Research – Realty Income (5/10/19)

Description: Realty Income is a company dedicated to providing stockholders with dependable monthly income. The company is structured as a Real Estate Investment Trust (REIT), and its monthly dividends are supported by the cash flow from over 5,800 real estate properties owned under long-term lease agreements with regional and national commercial tenants.

Ticker: O
Price: $67.36
Market Cap: $21.2B
Performance: +8.2% YTD

Analysis

When examining REITs what should we be looking for? The list is long but just to name a few:

1. Stable cash flow to pay dividends
2. Diversified portfolio of investments
3. Top tier management
4. Scalability and valuation
5. Earnings growth
6. Occupancy rates & increasing rents
7. New business opportunities

Realty Income is a net lease REIT. What does “net lease” mean? Net leases are typically 10-20 years long in their initial term and involve few landlord responsibilities.

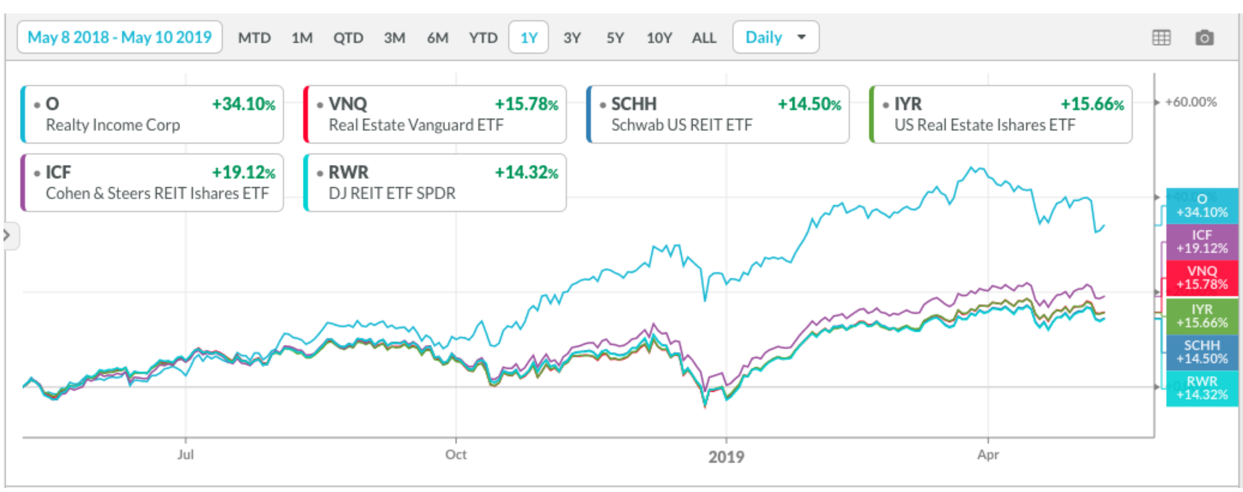
The term "net lease" covers a few different variations of maintenance and financial responsibilities. A plain "net lease" is one in which the tenant handles its own maintenance, but the landlord pays for insurance and property taxes.

A "NN" or "double net" lease typically has the tenant handle all maintenance inside the building plus insurance and taxes while the landlord is responsible for roof, structure, and parking lot. If the building is located in a larger retail center with a common area agreement, the landlord may or may not be responsible for common area maintenance.

A "triple net" lease is one in which the tenant pays for *all* maintenance, insurance, and taxes associated with the property, though sometimes the lease requires the landlord to initially pay the expenses only to be reimbursed by the tenant later. An "absolute triple net" property is one in which the landlord bears *zero* responsibilities, requiring the tenant to pay directly for all maintenance, insurance, and taxes.

To date, Realty Income has declared 586 consecutive common stock monthly dividends throughout its 50-year operating history and increased the dividend 101 times since Realty Income's public listing in 1994. This automatically checks off some very important boxes. Realty Income is most certainly an established company that has proven themselves time and time again. Looking at the chart below we can see O’s performance vs. various REIT ETFs like that of Vanguard’s Real Estate ETF (VNQ), Schwab’s U.S. REIT ETF (SCHH), iShares U.S. Real Estate ETF (IYR), iShares Cohen & Steers REIT ETF (ICF), and SPDR Dow Jones REIT ETF (RWR).

