Seeking Alpha^α

It's Now Time To Buy The #1 REIT In The World

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by: Brad Thomas

Summary

- FRT was not fazed by the Toys R Us news last week, and it appears that this could be a very good time to hit the Buy button.
- The strength of FRT's best-in-class capital structure positions the company to continue to significantly differentiate as the company moves forward in a challenging retail and capital market landscape.
- I am taking advantage of the pullback and increasing exposure in FRT.
- *This idea was discussed in more depth with members of my private investing community, Intelligent REIT Investor.*

Last week I wrote a Forbes article that generated over 700,000 page views, the most clicks I have ever generated from one article. I was surprised with the traffic that the article generated, but in hindsight, the timing (of the article) and title (to the article) were the obvious reasons that it went viral: *Farewell Toys R Us, We Will Miss You. I explained:*

> "I don't think there are enough viable candidates to take these emptied spaces (again, if the stores do close). If you have the money to divide up the space and bring in a handful of smaller tenants, that's great. But likely many landlords hadn't baked this scenario into their 2018 capital allocations."

It's sad that Toys R Us is closing all its stores, and "I think we're going to see a lot of dark space on the real estate market, and for a long time, and my kids are really going to miss romping through the halls of the only 'pure play' big box toy store in my hometown."

In a recent CNBC article, Lauren Thomas explains:

> "The retail real estate industry has had its share of departures by key tenants in the past, including Circuit City, Sports Authority and RadioShack. Toys R Us' moves are viewed as further dragging down the reputation of U.S. strip centers anchored by bigger boxes…
>
> REITs including Simon (13 small-format locations at its outlets), Kimco (24 stores), Brixmor (12 stores), Weingarten (four stores) and DDR (20 stores) own a handful of shops, while the remainder is owned directly by the toy retailer, securities filings show.
>
> Urban Edge Properties, a spinoff from Vornado, which played a role in acquiring Toys R Us in 2015, has a larger percentage of exposure to the retailer with nine locations in its portfolio of only 90 centers."

As viewed below, DDR (NYSE:DDR) and Urban Edge Properties (NYSE:UE) were hit the hardest when the Toys R Us news was made public:

However, **Federal Realty** (FRT) was not dazed whatsoever by the Toys news, the Bethesda-based shopping center REIT has been one of the best capital allocators in the entire REIT sector.

Last week FRT scored well in my annual March Madness series; I explained:

> "FRT is what I call (or actually what Dicky V calls) a 'high riser' (good leaper) and this Dividend Aristocrat has the very best dividend record in the entire REIT sector. Pound for pound, FRT is one of the best REITs around."

In an article, over a year ago, I wrote, "Is It Time To Buy The #1 REIT In The World?", and I concluded the article be suggesting:

> "I consider the valuation to be on the upper end of sound value. In other words, I don't view the pricing as a "nose bleed" anymore, but prefer to wait for a better entry price."

FRT is now trading at ~$118 per share, well below $140 when I explained that I would "wait for a better entry price". FRT was not fazed by the Toys R Us news last week, and it appears that this could be a very good time to hit the Buy button. Let's take a closer look...

Photo Credit

The Oldest REIT

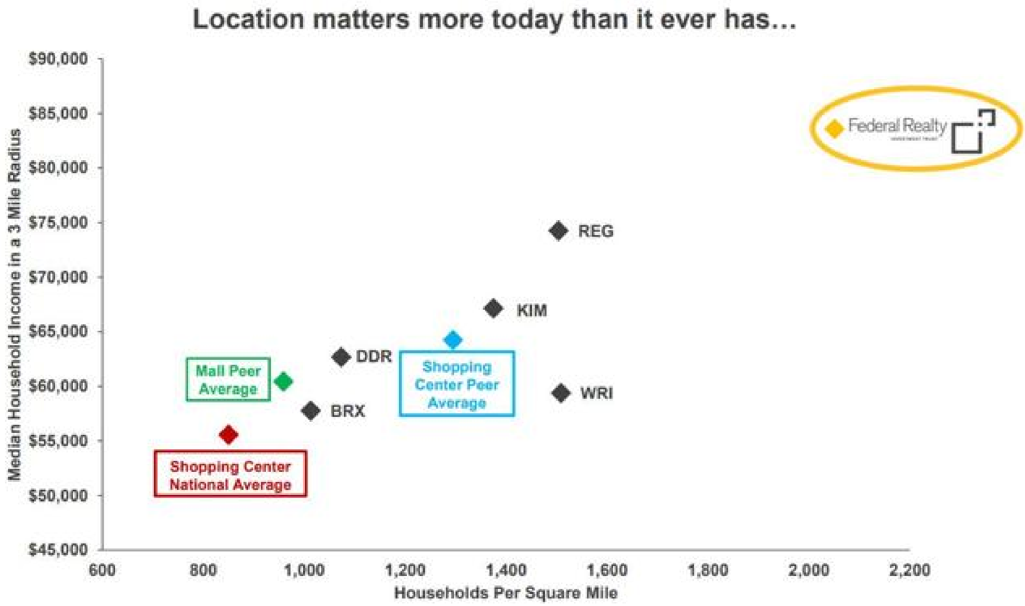
Federal Realty is a recognized leader in the ownership, operation and redevelopment of high-quality retail based properties located primarily in major coastal markets from Washington D.C. to Boston as well as San Francisco and Los Angeles.

