Seeking Alpha

The Top 5 REITs For 2018

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by: Sure Dividend

Summary

- REITs will continue to be popular investments for income next year, with dividend yields well above the S&P 500 average.
- Rather than chasing extreme high-yielders, focus on REITs with strong portfolios, high-quality tenants, and growth potential.
- This list is diversified across REIT industries.
- *This idea was discussed in more depth with members of my private investing community, Undervalued Aristocrats.*

By Bob Ciura

Investors typically buy Real Estate Investment Trusts, or REITs, for dividend income. There is good reason for this. Interest rates remain low, which has suppressed bond yields, and the average dividend yield in the S&P 500 Index is a paltry 2%.

High investment income is hard to come by nowadays, which makes REITs relatively attractive. Many of the 171 dividend-paying REITs we track offer high yields of 5%+. You can see all 171 REITs here.

As 2017 nears its end, it is a good time for income investors to assess dividend investing opportunities for 2018. There are many high-quality REITs that offer a blend of high dividend yields, growth potential, and strong balance sheets.

This article will discuss the top 5 REITs for 2018, in no particular order.

Dividend REIT #5: Realty Income (O)

Dividend Yield: 4.6%

Realty Income is one of the highest-quality REITs out there. Since its IPO in 1994, Realty Income has delivered compound annual returns of 16.4%. It has increased its dividend for 80 quarters in a row.

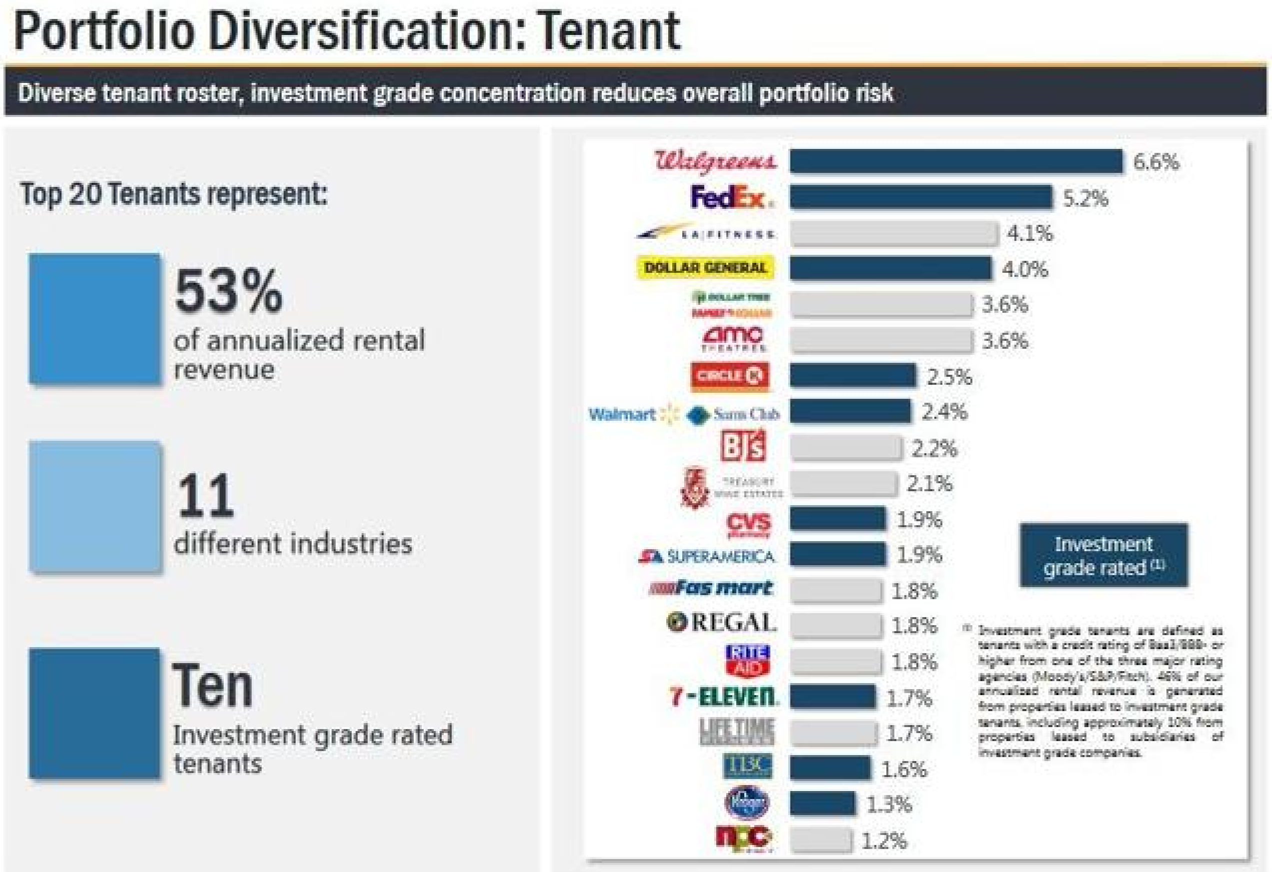
And, Realty Income has an added bonus, which is that it pays its dividend each month, rather than the more typical quarterly schedule. Realty Income has paid 568 consecutive monthly dividends.