1-YR Performance (Realty Income outperforming ETFs by 15-20%)



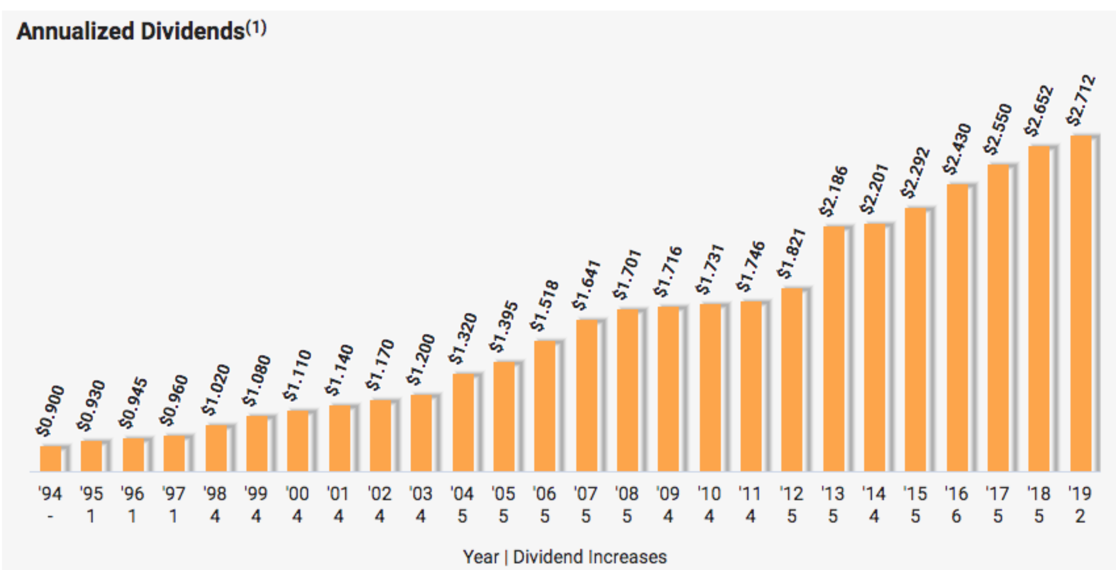
3–YR Performance (Realty Income slightly outperforming ETFs by 0.5-8%)

5-YR Performance (Realty Income outperforming ETFs by 22-49%)

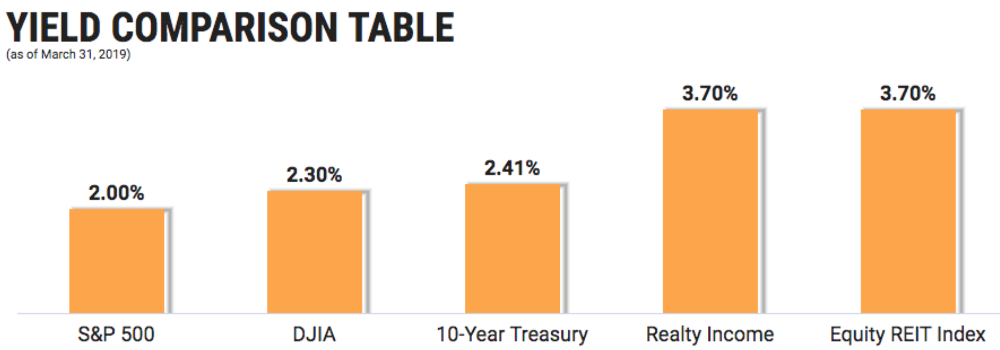
Let's dive into Realty Income's details. At this moment in time, O is providing investors with a 4.03% dividend yield. If we look at the history of the company below we'll see that this is generally lower than usual due to how much shares have grown over the years forcing the yield down.

We already highlight some facts about Realty's dividend but let's break it down even more. Since being founded in 1969:

• 585 consecutive monthly dividends paid
• 101 dividend increases
• 86 consecutive quarterly increases
• Dividend growth of 201.3%
• Compound average annual dividend growth rate of approximately 4.6%



If those numbers weren't impressive enough, the chart above shows the dividend growth since O became public in 1994 alongside how many dividend hikes they did in each year. *Even during the 2008/2009 financial crisis, Realty Income grew their dividend and raised it as much as 5x in a given year*. This shows how solid of a job management has done in ensuring capital is delivered to shareholders. Five months into this year, O has already hiked their dividend twice and looks as though the streak of 5-6 increases will remain intact.