Founded in 1962, FRT's mission is to deliver long-term, sustainable growth through investing in densely populated, affluent communities where retail demand exceeds supply. FRT's expertise includes creating urban, mixed-use neighborhoods like Santana Row in San Jose, California, Pike & Rose in North Bethesda, Maryland, and Assembly Row in Somerville, Massachusetts.

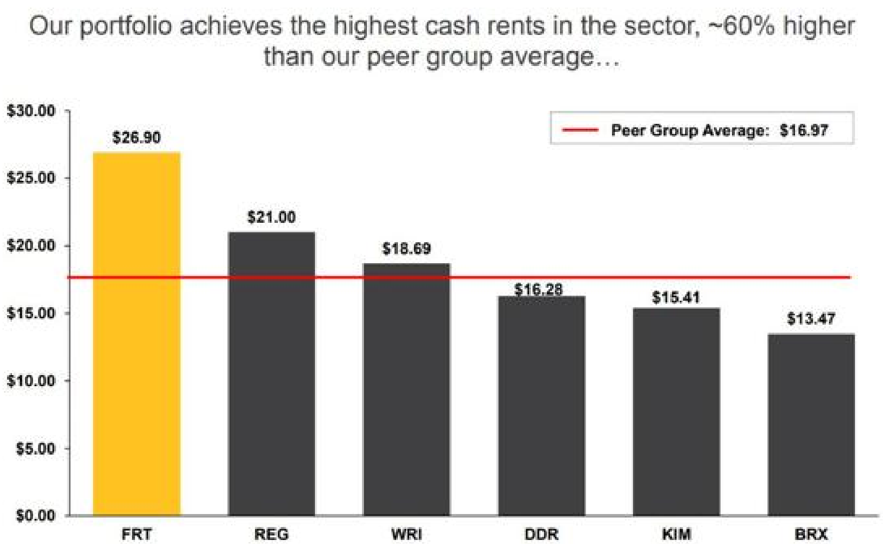
These unique and vibrant environments that combine shopping, dining, living and working provide a destination experience valued by their respective communities. FRT's 96 properties include over 2,800 tenants in approximately 22 million square feet and over 1,800 residential units.

Although FRT does enjoy a diverse revenue stream, the company has not "cracked the secret code" based on size alone. By favoring quality over quantity, FRT has the greatest concentration (77.1%) of assets in the nation's top 20 markets, which comprise 37% of US retail expenditures.

There's no question that FRT's demographics are unequaled with incomes that exceed the peer group by 32% and the national average by 50%. FRT has the highest concentration of "SuperZips" (zip codes representing the 95th percentile and above in income and education). Clearly, this unmatched combination of density and affluence sets FRT centers apart from the competition.



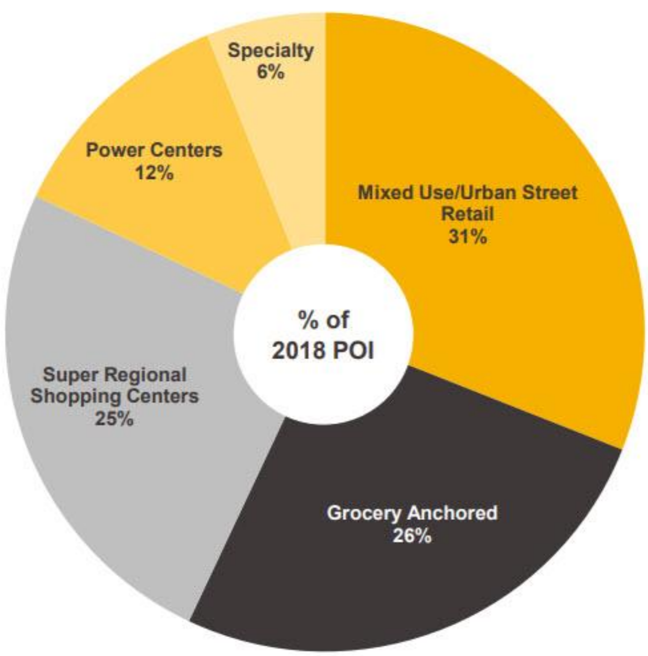
Density is directly correlated to Federal's durability metrics. The company's premier operating portfolio has about 50% greater household density than the peer group average and 124% greater than the national average. As you can view below, FRT's portfolio achieves the highest cash rents in the sector, ~60% higher than the peer group average.