This makes Realty Income more attractive for investors who want dividend income each month. Realty Income is one of 41 stocks we have identified, that pays dividends each month. You can see all 41 monthly dividend stocks here.

Source: Third Quarter Investor Presentation, page 45

Realty Income's portfolio is comprised mostly of retail properties, such as retail outlets, drug stores, movie theaters, and fitness gyms. This could be an area of concern, given the explosive growth of e-commerce, which threatens brick-and-mortar retail. However, Realty Income has mitigated this risk, with a strong tenant portfolio.

Realty Income utilizes triple-net leases, which is an advantageous structure that provides a steady stream of cash flow. Tenants are responsible for taxes, insurance, and maintenance. It has a diverse portfolio, consisting of more than 5,000 properties in 49 U.S. states and Puerto Rico. The tenant base includes many well-known companies with established business models.



Source: Third Quarter Investor Presentation, page 16

Realty Income's adjusted funds from operation (FFO) rose 5.1% in 2016, thanks to rising rents and occupancy. The company ended last quarter with 98.3% occupancy, and has never had occupancy below 96%. It is off to a strong start to 2017. Over the first three quarters, adjusted FFO increased 15% from the same period last year. Adjusted FFO-per-share increased 7.5% over the first nine months.

Future growth will come from increasing rents at existing properties, as well as acquisitions of new properties. Same-store rents increased 1% over the first three quarters of 2017. In addition, Realty Income expects to complete approximately $1.5 billion in acquisitions in 2017. For 2017, Realty Income expects adjusted FFO-per-share of $3.03 to $3.07, representing growth of 5.2% to 6.6% for the full year.

Realty Income has a strong balance sheet. It has a credit rating of BBB+ from Standard & Poor's, which is solidly investment-grade. Its debt-to-EBITDA ratio is 5.2, which is in-line with its peer group. It also currently has a fixed charge coverage ratio of 4.7, the highest in the company's history.

Dividend REIT #4: Kimco Realty (KIM)

Dividend Yield: 6%

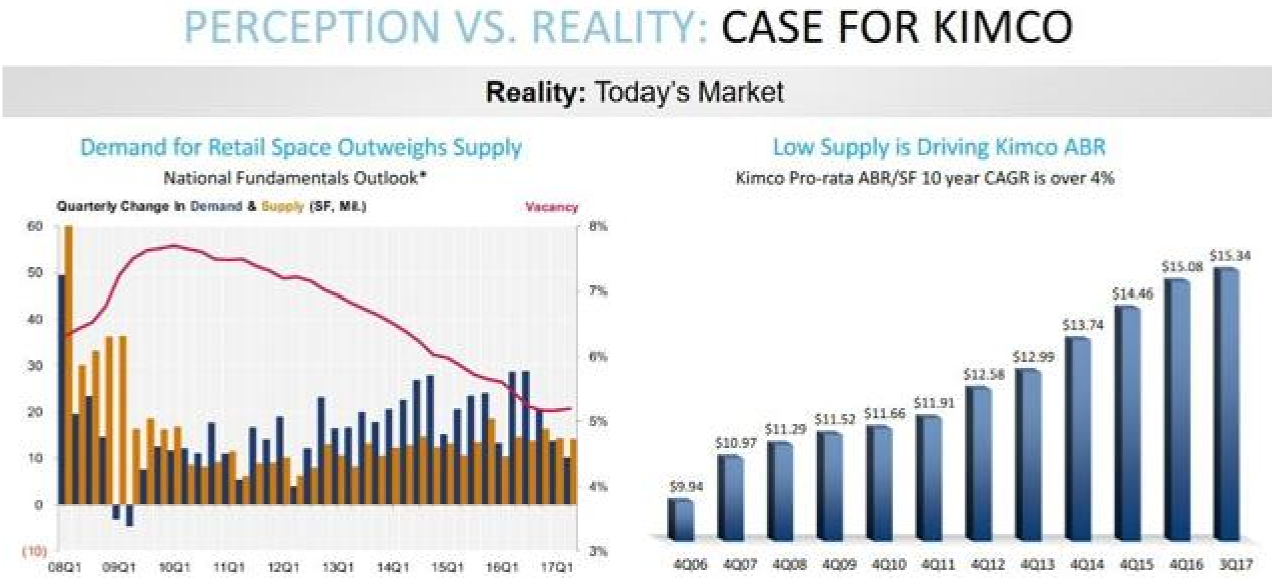
Kimco earns a place on the list, because of its high dividend yield of 6%. Its dividend yield is three times that of the average S&P 500 stock. Kimco is one of 402 dividend-paying stocks we have identified with a yield of 5% or more. You can see all 402 stocks with 5%+ yields here.