For comparison, Realty Income currently stacks up well vs. the S&P500's average dividend yield of 2%, Dow Jones' 2.3%, 10YR Treasury yield of 2.41%, and right in-line with its peers in the equity REIT space of 3.7%.

How has management been able to have such a sustained and stellar performance? This is a perfect time to talk about their portfolio of investments. We know they own nearly 6000 properties but what are they comprised of?

Top 20 Tenants

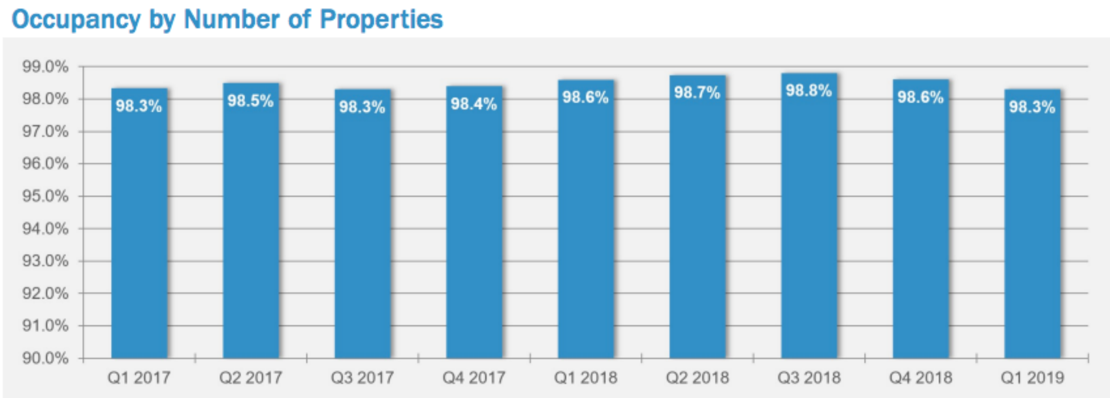
Our 20 largest tenants based on percentage of total portfolio annualized rental revenue at March 31, 2019 include the following:

Tenant	Number of Leases	% of Revenue	Investment Grade Ratings (S&P/Moody's/Fitch)
Walgreens	218	6.1%	BBB/Baa2/BBB
7-Eleven	398	5.4%	AA-/Baa1/-
FedEx	42	4.7%	BBB/Baa2/-
Dollar General	600	4.0%	BBB/Baa2/-
LA Fitness	54	3.6%	-
Dollar Tree / Family Dollar	469	3.4%	BBB-/Baa3/-
AMC Theatres	32	3.2%	-
Walmart / Sam's Club	51	2.7%	AA/Aa2/AA
Life Time Fitness	14	2.4%	-
Circle K (Couche-Tard)	297	2.3%	BBB/Baa2/-
BJ's Wholesale Clubs	15	2.0%	-
Treasury Wine Estates	17	1.9%	-
CVS Pharmacy	84	1.8%	BBB/Baa2/-
Regal Cinemas	24	1.8%	-
Kroger	20	1.7%	BBB/Baa1/-
Super America (Marathon)	137	1.7%	BBB/Baa2/BBB
GPM Investments / Fas Mart	210	1.6%	-
TBC Corporation (Sumitomo)	159	1.5%	A-/Baa1/-
Home Depot	17	1.3%	A/A2/A
Rite Aid	49	1.2%	-
Total	2,907	54.3%	

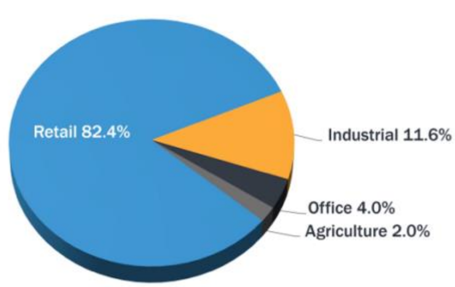
As we can see from the table above, some of O's largest holdings include pharmacies (Walgreens, CVS, Rite Aid), fitness centers (LA Fitness and Life Time Fitness), and large chain hypermarkets (Walmart/Sam's Club, BJs Wholesale, Krogers). In our view, this is a well established and diversified portfolio as it's evenly spread amongst some highly credible, credit-worthy companies of differing industries.

Side note: Rite Aid at a 1.2% allocation is the most concerning on the list as they are having some serious trouble. For this year, RAD expects more headwinds with net losses expected to be between $170.0 million and $220.0 million for the year.