FRT has a highly diversified portfolio with no one tenant that represents more than 3% of ABR and no single category is greater than 9%. The company owns flexible real estate purposefully positioned to be the real estate of choice for the widest selection of tenants. Notably, Toys R Us in not in the Top 25 list:

Rank	Tenant Name	Annualized Base Rent	Percentage of Total Annualized Base Rent (3)	Tenant GLA	Percentage of Total GLA (3)	Number of Stores Leased
1	Ahold USA, Inc.	$ 17,353,000	3.06%	1,036,000	4.58%	17
2	TJX Companies, The	$ 14,228,000	2.51%	816,000	3.61%	25
3	Bed, Bath & Beyond, Inc.	$ 13,265,000	2.34%	736,000	3.25%	20
4	Gap, Inc., The	$ 12,808,000	2.26%	354,000	1.56%	26
5	Splunk, Inc.	$ 10,276,000	1.81%	235,000	1.04%	1
6	L.A. Fitness International LLC	$ 8,662,000	1.53%	389,000	1.72%	9
7	CVS Corporation	$ 7,994,000	1.41%	194,000	0.86%	16
8	Ascena Retail Group, Inc. (Dress Barn, Loft, Lou & Grey, Ann Taylor, Catherine's, Justice, Lane Bryant)	$ 6,656,000	1.17%	218,000	0.96%	36
9	AMC Entertainment Inc.	$ 6,572,000	1.16%	317,000	1.40%	6
10	DSW, Inc.	$ 6,390,000	1.13%	229,000	1.01%	11
11	Dick's Sporting Goods, Inc.	$ 6,185,000	1.09%	257,000	1.14%	6
12	Home Depot, Inc.	$ 5,667,000	1.00%	438,000	1.94%	5
13	Barnes & Noble, Inc.	$ 5,417,000	0.96%	244,000	1.08%	9
14	Best Buy Stores, L.P.	$ 5,410,000	0.95%	186,000	0.82%	4
15	Michaels Stores, Inc.	$ 5,331,000	0.94%	286,000	1.26%	12
16	Bank of America, N.A.	$ 5,043,000	0.89%	97,000	0.43%	20
17	Nordstrom, Inc.	$ 4,913,000	0.87%	195,000	0.86%	5
18	Whole Foods Market, Inc.	$ 4,425,000	0.78%	167,000	0.74%	4
19	Kroger Co., The	$ 4,194,000	0.74%	356,000	1.57%	8
20	Ross Stores, Inc.	$ 4,193,000	0.74%	238,000	1.05%	8
21	Saks & Company	$ 4,090,000	0.72%	100,000	0.44%	3
22	Staples, Inc.	$ 3,884,000	0.69%	171,000	0.76%	9
23	AB Acquisition LLC (Acme, Safeway)	$ 3,790,000	0.67%	404,000	1.79%	7
24	Wells Fargo Bank, N.A.	$ 3,750,000	0.66%	48,000	0.21%	14
25	Starbucks Corporation	$ 3,712,000	0.66%	64,000	0.28%	39
	Totals - Top 25 Tenants	$ 174,208,000	30.74%	7,775,000	34.36%	320
	Total:	$ 566,672,000 (1)		22,630,000 (2)		2,856

Also, as you can see below, FRT is not solely focused on power centers (12%), super-regional centers (25%), mixed use (31%) or grocery-anchored (26%). The company maintains tactical exposure within its retail portfolio, focusing on underlying demographics and high-quality tenants.



The Fortress Balance Sheet

FRT is one of just a handful of REITs with an A-rated balance sheet. In October, Fitch Ratings affirmed FRT's ratings, including its A- long-term issuer default rating with a stable. The ratings and outlook reflect FRT's "consistent and steady" cash flow growth generated from its community shopping centers, as well as the prudent management of its balance sheet and its creative redevelopment and mixed-use development, Fitch said in a note.

Credit Ratings

Moody's	S&P	Fitch
A3	**A-**	**A-**
Stable	Stable	Stable

Fitch also affirmed the company's unsecured revolving credit facility, senior unsecured term loan and senior unsecured note ratings at A-, and its redeemable preferred share rating at BBB.

Capital Structure Metrics

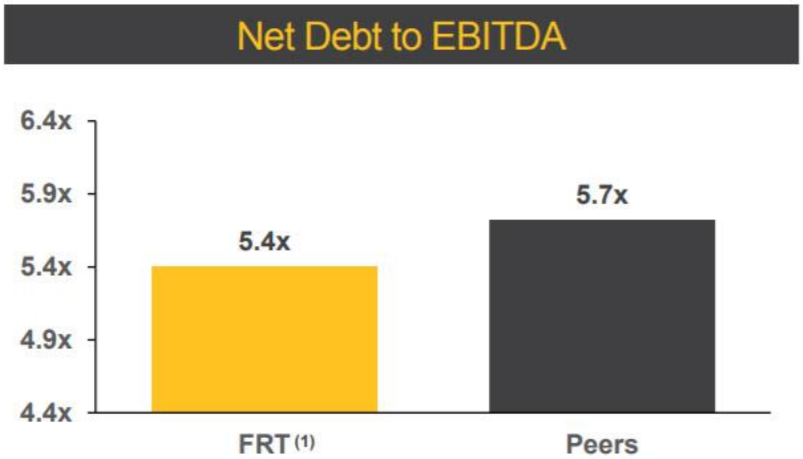
Debt to Market Cap	25%
Net Debt to EBITDA	5.86x
Fixed Charge Coverage	3.9x
Fixed Rate Debt	99%
Weighted Average Interest Rate	3.82%
Weighted Average Maturity	11 years
FFO Payout Ratio	68%

FRT continues to be opportunistic, and during Q4-17 the company further de-risked the best-in-class balance sheet.

