STOCKTRADES PREMIUM COMPANY SUMMARY

ALLIED PROPERTIES REIT

AP.UN.TO

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Stocktrades Premium

Allied Properties Real Estate Investment Trust is a real estate investment trust engaged in developing, managing, and owning primarily urban office environments across Canada's major cities. Most of the total square footage in the company's real estate portfolio is located in Toronto and Montreal. Allied Properties derives nearly all its income from rental revenue from tenants in its properties. The majority of this revenue comes from its assets located in Central Canada. Allied Properties' major tenants include IT, banking, government, marketing, and telecommunications firms. The company also controls a number of telecommunications/IT and retail properties within its real estate portfolio.

OUR REIT SCORE: 3.5/5

Sector: Real Estate

Industry: REIT - Office

Current Price: $16.95

RANK: 1st of 38 tracked REITs

Stock Type: Income

Our Risk Rating*: Moderate

1 Year Price Target: $20.25

*Our Risk Rating: Our opinion of the overall risk an investment presents. Can be shown as Defensive (DEF), Moderate (MOD), or Aggressive (AGG). By no means is this an indication of future potential gains or lower volatility.

PROS

- Dividend Aristocrat with an 12-year growth streak
- Strong coverage ratios
- Managed to get above IFRS value for the urban data centre (UDC) business which helped lower debt and improve financial position.
- Attractive valuation (64% discount to NAV)
- Attractive yield (~10.6%)

CONS

- Shift to work at home has reduced demand for office space
- REITs, in general, could see further weakness if rates stay elevated
- Yield is getting uncomfortably high
- Two major peers have cut the distribution leading to negative sentiment
- REITs have been among the worst performing asset classes over the last year
- The company recently had a fair value adjustment that resulted in a $500M decline in the value of its properties a few quarters ago

OVERALL THESIS

The REIT space has been under significant pressure since rates began to rise. While we don't expect a significant rebound anytime soon, in our opinion, it is a good time to start looking at REITs that are trading at attractive valuations. Especially those in relation to peers, and Allied Properties fits that description.

As of the most recent quarter (Q1'24) Allied is trading at a 64% discount to NAV, and the reason is likely three-fold. First, office REITs have fallen out of favour since the pandemic. Secondly, many of its office REIT peers have announced distribution cuts in recent months.

Finally, the company is undergoing somewhat of a strategic shift. If we circle back to the weakness of office REITs, it is important to note that Allied's core segment is low-cost urban centre workspaces. This happens to be one of the fastest-growing sub-industries of the Office REIT industry. So while there is a caution to exercise here, Allied is one of the better positioned given its core focus.

In January of 2023, the company announced that it would look to dispose of its Urban Data Centres (UDCs) segment. Given that most investors look at the downside first, disposing of UDCs (sale value of $1.35B) will lead to a decrease in earnings. However, if we look at the big picture, a sale has not only helped the company strengthen its balance sheet but will also enable the company to re-focus and even spur growth in its core segment.

POTENTIAL RISKS

The pandemic has significantly impacted demand for office space as work from home is likely to continue to be a mainstay in the near future. This in itself is a risk to office REITs. When one factors in the high pace of rate hikes, we had a perfect storm for office REITS.

Part of the investment thesis is our positive outlook on the company's disposition of non-core assets. If a sale fails to materialize, the company has a higher-than-average debt profile, which has been on the rise in recent quarters. While the distribution is not at risk given their attractive payout ratio (~77% of FFO) and strong interest coverage (6.27x), it does put the company at risk if rates stay elevated for longer periods of time.

Beta	**1.08**
Alpha	**-20.38**
Our Risk Rating	**Mod***
Max Drawdown	**64%**

Finally, Allied's portfolio is heavily concentrated in Canada's urban centers - mainly Toronto, Montreal, Vancouver, and Calgary. As a result, their market value and rents are tied to the strengths and weaknesses of these communities. If any of these major centres experience a significant economic downturn in which property values and rents are negatively impacted, this in turn impacts Allied's value. We saw this recently, where the company adjusted the value of its properties in these areas, resulting in a $500M loss.

VALUATION

	TTM	5 Year Average	Industry Average
P/FFO	7.89	N/A	6.68
FFO/Interest	6.27	N/A	2.38
D/Equity	0.57	N/A	1.16
D/EBITDA	8.2	N/A	15.74
D/Assets	0.34	N/A	0.48

We've mentioned that Allied's debt level is a little high when compared to the REIT sector. However, the company has improved its financial position now that it has completed the UDC sale. D/EBITDA has dropped quarter over quarter (1.6x YoY), and debt to gross book value (assets) is now sitting at 0.359, down by 200 basis points over the course of 6 months.

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Management also expects its financial position to improve as developments come online in the next three years.

The company is now one of the better positioned to navigate these tough times and we find an attractive investment proposition when we combine Allied's current debt levels against their undervaluation.

