Is Dream Office Real Estate Investment Trust's 10.7% Yield Sustainable?

Description

These days, many investors won't buy a stock with a dividend exceeding 5% annually.

The reasoning is simple. Generally, when investors collectively send a stock down so much that the yield exceeds 5%, the market is giving you a message that is all but screaming to stay away from that stock. In other words, the yield is high because it's risky.

Personally, I've never gotten too excited about the dividend yield. As a value investor, I'm more concerned with the valuation of the underlying assets than I am with dividends. I like to refer to myself as dividend agnostic. I like dividends, but they're immaterial to my investment process.

Oftentimes, the kinds of value stocks I'm looking at have yields in excess of 5%. I'm perfectly okay buying these stocks, as long as the yield appears to be sustainable.

Is **Dream Office Real Estate Investment Trust** (TSX:D.UN) one of those stocks with a sustainable dividend, even though the yield is an eye-popping 10.7%? Let's take a closer look.

The issues

There are essentially two issues really plaguing Dream Office right now.

The first is its exposure to the Calgary market. The decline in the price of crude has hit Canada's largest energy producers hard, and they're all looking to cut costs. They've already slashed capital expenditures and axed employees. The next step is to cut back on things like office space.

That's bad news for a company that relies on Calgary for approximately 18% of its income, and that's not even counting exposure to other oil-rich markets like Edmonton or Saskatchewan.

The other issue is Toronto, Dream's largest market. Developers in the GTA have been aggressively adding office space both downtown and in suburban areas. Investors are concerned this new capacity will push down both rents and occupancy rates in Toronto.

And finally, Dream's results have been a little lackluster. Of particular concern is the company's occupancy, which has recently dipped below 93%. Although that's higher than most of its peers—an attribute Dream can achieve because of its solid portfolio of properties—it's still a little lower than the market wants to see.

The positives

Those issues have driven down Dream shares to the point where they're the cheapest of its peers.

The company trades at just 8.9 times its adjusted funds from operations (AFFO), which puts it as one of the cheapest stocks in Canada, at least on that metric. Its largest competitors trade between 10 and 15 times AFFO.

Additionally, Dream trades at a huge discount to its net asset value (NAV). Dream's NAV is currently $29.67 per share, while shares trade hands at $20.95 each. That's a discount of nearly 30%. It's akin to buying $100 worth of assets for just $70.

Dream has also been working on turning the bottom of many of its office towers into retail space. This has been quite successful so far, with the company earning $26 million annually on the 1.1 million square feet it already has in place. Dream wants to increase that by 20% over the next year.

Finally, the company is buying back its shares. It has already bought back $64 million (or 2.4 million units) in shares, and plans to buy back nearly $90 million more, funded by asset sales.

What about the dividend?

For income investors, all of this isn't much good without a sustainable dividend.

As it looks right now, Dream can indeed maintain its 10.7% yield. Annually, that works out to $2.24 per share in distributions. During 2014 the company earned $2.52 in AFFO per share, putting the payout ratio at 89%.

In 2015 the company has projected it will see a slight decline in AFFO, falling to $2.39 per unit. That still puts the payout ratio at 94%, which is acceptable, albeit a bit high. Management expects 2016's AFFO to recover slightly because of the share buybacks, which should help bring that payout ratio down towards the 90% range.

As it stands now, Dream Office REIT does have a sustainable dividend. But like any high-yielding stock, investors need to keep an eye on it and make sure future earnings cover the dividend.

CATEGORY

1. Dividend Stocks
2. Investing

TICKERS GLOBAL

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

Category

1. Dividend Stocks
2. Investing

Date
2025/09/12
Date Created
2015/09/24
Author
nelsonpsmith