First, with a $175 million reopening of benchmark 10-year notes due 2027. This decision came in advance of the expected mid-December Fed rate hike and the anticipated passage of tax reform, where there is a lock-in, a 3.32% rate at a record 10-year spread for Federal, of 97 basis points. FRT used the proceeds to redeem its 5.9% notes due in early 2020.

Second, FRT was able to tap the ATM program during Q4-17 to efficiently issue $66 million of common equity at a weighted average price of $132 per share. This opportunistic activity has set off FRT's A- rated balance sheet to be extremely well positioned in 2018.

FRT has prefunded its capital plan over the course of 2016 and 2017 at an extremely attractive cost, and effectively had no need to raise incremental capital in 2018.

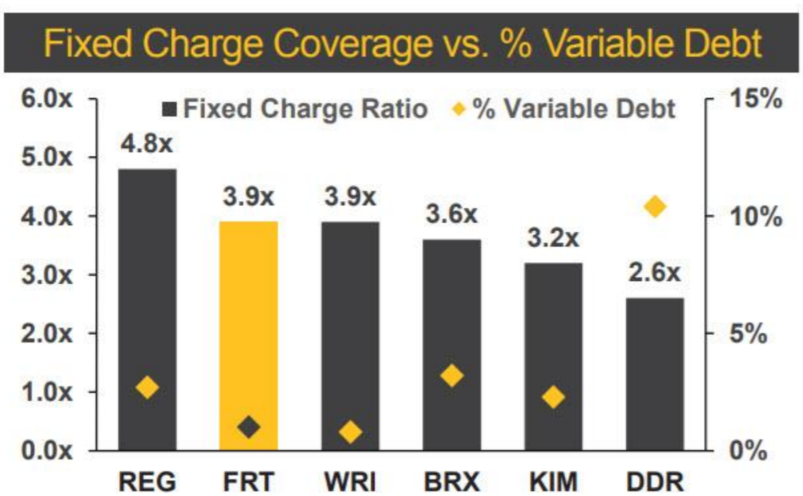


FRT's net debt-to-EBITDA ratio stands at a modestly elevated 5.8x and is poised to decrease into the 5 to 5.5x range over the course of 2018 as executed leases commence and as the company reduces leverage through condo sales, 75% of which are under contract.

Alloy Condo Sales at Assembly Row

	Actual	Expected[1]
Proceeds	$88 million *$850 psf*	$65 million *$625 psf*
Pre-Tax Gain	$12 million	$0
After-Tax Gain	$12 million	$0
Time	15 months	29 months

FRT's fixed-charge coverage ratio had a 4x run rate for 2017, and the company expects that 4x coverage to remain for 2018. The weighted average debt maturity has been extended to a sector-leading 11-plus years. And FRT reduced its weighted average interest rate to 3.8%, with 99% of that balance sheet fixed.



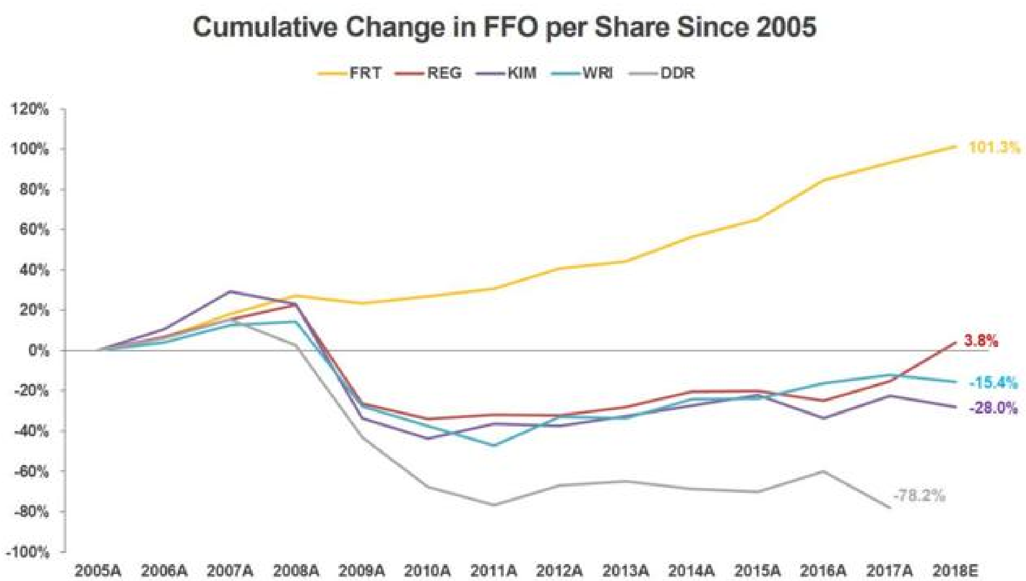
Despite the disruption in the equity markets and the rising interest rates, the strength of FRT's best-in-class capital structure positions the company to continue to significantly differentiate as it moves forward in a challenging retail and capital market landscape.