Overall, their occupancy rates have consistently remained above 98% as seen below.



As of March 31, 2019, O's portfolio consists of an 82.4% weight in retail followed by an 11.6% weight in Industrials, 4% in Offices, and 2% in Agriculture. At a first glance we were a bit nervous about the weight in retail given how rapid consumer behaviors have changed over the years as e-commerce dominates the world. Upon further inspection, it appears a large amount of the holdings are in retailers that require a physical location or whose businesses are supplemented by e-commerce rather than replaced by it. For example, Walmart and Home Depot. Home Depot has had great success with their order online and pick up in-store strategy. We also like the fact that Dollar General and Dollar Tree are names that hold more weight than say a Best Buy or GameStop as super discount retailers tend to do relatively well in rough economic times.



Property Type	Number of Properties	Approximate Leasable Square Feet	Rental Revenue for the Quarter Ended March 31, 2019 [1]	Percentage of Rental Revenue for the Quarter Ended March 31, 2019	Percentage of Annualized Revenue from Investment Grade Tenants [2]
Retail	5,702	65,128,800	$ 277,813	82.4%	46.3%
Industrial	117	26,804,700	39,038	11.6	78.3
Office	42	3,104,200	13,548	4.0	86.1
Agriculture	15	184,500	6,647	2.0	—
Totals	5,876	95,222,200	$ 337,046	100%	

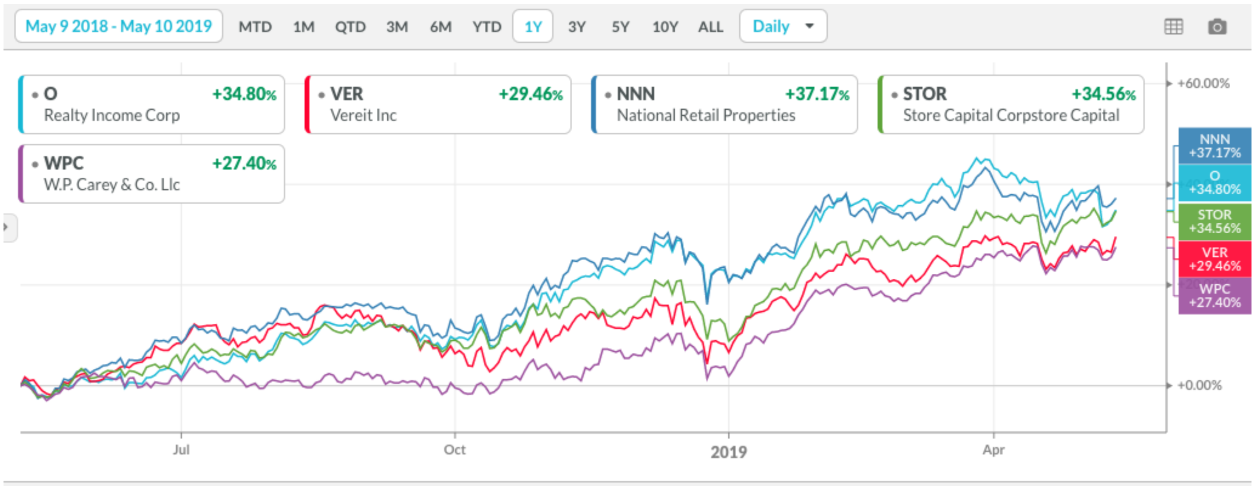
Valuation

We know Realty Income runs an excellent business and has proven this time and time again but how do they stack up vs. some other net lease REITs out there like W.P. Carey (WPC), National Retail Properties (NNN), STORE Capital (STOR), and VEREIT (VER).