Like Realty Income, Kimco operates in retail properties, which are under pressure as consumers turn to e-commerce. Kimco owns an interest in more than 500 U.S. shopping centers. However, only a small portion of its tenant base has closed stores so far this year. New store openings have far outweighed store closures among Kimco's tenants, so far in 2017.

Source: Third Quarter Presentation, page 8

Kimco's properties are focused in high-density markets, with high household incomes. Traffic remains robust in these areas, and Kimco has a high-quality tenant portfolio. Some of its largest retail tenants are doing very well, such as **TJX** (TJX) and **The Home Depot** (HD).

Kimco's portfolio has average lease term of 10 years. Portfolio occupancy was 95.8% at the end of last quarter, up 70 basis points from the same quarter last year. The fundamentals of Kimco's market still remain healthy. For example, the company notes demand for retail space outweighs supply. As a result, over the past 10 years, Kimco's average annual base rent per square foot rose more than 4% each year.



Source: Third Quarter Presentation, page 17

This has helped Kimco's cash flow hold up well this year. Adjusted FFO-per-share increased 1% over the first three quarters of 2017. Helping to boost FFO were higher occupancy, and property acquisitions. Kimco management anticipates $300 million to $400 million of property acquisitions for 2017, which will help generate growth next year and beyond.

For 2017, management expects adjusted FFO-per-share of $1.51 to $1.52. Adjusted FFO-per-share was $1.50 in 2016, so this year will bring modest growth for Kimco. All things considered, this is a solid performance, given the turbulence in the retail industry right now.

Sustaining strong cash flow allows Kimco to continue raising its dividend. On October 25th, the company hiked its dividend by 3.7%. The new annualized dividend rate of $1.12 per share, represents a payout ratio of 74%, which is manageable.

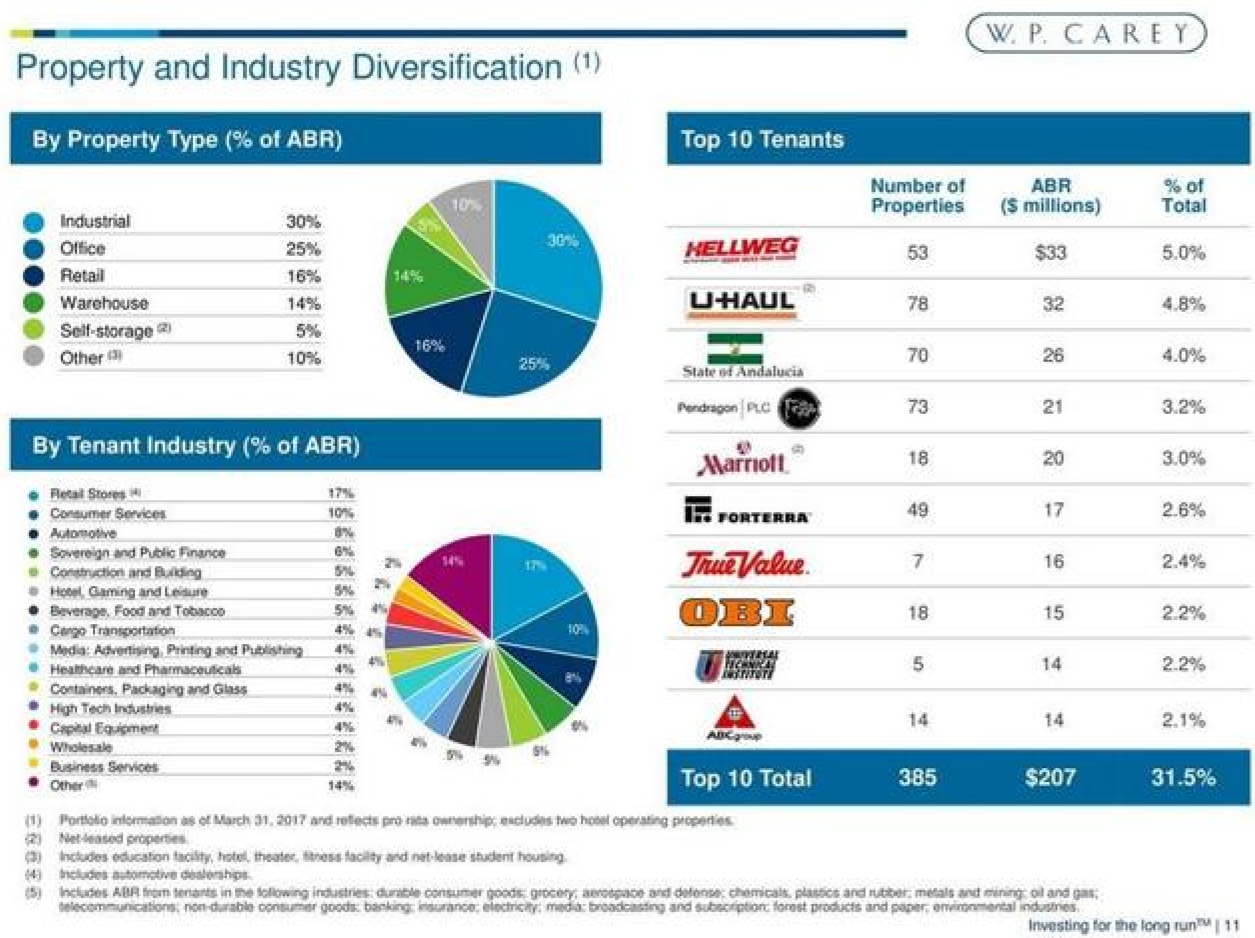
Kimco is working to improve its balance sheet. It has a net-debt-to-EBITDA near 6.0, which is high for a REIT. However, the company has an investment grade credit rating of BBB+. By 2020, Kimco expects to improve its credit rating to A-, by accelerating debt repayments.