The Latest Earnings Results

FRT generated FFO per share of $1.47 and $5.91 for Q4-17 and full year 2017, respectively, slightly ahead of expectations on both measures and ahead of consensus for the quarter.

The numbers in Q4-17 were driven by higher NOI, primarily due to higher percentage rent and less impact from tailing tenants, offset by higher G&A due to year-end compensation adjustments and costs associated with planned accounting and IT platform upgrade.

Considering that FRT reported FFO per share of $5.91, or even $5.74 when including the opportunistic cost of retiring the 5.9% notes due in 2020, it remains the only publicly traded shopping center company to grow FFO (by NAREIT's definition) each and every year since the beginning of this retail cycle in 2010, **the only one**.



The consistency in which FRT grows bottom line earnings truly sets the company apart and as FRT's CEO pointed out on the recent earnings call:

> "(It's) Hard for me to believe that history and track record don't matter in predicting the future."

FRT's leasing in Q4-17 was again strong at 15% rollover growth and remarkably consistent all year. On over 1.6 million square feet in 2017 rollover growth was 11% in Q1, 13% in Q2, 14% in Q3, and 15% in Q4. Also, keep in mind, tenant improvement dollars stayed relatively stable and under control.

Deals included TJX's HomeGoods concept at the Brick Plaza redevelopment, Marshalls' renewal at newly redeveloped Northeast shopping center and a new urban-format Target (NYSE:TGT) deal at Sam's Park & Shop in D.C. As the CEO pointed out:

> "Deals at redeveloped or remerchandised shopping centers clearly more than paved themselves in densely populated areas, and here again, our cost of capital advantage makes the underlying value creation even higher."

Occupancy gains in Q4-17 continued to trend favorably, and the overall portfolio lease rate was 95.3% (higher than both the 94.7% lease rate at September 30 and 94.4% at Q4-16). The gains over the course of 2017 can largely be attributed to the significant progress made on the anchor leasing front where the anchor lease percentage is back to a more normalized level of 98%.

With respect to 2018 FFO guidance, FRT provides an estimate range of $6.08 to $6.24 per share, affirming the preliminary guidance midpoint of $6.16. This 4%+ FFO per share growth positions the company at the upper end of the peer group.

This guidance assumes the following:

(1) Capital spend on development and redevelopment of $250 million to $300 million for the year, which effectively has been prefunded; closing on the sale of up to $150 million of condos at Assembly and Pike & Rose, the gains associated here will not impact FFO.

(2) FRT forecasts to refinance $275 million term loan in Q4-18 and will continue value-creating, proactive re-leasing activity in 2018, with leases already executed such as Anthropologie replacing Barnes & Noble (NYSE:BKS) at Bethesda Row; Target replacing Petco (Pending:PETC) at Sam's Park & Shop in D.C.; and Muji on Third Street Promenade replacing Abercrombie (NYSE:ANF), along with a few others.

This activity will weigh on results in 2018, creating $0.03 to $0.04 dilution on FFO, but it will also drive growth and value creation of $50 million to $60 million once stabilized. Here's a snapshot of my FFO per share FORECASTER (using FAST Graph data):

REIT	2016 FFO/Share	2017 FFO/Share	2018 FFO/Share	2019 FFO/Share	16-17 FFO/Share Growth	17-18 FFO/Share Growth	18-19 FFO/Share Growth	Average
DDR	1.28	1.18	0.99	0.99	-7.8%	-16.1%	0.0%	-8.0%
WPG	1.78	1.63	1.52	1.50	-8.4%	-6.8%	-1.3%	-5.5%
WSR	1.34	1.25	1.20	1.23	-6.7%	-4.0%	2.5%	-2.7%
KRG	2.06	2.04	2.01	2.07	-1.0%	-1.5%	3.0%	0.2%
KIM	1.50	1.52	1.44	1.51	1.3%	-5.3%	4.9%	0.3%
BRX	2.07	2.09	2.01	2.10	1.0%	-3.8%	4.9%	0.7%
AKR	1.44	1.51	1.39	1.50	4.9%	-8.0%	7.9%	1.6%
WRI	2.34	2.43	2.40	2.50	3.9%	-1.2%	4.1%	2.2%
UBA	1.26	1.15	1.29	1.40	-8.7%	12.2%	8.5%	4.0%
UE	1.27	1.34	1.34	1.45	5.5%	0.0%	8.2%	4.6%
ROIC	1.08	1.14	1.19	1.24	5.6%	4.4%	4.2%	4.7%
FRT	**5.65**	**5.91**	**6.18**	**6.57**	**4.6%**	**4.6%**	**6.3%**	**5.2%**
REG	3.29	3.69	3.80	3.98	12.2%	3.0%	4.7%	6.6%

