STAG's 4.7% Yield: An Industrial REIT With More Octane

Key Takeaways:

- Judicious risk-adjusted aggregation strategy
- Selective acquisitions and opportunistic dispositions
- Attractive Valuation, income and growth potential

STAG Industrial, Inc (STAG) is an attractive monthly dividend REIT that has experienced a sizeable increase in its asset base since its IPO in 2011. The company plans to continue on its path of acquisitive growth and has provided a stabilized acquisition guidance of $700 - $850 million for the year 2019. STAG's calculated strategy of aggregating properties along with purposeful diversification is expected to pay growing dividends for years to come. This article analyzes the various strengths of STAG, looks at the dividend yield, valuation, risks, and concludes with our opinion on why STAG is worth considering if you are a long-term income-focused investor.

Overview

STAG Industrial, Inc. ("STAG Industrial") is an industrial real estate operating company focused on the acquisition and operation of single-tenant, industrial properties throughout the United States. The company is structured as an umbrella partnership REIT, commonly called an UPREIT, and owns substantially all of its assets and conducts substantially all of its business through its operating partnership, STAG Industrial Operating Partnership, L.P. As of March 31, 2019, the company owned a 96.7% common equity interest in the operating partnership. STAG Industrial, through its wholly owned subsidiary, is the sole general partner of the operating partnership.

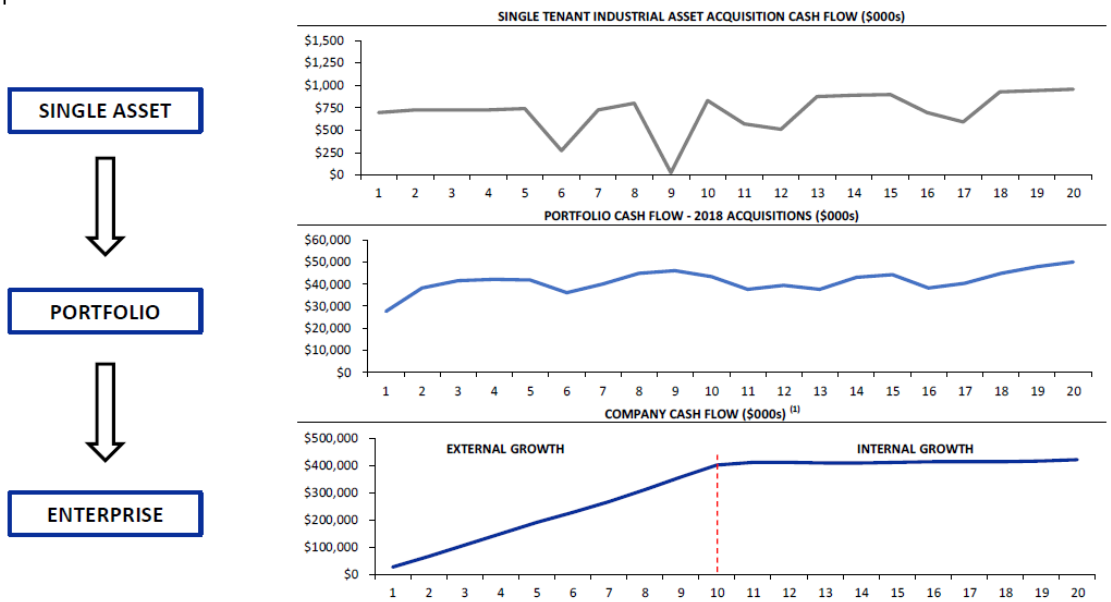
As of March 31, 2019, the company owned 395 buildings in 38 states with ~78.2 million rentable square feet, consisting of 328 warehouse/distribution buildings, 58 light manufacturing buildings, and 9 flex/office buildings. The company's buildings were ~95.2% leased to 359 tenants as of March 31, 2019, with no single tenant accounting for more than ~2.3% of total annualized base rental revenue ("ABR") and no single industry accounting for more than ~15% of total ABR.

Reaping the Benefits of Aggregation

STAG Industrial primarily owns, operates and develops single-tenant properties, which carry an inherent binary risk of being viewed as either fully occupied or completely vacant. This results in a higher potential volatility of cash flows as compared to multi-tenant properties. Due to the inflated risk component, investors apply high risk premiums or discount rates when evaluating single-tenant assets. This allows STAG Industrial to purchase properties at a cheaper rate.

