Can Dream Office Real Estate Investment Trst Maintain its 14.7% Yield?

Description

Investors looking for big dividends don't need to look further than **Dream Office Real Estate Investment Trst** (TSX:D.UN).

Canada's largest publicly traded pure-play office real estate company pays an eye-popping 14.7% yield, which is the most generous in its sector and among the highest in Canada. For many income-oriented investors, the payout appears to be a gift from the heavens.

As the old saying goes, there's no such thing as a free lunch in the stock market. Naysayers say the reason why Dream's yield is so generous is because it's a prime candidate to get cut in 2016 as a slowdown in Alberta hits Dream's bottom line hard.

Is that the case? Let's take a closer look.

Shaky dividends?

If you looked at Dream based on 2015's results, you'd probably think the market is getting a little too excited.

Results through the first nine months of the year saw adjusted funds from operations (AFFO) come in at $1.88 per unit, putting Dream on pace to earn $2.50 per share for the full year. Dividends are $0.186 per share each month, which works out to $2.24 per year. Based on that metric, the payout ratio looks to be approximately 90%. That's a little higher than investors probably want, but certainly not enough to warrant a 14.7% yield.

Looking ahead is vastly more important. According to recent analyst expectations, a decline in operating income from Calgary is set to hit the company just enough to put the dividend in serious jeopardy. AFFO is expected to be $2.25 per share in 2016, giving the company a payout ratio of 100%.

The argument from a bearish standpoint is that the company might as well cut its dividend because the market doesn't believe it can be sustained. If the dividend was slashed by 50%, it would free up approximately $90 million per year, which could be used to decrease debt or buy back undervalued shares.

But at the same time, I'm not sure a dividend cut is all but assured. Approximately a third of all dividends are paid out in the form of more shares. Thus, the cash payout ratio is closer to 70% of earnings, not 100%. Dream's management has been embarking on an aggressive program to buy back these additional shares, plus more. This, combined with a soft landing in weak markets, could be enough to avoid a dividend cut.

Forget about the dividend

I personally own Dream shares in my portfolio, and the dividend isn't very high on my list of concerns.

I view the company as a value investment that just happens to pay a dividend. I know it has the earnings power to support paying some sort of dividend, whether that's 5%, 10%, or 14.7% of today's price.

According to the company's most recent investor presentation, the company has a net asset value of $32.78 per share, yet the company trades for less than half of that. And since the value of these properties is adjusted each quarter–as per REIT accounting rules–I'm confident the net asset value is a relatively accurate number.

Properties in western Canada generate 39% of the company's operating income. If we assume a 50% haircut in the value of these properties, investors are still picking up the entire company for about 55% of its net asset value. Even if we value the western Canadian part of the company at zero, investors are still only paying 69% of the net asset value of the eastern Canadian portion.

Dream is a risky dividend investment–that much is obvious. There's a very real possibility the dividend goes down 50% in 2016. But at the same time, investors are getting the company at less than 50% of net asset value, seven times estimated AFFO, and with huge potential upside when crude recovers. Those are the reasons to buy Dream today. The dividend is essentially a big distraction.

CATEGORY

1. Dividend Stocks
2. Investing

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

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