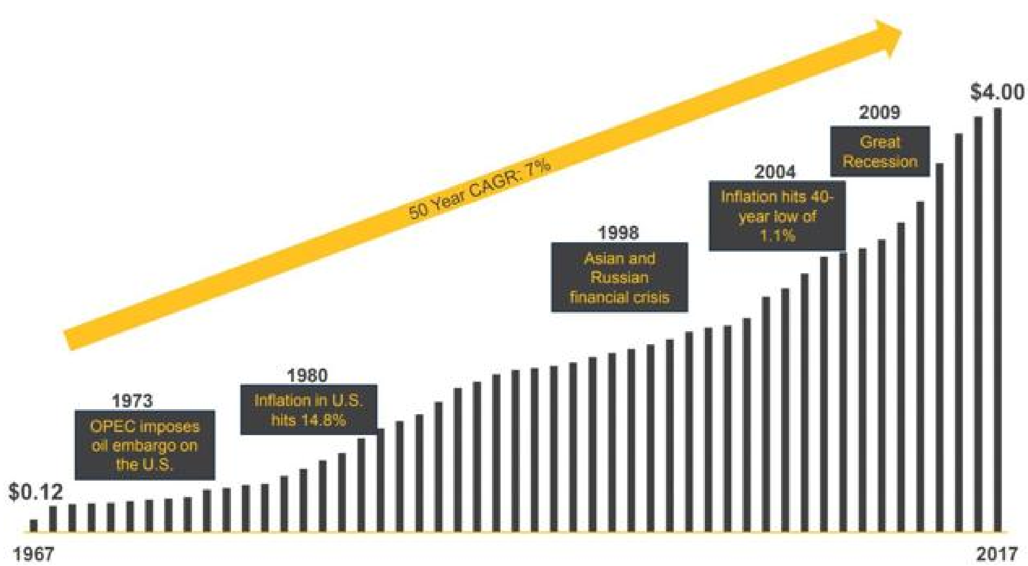
www.reitbracketology.com

The Dividend Dynamo

On the recent earning call, FRT's CEO said:

> "The retail real estate-based companies, who will not only survive but thrive in the years to come, were those who have positioned themselves to this point for their assets to be the real estate of choice for the widest possible selection of tenants, not a narrow, limiting business plan but a broader, wider funnel in select markets.
>
> It seems to us that in order to best position ourselves for that outcome, there are three important considerations.
>
> First, **location matters more today than it ever has**, it seems obvious to us.
>
> Two, **assets need to be in flexible formats** that can be improved upon through profitable reinvestment. And that's a big one because on many retail-based properties in the United States, the new revenue numbers that will be generated after redevelopment just aren't enough to justify that investment.
>
> And third, **truly enhancing the experience**. The placemaking, the tenant lineup and the customer services at those places is both critical and harder than it sounds. Creating that environment is a lot more than just going down a cool things to do checklist.
>
> So that's it. Everything that this company is doing today, even if it moderates growth in the short term, is meant to be able to act on this necessary long-term philosophy.
>
> The fact that we're doing it while still growing current earnings and cash flow at the same time, as we have throughout this entire cycle starting in 2010, is a true testament to the quality of our real estate and our team's vision and the execution competencies of that vision."

There aren't many shopping center REITs that can boast about such consistent growth, especially the larger cap names. However, FRT has a long history of outperformance as evidenced by the snapshot below - FRT has paid and increased annual dividends for 50 consecutive years in a row - **the longest record in the REIT industry**.



What makes FRT unique, of course, is the company's strong sources of income, with a tactical allocation to food (grocery), shelter, and clothing. Let's look at the dividend growth forecasted by FRT and the peers:

REIT	2016 DIV/Share	2017 DIV/Share	2018 DIV/Share	2019 DIV/Share	16-17 DIV/Share Growth	17-18 DIV/Share Growth	18-19 DIV/Share Growth	Average
WPG	1.00	1.00	1.00	1.00	0.0%	0.0%	0.0%	0.0%
DDR	0.76	0.76	0.76	0.76	0.0%	0.0%	0.0%	0.0%
WSR	1.14	1.14	1.14	1.14	0.0%	0.0%	0.0%	0.0%
UBA	1.03	1.06	1.08	1.09	2.9%	1.9%	1.1%	2.0%
FRT	**3.84**	**3.96**	**4.08**	**4.24**	**3.1%**	**3.0%**	**3.9%**	**3.4%**
KIM	1.03	1.09	1.12	1.15	5.8%	2.8%	2.7%	3.8%
ROIC	0.73	0.76	0.78	0.82	4.1%	2.6%	5.1%	4.0%
AKR	1.01	1.05	1.09	1.14	4.0%	3.8%	4.6%	4.1%
WRI	1.46	1.54	1.60	1.65	5.5%	3.9%	3.1%	4.2%
KRG	1.17	1.23	1.27	1.33	5.1%	3.3%	4.7%	4.4%
UE	0.82	0.88	0.90	0.94	7.3%	2.3%	4.4%	4.7%
REG	2.00	2.10	2.22	2.31	5.0%	5.7%	4.1%	4.9%
BRX	0.99	1.05	1.11	1.15	6.1%	5.7%	4.5%	5.4%

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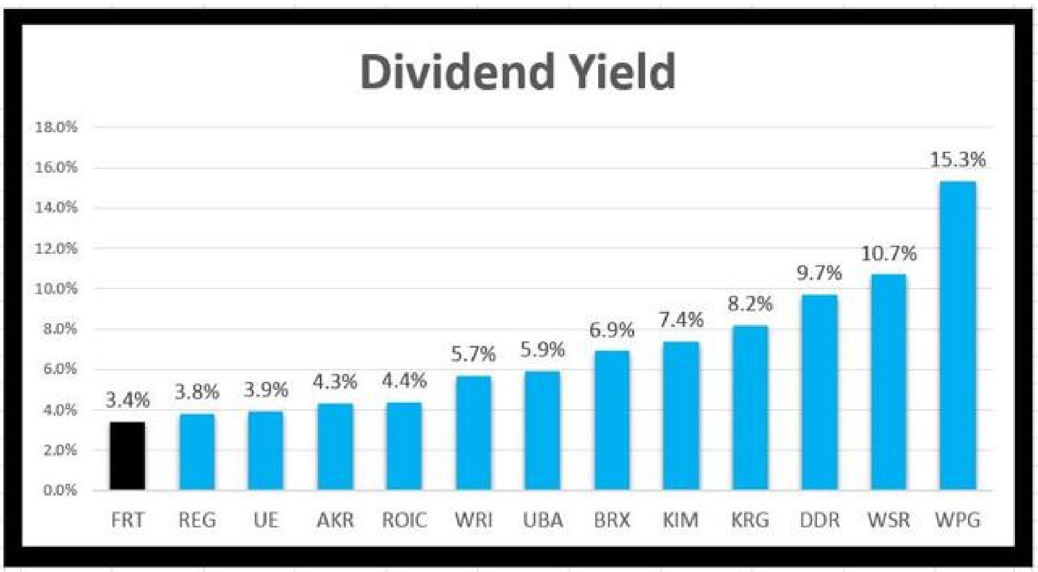
Now take a look at the dividend yield:

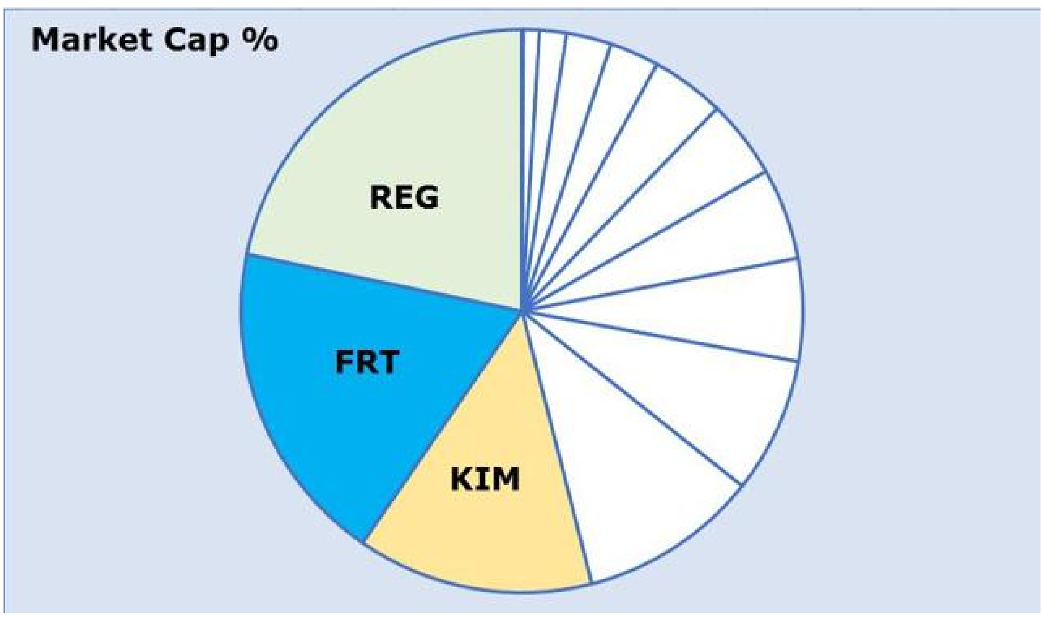


Now compare the P/FFO multiple with FRT and the peers, and the comparison with four-year averages:

REIT	4 Year Trailing FFO	P/FFO	Difference
UBA	17.6	15.3	-13%
UE	20.0	16.7	-17%
ROIC	18.6	15.3	-18%
AKR	20.8	16.9	-19%
FRT	**25.0**	**19.7**	**-21%**
WPG	5.3	4.1	-23%
REG	**20.7**	**15.9**	**-23%**
WSR	11.4	8.6	-25%
WRI	14.9	11.2	-25%
KRG	11.3	7.7	-32%
BRX	**11.3**	**7.6**	**-33%**
KIM	15.6	10.1	-35%
DDR	11.1	6.8	-39%
WHLR	35.3	11.2	-68%

FRT
REG
BRX

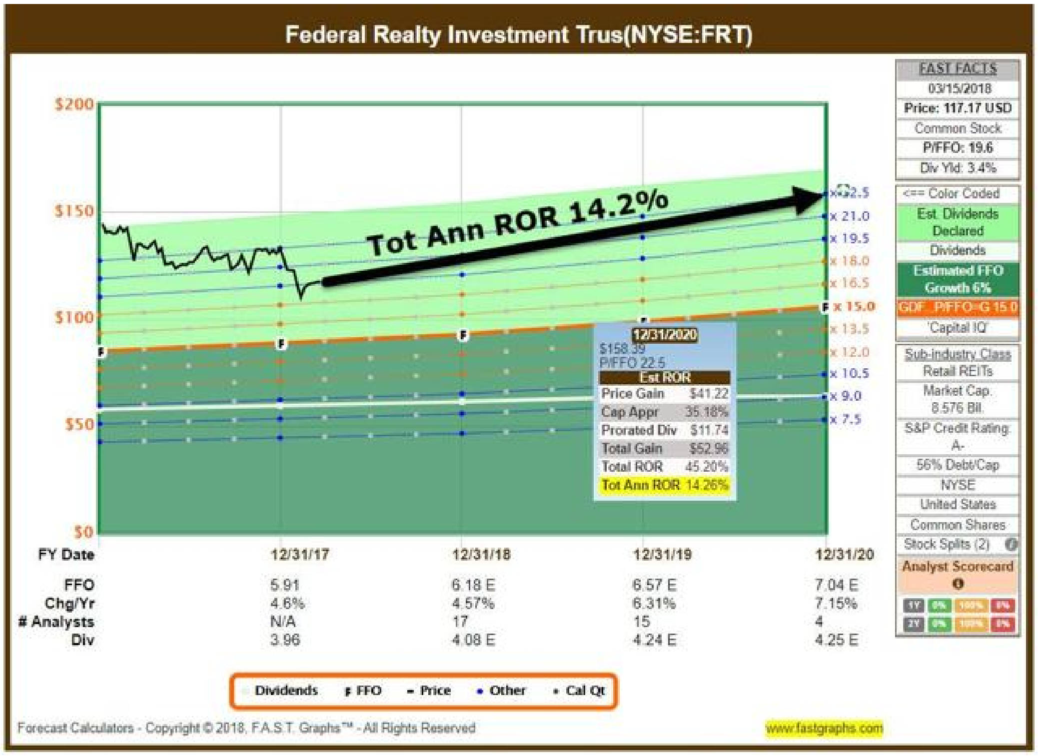
As you can see below, three REITs dominate the shopping center sector (REG, BRX, and FRT) with a combined market capitalization of 52%:



In summary: Federal Realty is "pound for pound" one of the highest quality shopping center REITs based on durability. This dominance is summed up by Josh Peters, author of *The Ultimate Dividend Playbook*:

> "Durability implies that the firm can take a financial punch in one year and come back swinging the next. Durability implies an earnings stream that, if not quite predictable in any one year, can be relied upon over a series of years, during which short-term fluctuations should average out."

I am taking advantage of the pullback and increasing exposure in FRT; this means that I am maintaining a Buy and forecasting growth in the range of 12-15% over the next 12-24 months. FRT's trailing P/FFO (4-year) is 25x and recognizing the continued pressure on retail, I am forecasting normalized P/FFO at 22x. In conclusion, "**It's Now Time To Buy The #1 REIT In The World.**"



Note: *Brad Thomas is a Wall Street writer, and that means he is not always right with his predictions or recommendations. That also applies to his grammar. Please excuse any typos, and be assured that he will do his best to correct any errors if they are overlooked.*

Finally, this article is free, and the sole purpose for writing it is to assist with research, while also providing a forum for second-level thinking. If you have not followed him, please take five seconds and click his name above (top of the page).

Source: FAST Graphs and FRT Investor Presentation.

Other REITs mentioned: WHLR, ROIC, WSR, KIM, WPG, BRX, UE, DDR, KRG, AKR, WRI, and UBA.

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