3 Reasons Tricon Capital Group Inc. Is 1 of the Best Stocks on the TSX

Description

At the end of October, I'd named **Tricon Capital Group Inc.** (TSX:TCN) one of the five best stocks on the TSX alongside index heavyweights **Brookfield Asset Management Inc.** (TSX:BAM.A)(NYSE:BAM) and **Alimentation Couche Tard Inc.** (TSX:ATD.B).

Only real estate investors are probably familiar with the Toronto small-cap asset manager. However, up 21% with one month left in 2017, I imagine more people are going to find out about it in 2018.

Why did I name Tricon one of the five best stocks on the TSX?

Originally, when I'd first covered its stock, it was primarily because I thought Tricon was undervalued relative to its real estate peers.

"If you're leery of U.S. real estate, then perhaps this shouldn't be one of your three best stocks under $10," I wrote May 2, 2016. "I, on the other hand, see a stock returning to $12 very shortly."

At the time it was trading at $8. It hit $12 on June 4, 2017, but it has since traded in a $2 range down to $10. If it goes below $10 again, I recommend you back up the truck.

In the meantime, let me explain why I believe Tricon is such an exciting stock.

The company eats its own cooking

In the mutual fund business, a company "eating its own cooking" suggests the portfolio manager running a fund is also putting their money into the fund, so your interests are aligned.

Well, Tricon does the same.

Although Tricon manages real estate assets for other investors, it's principally, like Brookfield, an investor first and an asset manager second. Of the $5.8 billion in assets currently under its management, 74% is owned by Tricon shareholders.

The combination of long-term investment income and capital gains with short-term recurring revenue makes for a very strong business model designed to be successful in all economic climates.

Single-family rentals continue to be a big part of its business

Although Tricon sold 1,523 single-family rental homes in October to an institutional buyer for US$153 million, the assets weren't core holdings of its Tricon American Homes division.

Most of the homes sold were renting for less than US$1,000 per month; that is outside its middle-market strategy, which focuses on households earning between US$50,000 and $95,000 annually and paying between US$1,000 and $1,600 per month in rent.

This is the sweet spot between households who are more likely to default on their rent — those earning less than US$50,000 — and those in temporary digs until buying another house. They might earn more than the middle market — US$95,000 and above — but they're far less committed to the renter lifestyle.

After the sale of the non-core assets, it has a little over 15,000 single-family homes, each generating average monthly rent of US$1,256 and a net operating income (NOI) margin of 61.3%, which translates into US$108 million annually on its US$2.8 billion in appreciating assets.

It's nice, steady cash flow.

Master-planned communities

This is the next biggest component of the Tricon asset base; it accounts for 30% of its $5.8 billion in assets under management.

Tricon invests with local and regional homebuilders in both Canada and the U.S. in hot spots like Atlanta, Phoenix, Charlotte, Toronto, Vancouver, and Calgary. As the builders develop the lots, they're sold off, and the company liquidates its investment over time.

The beauty of this part of the business is, it's not quite as capital intensive as single-family home rentals, allowing for a long-term holding period of up to 15 years without breaking the bank, while generating recurring revenue through land sales.

Bottom line

Tricon has been simplifying its business model over the past two years to reduce the number of revenue streams to the two to three most reliable. It's part of the way there and should be completely transformed by the end of 2018.

By then, it will be a lean, mean, real estate-investing machine with a much easier story to tell, which should help drive its stock into the $20s before the end of the decade.

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