Dividend REIT #3: W.P. Carey (WPC)

Dividend Yield: 5.7%

W.P. Carey invests in commercial real estate. At the end of last quarter, the portfolio consisted of consisted of 890 net lease properties. The average lease term of the portfolio is 9.5 years, and occupancy stands at 99.8%. Properties are located in the U.S. and Europe, with approximately two-thirds of properties in the U.S.

W.P. Carey specializes in sale-leaseback transactions, in which a tenant sells a property to an outside investment firm, which then leases it back to the tenant. W.P. Carey also generates fee income, derived from management of assets.



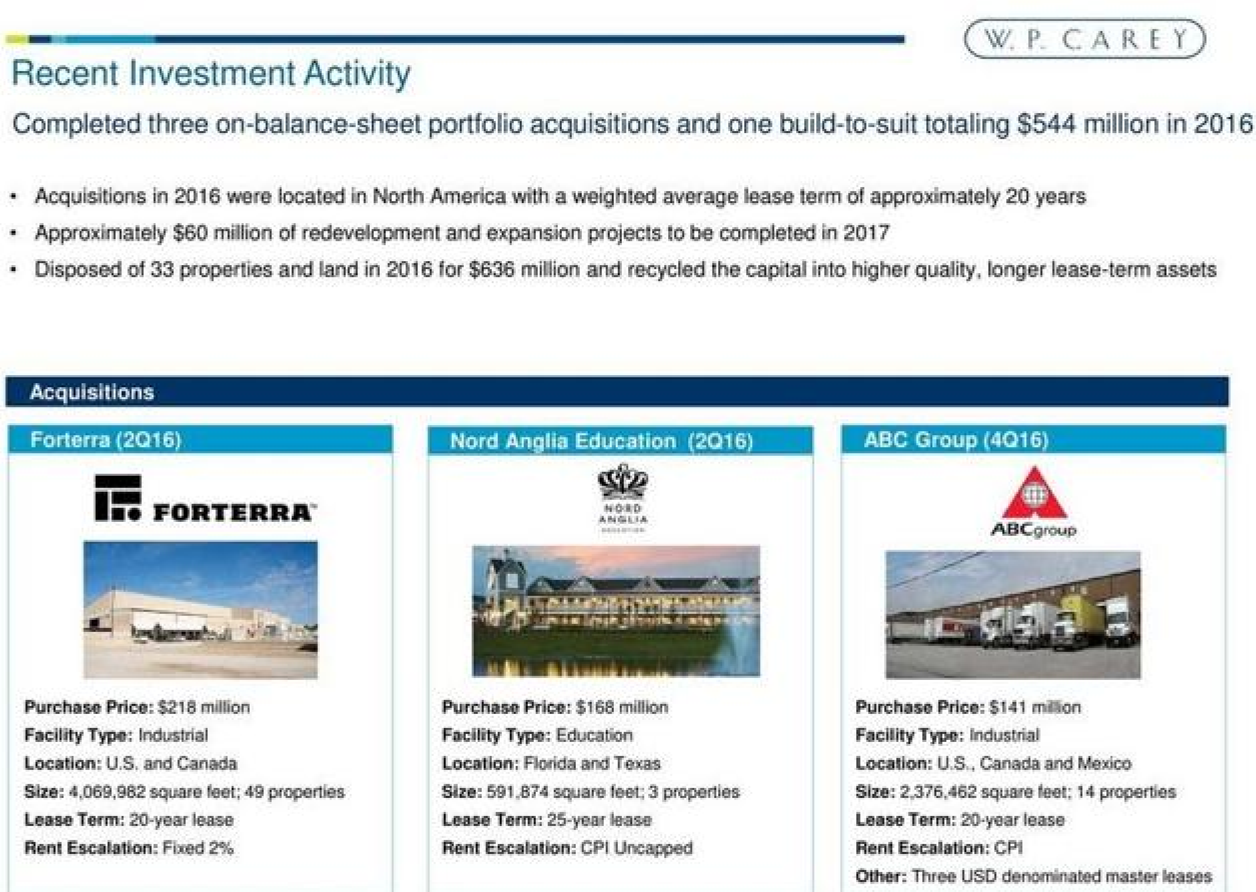
Source: 2017 Investor Presentation, page 11

Approximately 95% of annual FFO comes from owned real estate, while the other 5% is derived from investment management activities. W.P. Carey's investment management business ended the third quarter with assets under management of approximately $13.2 billion.

