Is Dream Office Real Estate Investment Trust’s 10.4% Yield Safe?

Description

Over the last few months, it hasn’t been good to be a **Dream Office Real Estate Investment Trust** (TSX:D.UN) shareholder.

Since shares hit a 2015 high of more than $28 each in April, they’ve gone down at almost a 45 degree angle. As I type this, the company currently trades at $21.50 per share, which is good enough for an eye-popping 10.4% yield.

Obviously, with a yield that high the market isn’t a believer that Dream can maintain its generous payout. Is that a forgone conclusion? And is there a case to buy shares even if the payout looks to be less than sustainable? Let’s take a closer look.

A risky yield?

A couple of weeks ago, Dream came out with second-quarter earnings results, which were pretty solid. The company had funds from operations of $0.73 per share, which compared with $0.71 per share in the first quarter and $0.73 per share in the same quarter last year. Those numbers look okay to me.

Perhaps one issue investors have focused on is the company’s occupancy. Its in-place occupancy rate dipped to 91%, compared with 92.5% in the same quarter a year ago. If you include committed tenants that haven’t moved in yet, the occupancy rate does improve to 92.8%, but that’s also down from 94.1% in 2014.

The big concern the market has is with Dream’s assets in Alberta, particularly in Calgary. But so far in 2015, Calgary results have been pretty strong. It increased occupancy in its suburban Calgary portfolio from 85.2% in the second quarter last year to 89.1% in the most recent quarter. It even had rents slightly creep up as well.

For the first six months of 2015, Dream has paid out $1.12 in dividends, while earning $1.44 in funds from operations. That’s a payout ratio of just 78%. At least for now, it sure looks to me that Dream’s 10.4% yield is still pretty safe.

But what about the future?

It's much easier to look backwards rather than forwards. Looking ahead is where Dream starts to get a little murky.

Firstly, the company's occupancy numbers continue to get a little weaker seemingly every quarter. While the numbers are good enough–at least, for now–to maintain the distribution, it's obvious investors are looking at the trend and not the results. And even though Calgary's suburban market hasn't been as bad as investors feared, Dream's downtown portfolio in the city continues to lose tenants, falling to an occupancy rate of just 88.2%.

But is Calgary even that big of a deal? Out of Dream's more than 24 million square feet in total leasable area, only 4.9 million square feet are located in Calgary. It also owns property in other oil-rich areas like Edmonton, Regina, and Saskatoon, but these economies are far more diverse than Calgary's. The 20% of the portfolio in a risky area is manageable, especially considering how shares have declined more than 30%. It seems to me the risk is already priced into the shares.

In short, I think the market is overreacting to a situation that hasn't even turned ugly yet.

Cheap assets

Even if Calgary turns ugly and Dream is forced to cut the distribution to zero, I still think there's a case to be made for buying the company at today's levels.

Dream is selling at a steep discount to the value of its assets. The company's book value checks in at $33.64 per share, or more than 50% higher than shares trade at now. That's a huge discount, especially considering the strength of Dream's overall portfolio. It owns buildings in the downtown core of some of Canada's largest cities. It's not very easy to replicate that.

There's a risk that Dream's succulent dividend could get cut. But even if it gets slashed in half, investors are still buying high-quality assets at a steep discount compared with what they're worth. And if the energy sector starts to recover, investors could see a quick move upwards on the shares.

CATEGORY

1. Dividend Stocks
2. Investing

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1. TSX:D.UN (Dream Office Real Estate Investment Trust)

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Date
2025/07/08
Date Created

2015/08/21

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