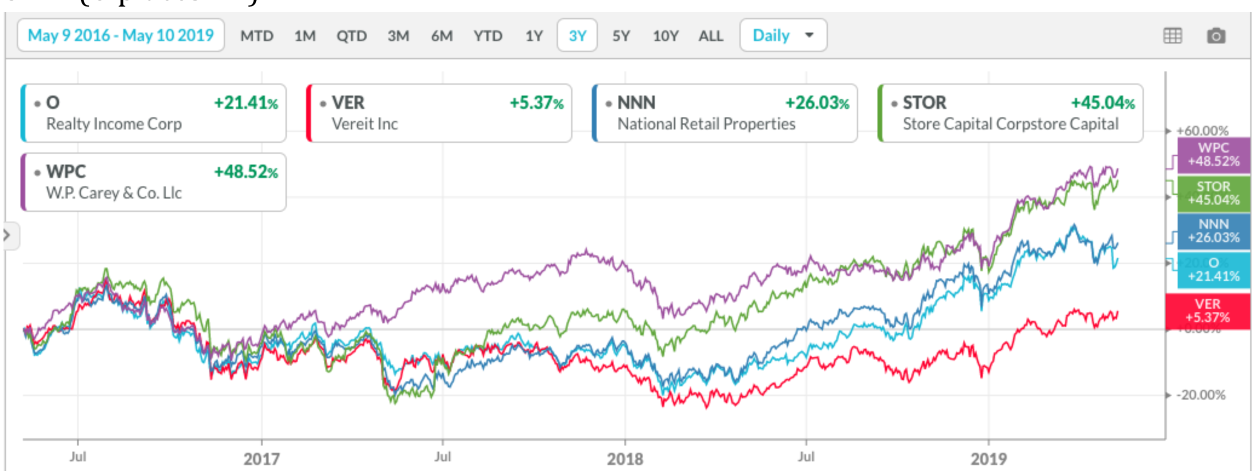
	O	WPC	NNN	VER	STOR
Dividend Yield	4.03%	5.29%	3.82%	6.69%	3.98%
Price to Earnings	49.6x	28.9x	33.1x	72.6x	35.1x
Price to Adjusted Funds From Operations (FFO)	20.6x	15.8x	19.2x	12x	17.4x

Based on the table above, O is one of the more expensive REITs but at the same time rightfully so as their track record is stellar. While the P/E ratio is important, when it comes to REITS the Funds from Operations and Dividend Yield is king. In this case, O is middle of the road on the yield and priciest on P/FFO. We displayed earlier in this report how O has outperformed vs. REIT ETFs but how about their peers in the net lease space?

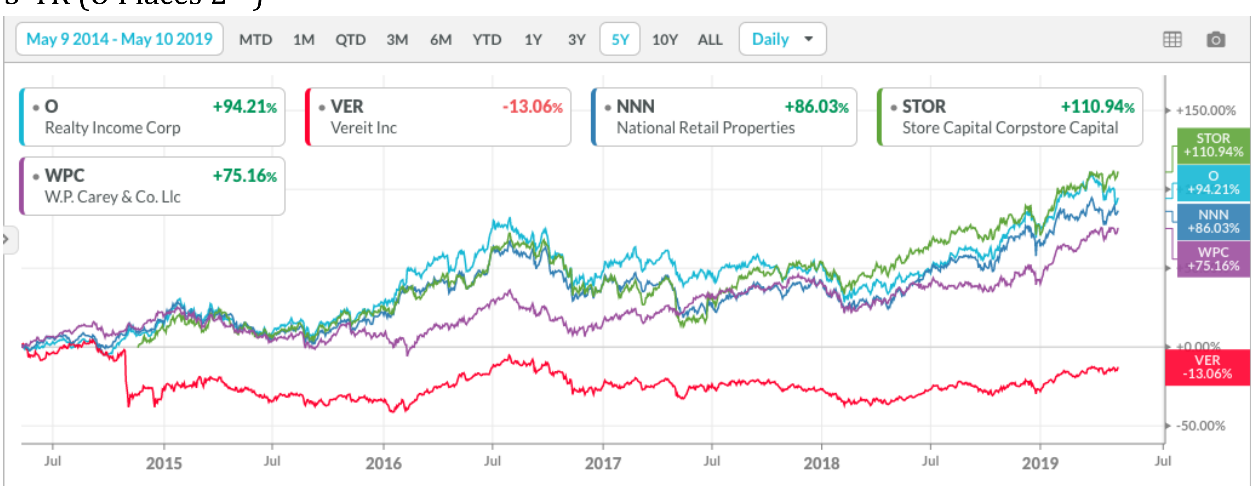
1-YR (O places 2nd)