W.P. Carey has a strong portfolio, and also possesses an advantage. It has reduced its exposure to retail, thus shielding it from the retail downturn over the past few years. Less than 20% of W.P. Carey's investment portfolio is comprised of retail store tenants.

FFO-per-share increased 3% in 2016, to $5.12, due to 2% rent increases. The company is off to a good start to 2017, with 2.6% adjusted FFO-per-share growth through the first three quarters. Going forward, growth will be fueled by continued rate increases, as approximately 99% of its leases have built-in rent increases. In addition, growth will come from new property acquisitions.

2016 was a year of particularly aggressive acquisitions for W.P. Carey. It placed over $500 million in acquisitions in North America, which will help generate growth in 2017 and beyond.



Source: 2017 Investor Presentation, page 16

For 2017, W.P. Carey management expects adjusted FFO-per-share of $5.25 to $5.35. At the midpoint of guidance, the company would grow FFO by 3.5% this year. This is not an overly exciting growth rate, but it should be enough to continue increasing the dividend. W.P. Carey has a habit of raising its dividend by a small amount each quarter. On September 20th, the company raised the dividend to $1.005 per share, a 2% increase from the same quarterly dividend last year.

W.P. Carey pays an annualized dividend of $4.02 per share. Using 2017 guidance, the company will likely have a payout ratio of 76%. This indicates the current dividend is sustainable. W.P. Carey also has solid credit metrics, with a fixed charge coverage ratio of 4.4, and an investment-grade credit rating of BBB.

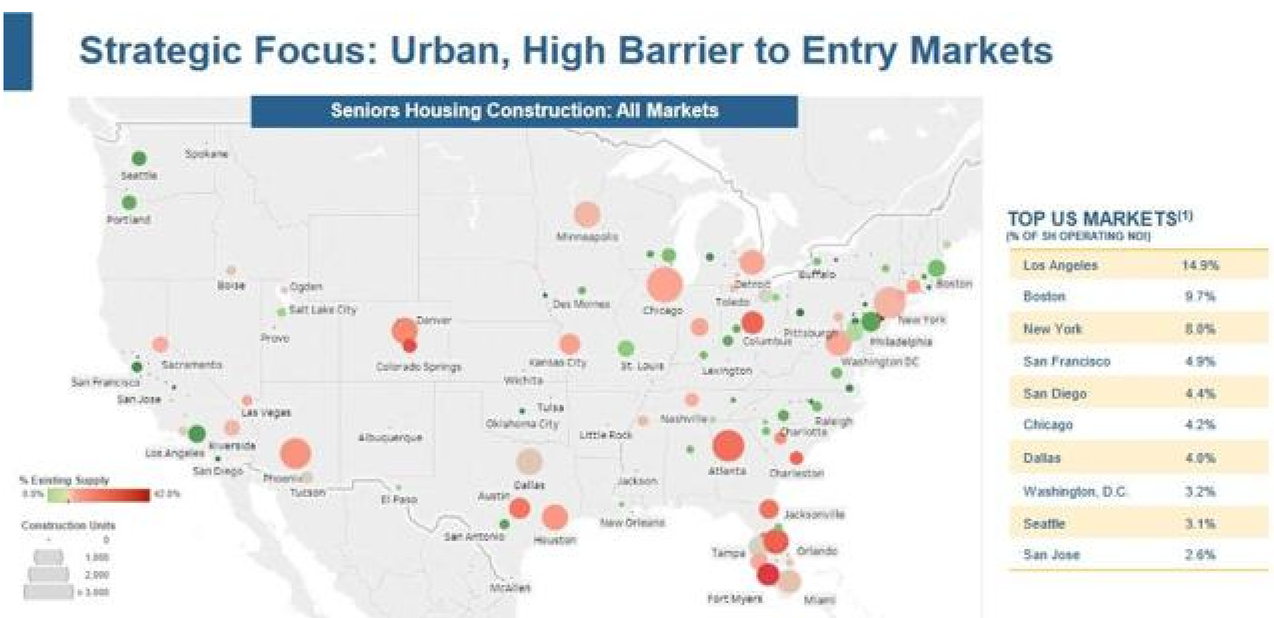
Dividend REIT #2: Welltower (HCN)

Dividend Yield: 5.2%

Welltower a healthcare REIT. It invests in properties such as senior housing, post-acute communities, and outpatient medical properties. It has a diversified portfolio, with 1,334 properties spread across the U.S., Canada, and the U.K.

