead flock to real estate investment trusts (REITs). The potential returns are medium to high, although there's price volatility.

Recent developments in the bond market, however, could diminish interest in REITs once more. Increasing bond yields could impact the high-yield sector. Most of these property owners rely on external debt to buy new rental properties. But if interest rates rise, it would be difficult for REITs to achieve profitable growth, much more sustain dividend payments.

During the 2020 pandemic, the Canadian REITs experienced dramatic high and lows. For landlords in the retail, hotel, office, and even commercial sectors, COVID-19's impact was severe. Popular REITs like **RioCan** (TSX:REI.UN) and **American Hotel Income Properties** (TSX:HOT.UN) suffered tremendously. With bond yields spiking, more trouble is ahead for the former high-yield stocks.

One-third dividend reduction

RioCan is one of the largest and most prominent REITs in Canada. The $6.02 billion landlord portfolio (221 properties) consists of retail-focused and mixed-use properties scattered in prime, high-density transit-oriented areas.

In the nine months ended September 30, 2020, RioCan reported a net loss of $130.4 million versus the $625 net income in the same period last year. In early December 2020, the Board of Trustees made an inevitable decision. The REIT slashed its dividends by one-third. From 7.41%, the yield is down to 3.98%.

Edward Sonshine, RioCan's CEO, said the prudent move was necessary so the REIT can navigate through the uncertain retail landscape. The dividend cut or a conservative payout will result in an additional annual cash flow of approximately $152 million. RioCan investors lost in 2020 with theREIT's -32% total return.

While RioCan has a well-positioned portfolio, solid tenant base, and deep liquidity, the unknown length and breadth of retail closures worry Sonshine. A rebound in 2021 is a big question mark, although analysts still forecast the price to climb 16% ($18.95 to $22) in the next 12 months.

Business disruption

American Hotel Income Properties or AHIP suffered big-time in the global pandemic. Hotel accommodations and guest counts dropped significantly because of travel restrictions. The REIT had to reduce staff levels by 65%, shut down some properties' operations and stop dividend payments to preserve cash. The stock pays a high 7.8% dividend pre-corona.

The worst part for AHIP was that it was doing property-renovations and undergoing rebranding when COVID-19 struck. The refurbishing drained cash flows, while the pandemic knocked out its earning potential or rental income streams. Now, management is uncertain when business levels will improve.

Apart from the dividend suspension, AHIP investors lost 53% in 2020. The share price today is $3.85. The REIT will report its full-year 2020 results on March 11, 2021. In the nine months ended September 30, 2020, the lower demand caused total revenues and net operating income to decrease by 47.7% and 58.2% from the same period in 2019.

Rising bond yields

The Government of Canada's (GoCs) benchmark bond yields are rising in recent weeks. The five-year GOC yield is close to 1%, while the 10-year GOC rose to 1.508%. If mortgage rates rise, it will slow down real estate price growth. Investors might shift from REITs and shift to less risky bonds if yields continue to increase.

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2. TSX:REI.UN (RioCan Real Estate Investment Trust)

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