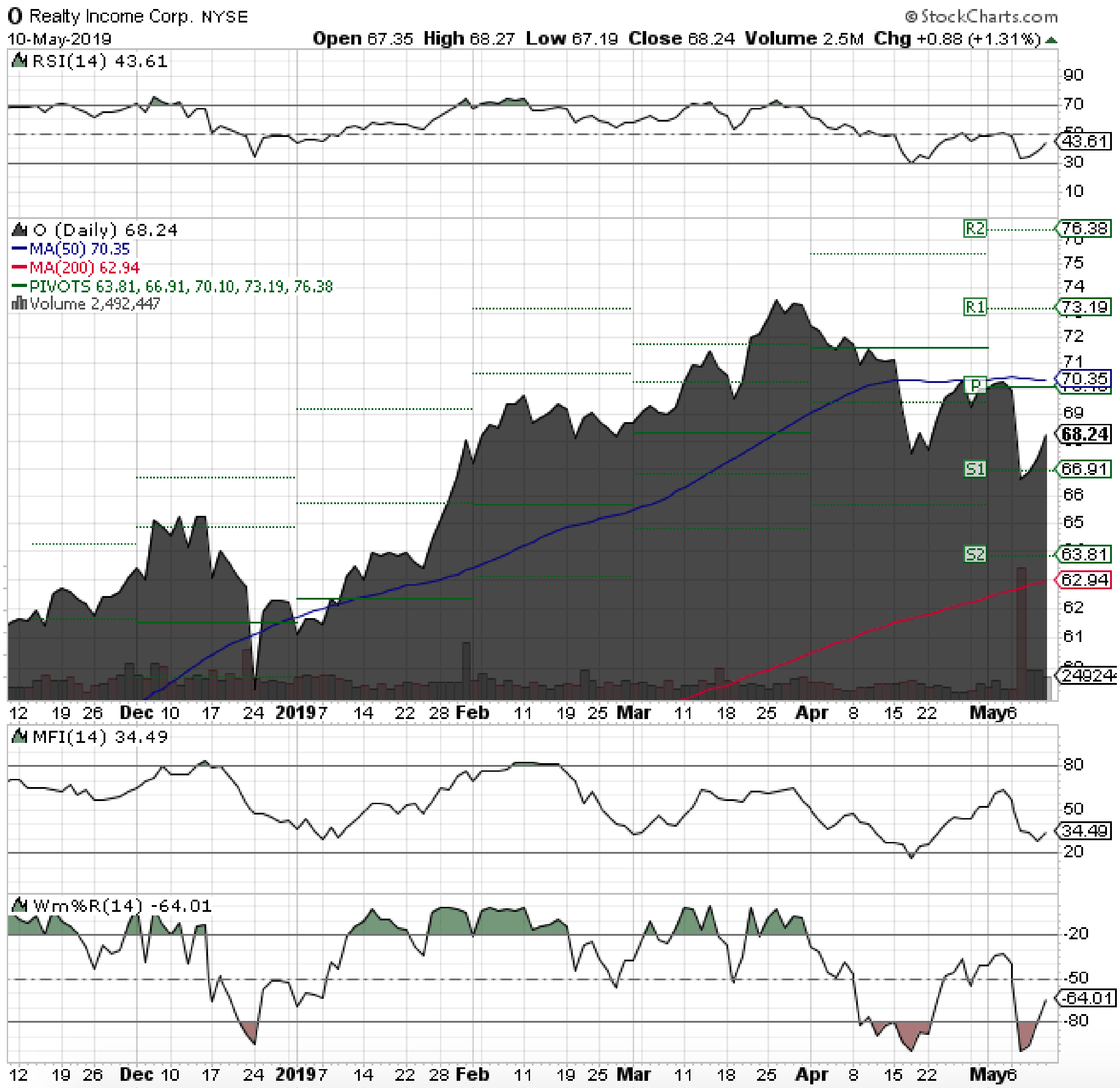
3-YR (O places 4th)



5-YR (O Places 2nd)



Technical Analysis



Based on the charts here, we saw a huge spike in volume when shares fell and have since seen a decent bounce off its support at $66.91 but on albeit weaker volume. Much of the reason O is performing so well this year is attributed to the fact that the Fed doesn't have any plans on raising rates and that is huge for O considering their leases are long-term and can be badly hurt by high inflation. Right now, we think O still a bit expensive and can fall it a little more but this is one of those investments where consistently adding to your position and reinvesting the monthly dividends is what it's all about. As always feel free to look into the other net lease REITs we listed to diversify even more as the other companies have very different portfolios, geographies, business stages, etc.

All in all, we like Realty Income. Their ability to grow their dividend and consistently distribute it even during the worst of times makes for a great reason as to why shares should trade at a premium to their peers.