The company has restructured its portfolio in recent years. In 2010, 69% of Welltower's operating profit was derived from private-pay sources. At that time, it had a heavy presence in long-term/post-acute care facilities. Today, it has more than halved its exposure to long-term/post-acute facilities, and now generates 93% of profit from private-pay sources.

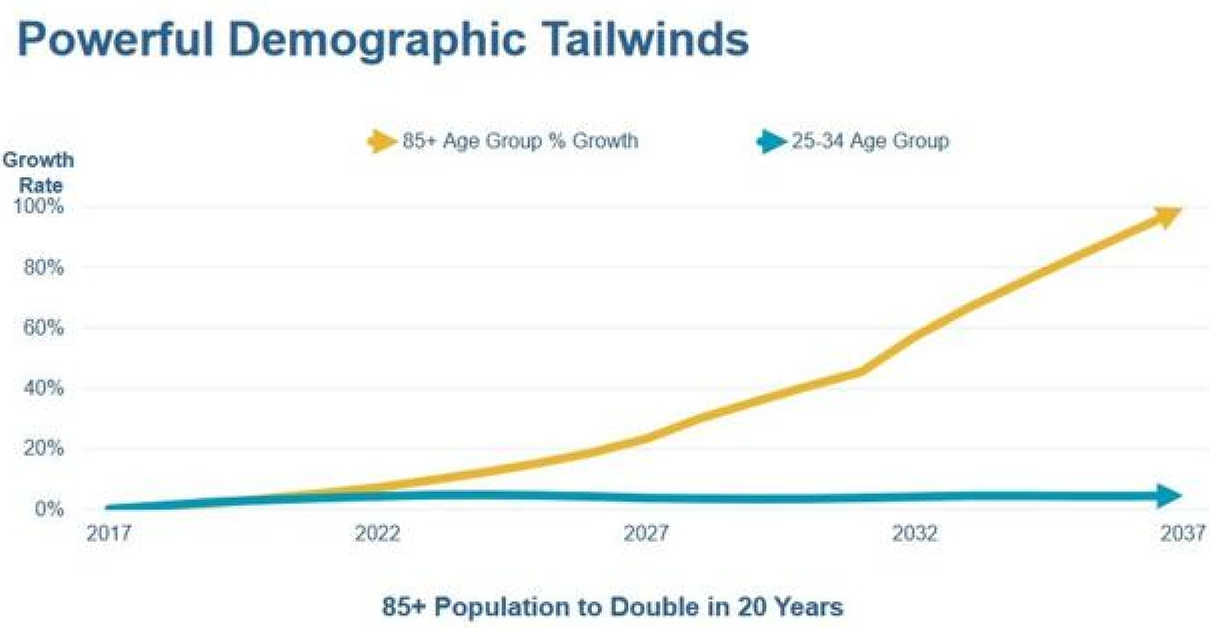
The company decided to expand its presence in senior housing, which now accounts for 70% of operating income. Welltower's strategy is to focus on property investments in densely-populated urban areas, with high barriers to entry.



Source: November 2017 Investor Presentation, page 15

Welltower's portfolio restructuring has worked well for the company. In 2016, FFO increased 4%, due to higher rents on owned properties, as well as new property additions. It completed $3.0 billion of gross property investments in 2016.

The investment case for healthcare REITs like Welltower is simple. Life expectancies are rising in developed markets like the U.S. and U.K. Welltower expects the 85+ population will double over the next 20 years. Aging populations will result in high demand for healthcare properties. These demographic changes should give Welltower a sustained growth tailwind for many years.



Source: November 2017 Investor Presentation, page 6

In addition to aging demographics, healthcare spending is rising as a percentage of GDP. According to Welltower, per-capita spending in the 85+ age group is expected to exceed $34,000 per year. This is more than double the level of per-capita spending for the 65-84 age group.

The aging population trend is even more pronounced in the U.K., where Welltower has 105 facilities. Over the next 20 years, the company expects the 75+ population in the U.K. will grow at six times the rate of the general population.

Welltower has a secure dividend payout. The company currently pays an annualized dividend of $3.48 per share. This represents a payout ratio of 82% of projected 2017 FFO. Welltower has increased its dividend for over 10 years in a row, which makes it a Dividend Achiever. You can see all 264 Dividend Achievers here.

Importantly, the balance sheet is in good condition. Welltower has a credit rating of BBB+, and an average debt maturity exceeding 7 years. It also has a fixed charge coverage ratio of 3.7, and a manageable debt-to-EBITDA ratio of 5.2.

