Dividend Investors: Killam Apartment REIT 15% Undervalued

Description

Killam Apartment REIT (TSX:KMP.UN) is a bright light in the midst of a brewing storm. Residential REITs in Canada have been hit hard lately with pervasive weakness in Canada's housing sector. With **Royal Bank of Canada** announcing on Tuesday that it will be raising mortgage rates to soften the blow of rising global borrowing costs, this weakness may materialize in ways that adversely affect REITs.

I've decided to pick Killam out of the crowd because it may be best able to withstand the impending storm.

Solid fundamentals support a bullish long-term outlook

Killam's fundamentals are very strong with a number of key metrics above the industry average. The company's strong earnings growth and sustained elevated profit margin with a stable debt load are signs of strength in an otherwise overleveraged REIT sector.

The company's portfolio of real estate assets is primarily located in eastern and Atlantic Canada with little exposure to the B.C. and Albertan markets, which may pose a risk to other Canadian REITs in the near term. The debt load as a percentage of assets of approximately 55% has been relatively stable over the past three years, and the interest coverage ratio remains strong and stable at above two.

The REIT's current price to book (P/BV) ratio sits at 1.12. This means that investors are able to buy equity in Killam at approximately the value of the assets (the book value of real property is also recorded at its purchase price, so the P/BV ratio will likely actually be lower in this case).

The logic behind buying an asset at or below face value is that zero consideration is given for any future asset appreciation or the future stream of dividends.

The dividend yield of 5% is particularly attractive to long-term investors.

Dividend consistent, yield remains very attractive

The reason why Killam's dividend yield is so important in determining whether or not to buy this stock is that it partially determines what price we are willing to pay due to the pricing of the present value of future revenue streams. By looking just at the dividend yield and how stable dividends have been over the past three years, we can extrapolate what the value of the stream of dividends will be assuming the yield remains somewhat constant at about 5%.

In other words, we'll make some crazy assumptions to equate this stock to a bond with a par face value and a 5% annual yield:

1. Assuming the value of the company's assets will remain the same over time
2. Assuming the dividend yield remains constant at 5% per year
3. Assuming 2% annual inflation (to get real returns)
4. Assuming our target holding period for this stock is 10 years

We get to a current real face value of this "bond" of approximately $127, which would mean we'd be willing to pay a 27% premium over the value of assets for an equivalent portfolio of future cash flows, assuming there's no price appreciation for the underlying asset portfolio. Since the stock is currently trading at a P/BV of 1.12, we can say very comfortably that an upside for this stock of at least 15% in the short term is reasonable.

The company is also able to pay out a 5% yield, while only paying out approximately 62% of earnings. That means the REIT is able to reinvest the rest of the funds or keep the funds internally as a buffer against future volatility in the housing sector.

In short, Killam Apartment REIT is a stock every long-term investor should consider for their portfolio.

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