While Allied is trading at a premium on a P/FFO basis compared to industry peers, that premium is deserved considering its strong coverage ratios. If you look at the most recent distribution cuts by True North (TNT.UN) and Slate Office (SOT.UN), both had payout ratios teetering close to or above 100% for several quarters. Thus far, Allied is in reasonably good shape as it ended Fiscal 2023 with an FFO Payout ratio of ~73.3%. and on an adjusted FFO basis 80%. It is much better positioned than its peers, and Allied's valuation is being dragged down with the rest.

Combine strong coverage ratios with the fact that it trades at a 64% discount to Net Asset Value, and you have an attractive risk-to-reward proposition. True, there are cheaper office REITs out there, but none have as strong of a balance sheet, and none are expected to grow as fast as Allied's core segment, which is low-cost urban centres.

COMPETITOR ANALYSIS

There is a handful of office REIT pure-plays on the TSX Index. Allied is by far the largest and 3x bigger than Dream Office REIT (D.UN) and True North (TNT.UN), the only others with markets caps bigger than $500M.

Whether you compare against only these or the entire basket, Allied has the highest expected growth rate, the second lowest payout ratio, and, as mentioned previously, one of the strongest balance sheets. It is also worth noting that Allied is the only one that has any semblance of a dividend growth streak and has consistently grown the top line, while many of its peers have seen declining revenue in recent years.

Also worth noting, the company's core market is fragmented, with many smaller, private players. This is why the company's runway for growth is quite strong since it can be a leading consolidator.

DISTRIBUTION ANALYSIS

Annual Distribution	FFO Payout Ratio (TTM)	5 Year Dividend Growth %	Dividend Growth Streak
$1.80	77%	3%	12

Few REITs have achieved consistent distribution growth. There are only 8 which have growth streaks longer than five years. For its part, Allied's 12-year streak is the second-longest among all TSX-listed REITs.

The company has averaged 3% annual dividend growth over the past five years. While this may not seem like much, it is important to understand that most REITs already have high payout ratios, and unless they are growing cash flows at a blistering pace, dividend growth will likely remain tempered. The company last announced a 2.9% raise on December 2, 2022.

That said, combining low, single-digit growth with a ~10% yield becomes an attractive income option for investors. Is growth sustainable?

Allied's FFO payout ratio in Fiscal 2023 came in at a respectable 73.3%. The company is expected to drive FFO growth as new developments come online in the next few years. After selling its UDC portfolio, management indicated they have $900M in unsecured credit. This provides ample flexibility even though it does not intend to 'materially' use it over the next few years. The company feels it has enough new development coming online to focus on improvements to current properties as it builds its FFO base and continues to improve its financial position.

We believe the company's current payout ratio is sustainable. However, now that the company's yield is touching 10%, we'd be remiss if there wasn't risk on that alone. Heck, if it weren't for the yield, we would have even leaned toward potential distribution growth. We don't expect that now, but in our opinion, a cut would be overly cautious.

Of note, investors got a special distribution of $0.47 per share in cash and the balance in units. The cash dividend is being provided to help "taxable unitholders in funding the associated tax liability". This is a direct result of the sale of the UDC portfolio, which will result in a significant increase in 2023 taxable income. Post special distribution, outstanding units will be consolidated such that unitholders will hold the same number of units as before.

RECENT EARNINGS

Earnings Estimates	2024	2025	2026
EPS	N/A	N/A	N/A
Revenue	$624M	$759M	N/A
EBITDA	$380M	$402.7M	N/A
EBITDA Margin	63%	53%	N/A

Considering the macro environment, Allied Properties produced a relatively solid second quarter. Adjusted funds from operations per unit came in at $0.537 per share. The company has driven nearly 5% increases on its leasing renewals, helping to offset lower occupancy rates amid a decline in office property demand.

The company's net asset value continued to decline on the quarter, falling from $45.60 to $44.84. Considering the overall environment for office real estate demand in Canada, this isn't all that surprising. At current share prices today, this represents a 64% discount from the REITs net asset value.

The company has paid off 14.5% of its debt year over year. Although leverage ratios are higher year over year, they are lower than in the fourth quarter of 2023.

Occupancy rates remain relatively steady at 85.9%. With an average leasing term of 5.7 years, the company is likely to be able to maintain these rates moving forward despite some harsh conditions.

Adjusted funds from operations increased by 0.8% year-over-year, and overall, the distribution looks to be well covered at this point. AFFO payout ratios come in at 83.8%, a 60 basis point (0.6%) improvement from the second quarter of 2023. Typically, we look for REITs to have coverage ratios of 90% or less, so Allied is well within that range.

However, with the fund yielding as high as it is, we cannot say for certain the dividend isn't at risk at this point. We're not saying the fund will cut the distribution, but it would not surprise us if they mulled over the idea of trimming it back. It would allow the company to provide a market-leading yield while allocating more capital to debt reduction.

Again, we don't believe this is on the horizon, but we'd be surprised if they have not considered it and are currently debating what would benefit investors over the long term.

Regardless of what happens it was relatively strong quarter from Allied.

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