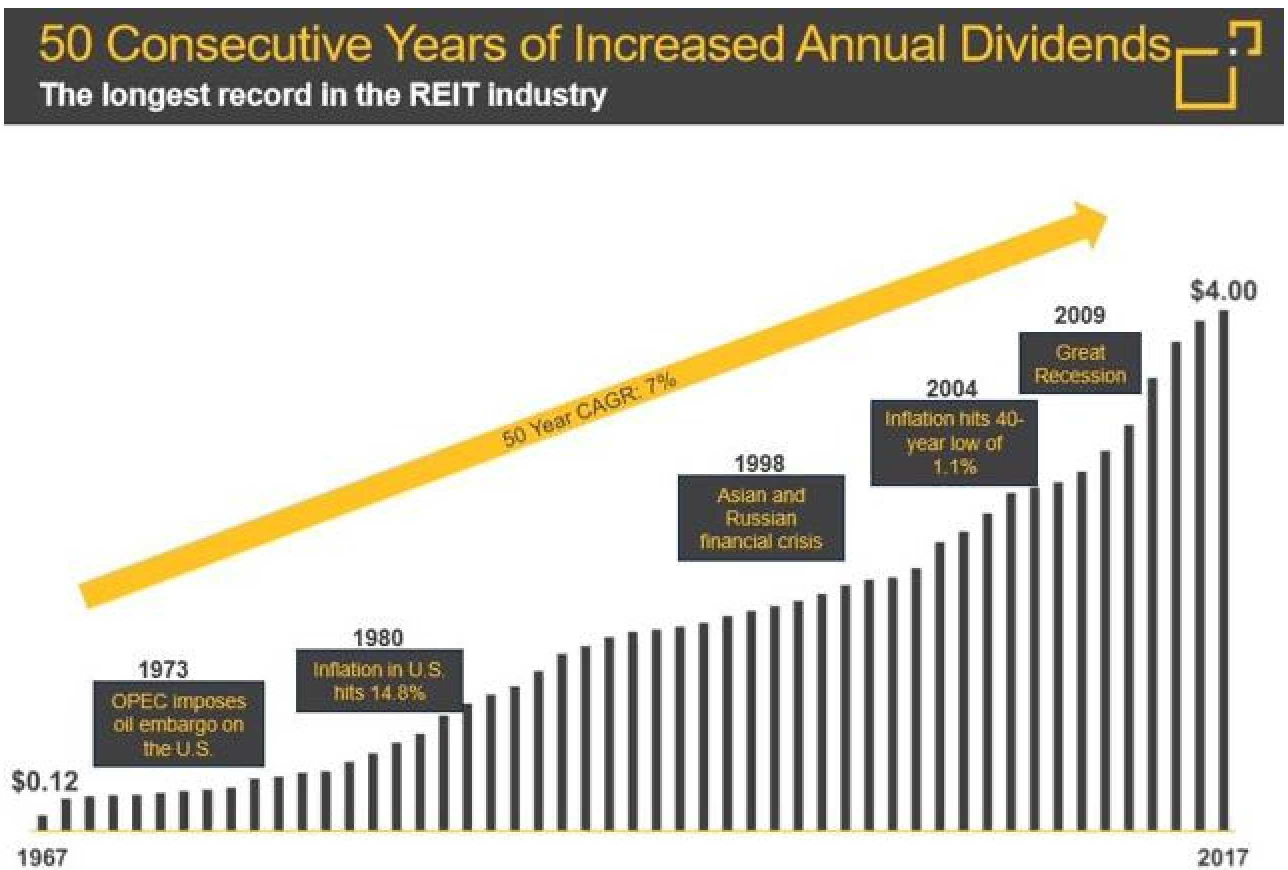
Dividend REIT #1: Federal Realty Investment Trust (FRT)

Dividend Yield: 3%

Federal Realty primarily owns shopping centers. It also operates in redevelopment of multi-purpose properties including retail, apartments, and condominiums.

At first glance, Federal Realty doesn't seem to be an attractive dividend stock. It has a 3% dividend yield, which is fairly low for REIT standards. But there is much more to Federal Realty than meets the eye. The company has a lower dividend yield than many other REITs, but it earns a place on the list because of its long history of dividend growth.

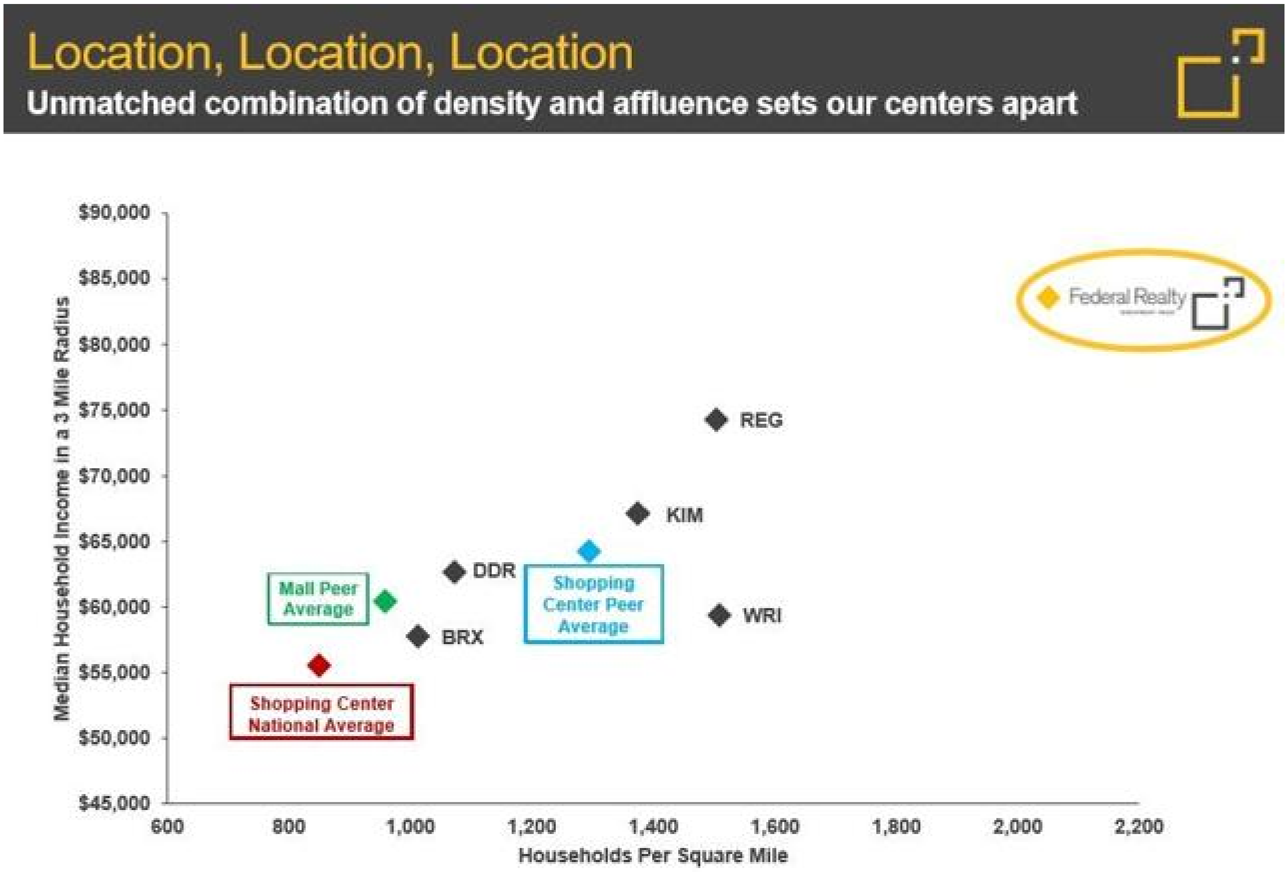
Federal Realty has increased its dividend for 50 years in a row. It is a member of the Dividend Aristocrats, which have increased their dividends for 25+ consecutive years. You can see all 51 Dividend Aristocrats here.



Source: Third Quarter Presentation, page 49

This is a unique distinction, as Federal Realty is the only REIT on the Dividend Aristocrats list. Not only is it a Dividend Aristocrat, it is a Dividend King as well. Including Federal Realty, there are just 22 Dividend Kings. You can see all 22 Dividend Kings here.

Over the course of those 50 years, Federal Realty increased its dividend by 7% each year, compounded annually. Federal Realty's long dividend growth streak is due to its operational strategy. It focuses on densely-populated, affluent communities, with high demand for commercial and residential real estate.



Source: Third Quarter Presentation, page 3

These qualities set it apart from the competition. According to the company, its cash rents are 60% above the industry average. Its strategy has led to strong growth rates in recent years. In 2016, Federal Realty grew its FFO by 12%, to a record of $5.65 per share. Over the first three quarters of 2017, FFO-per-share rose by 5.7%. Occupancy was 94.9% at the end of last quarter, up 60 basis points from the same quarter last year.

One potential risk factor is that Federal Realty has a fairly high amount of debt on its balance sheet, with a debt-to-EBIDTA ratio of 5.8 as of last quarter. However, the company expects to reduce its leverage ratio to 5.2 by the end of 2018.

And, this debt has a relatively low burden on the company's financial position. Federal Realty's debt has an average interest rate of 3.94%. And, 99% of debt is fixed-rate, which means the company is not at high risk of a sudden jump in interest expense if rates rise, as variable debt would. Federal Realty has a credit rating of 'A-', which is high for a REIT.

Final Thoughts

REITs are popular investments for dividend income, and good reason. That said, in the search for strong REITs, investors should resist the urge to chase yield. There are many REITs with sky-high yields, but questionable fundamentals.

Instead, investors should favor REITs that offer a blend of dividend yield, growth, and balance sheet strength. The 5 REITs in this article have a mix of these qualities, which makes them attractive dividend stocks for 2018 and beyond.

Federal Realty is the only REIT on the list of Dividend Aristocrats. Find out if its valuation makes it a confirmed buy with our service Undervalued Aristocrats, which provides actionable buy and sell recommendations on some of the most undervalued dividend growth stocks around. Click here to learn more*.*

Disclosure: I am/we are long HCN.

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