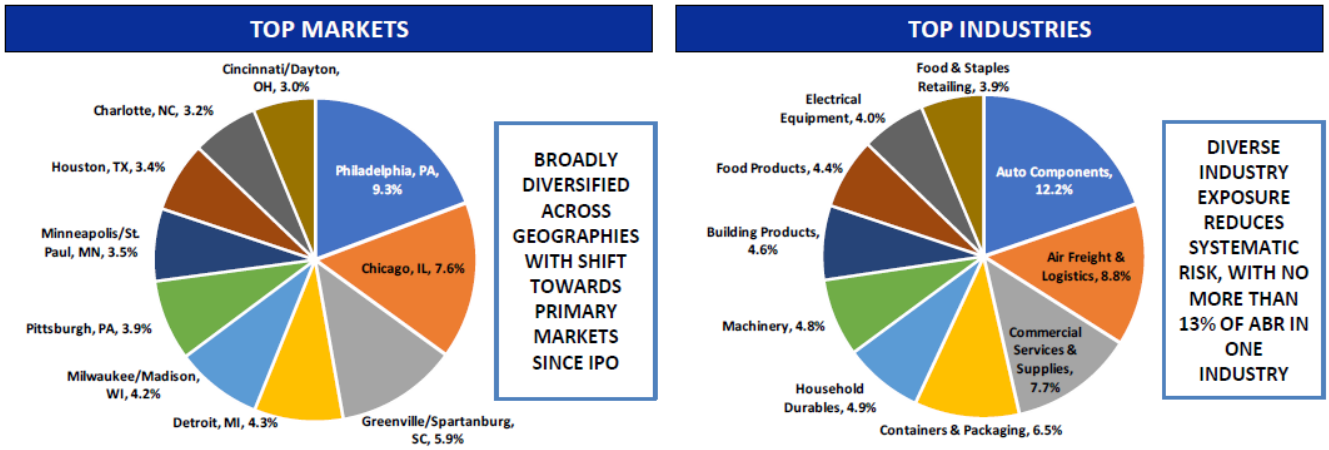
In order to mitigate this binary risk, the company has adopted a tactful operational strategy where the company aggregates single-tenant buildings with a focus on low correlation and portfolio construction, thus creating less volatile cash flows on an overall basis at the company

level[1]. Investors apply lower risk premiums to relatively less volatile cash flows, resulting in a higher price for the seller.



Thus, strategic aggregation of properties enables STAG Industrial to purchase 'mispriced' assets at a higher capitalization rate, resulting in a lower purchase price, and when required sell them at a lower capitalization rate, resulting in a higher selling price.

Mitigating Risk Through Diversification



As seen in the chart above[2], the company has consciously diversified its portfolio of properties across various geographies and industries. No geographic market accounts for more than 10% of STAG Industrial's ABR while no industry accounts for more than 13% of ABR. This helps safeguard the company against potential risks of default associated with a downturn in the economy of a specific state as well as an operational and/or financial crisis emerging in a particular industry.

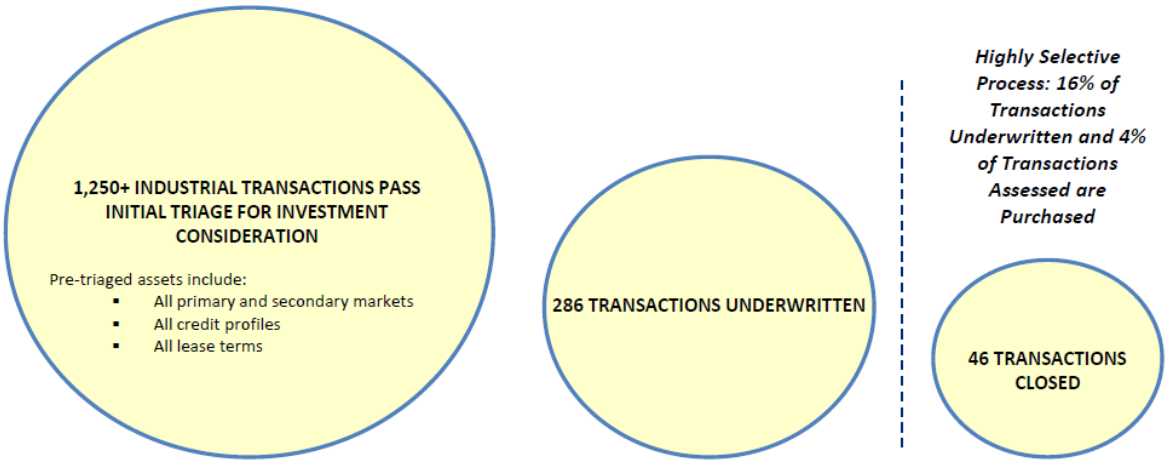
[1] STAG Investor Presentation Spring 2019
[2] STAG Investor Presentation Spring 2019

The company follows this strategy down to the individual tenant level, where no tenant accounts for more than 2.2% of ABR and the top 10 tenants cumulatively account for 11.5% of ABR. This is a significant improvement from 2011, when the top 10 tenants accounted for 33.2% of ABR. Diversification has however not come at the cost of low occupancy as 95% of the company's properties were leased as of Q1 2019. According to Stage management during the Q1 2019 earnings call:

"The tenants in our portfolio are both healthy and active. They continue to sign leases with significant rollups and elevated contractual rental escalators. After many consecutive quarters of net industrial demand exceeding new supply, the elevated supply is projected to potentially reverse that balance in 2019. However, it is important to note that this excess supply is isolated in a handful of large primary markets, and in some cases more specifically, certain submarkets within these markets. Supply remains constrained across the vast majority of markets and some markets in which STAG operates."

Disciplined Purchase and Selective Disposition

The company's inorganic growth model is a play on the riskiness of a property measured by the capitalization rate. The nature of the business model requires the company to conduct extensive research and exhaustive analysis to identify mispriced assets that can be acquired on an attractive risk-adjusted return basis. STAG Industrial uses a probabilistic risk assessment model for evaluation of cash flows on a risk-neutral basis and assets are assessed in the context of how they are positioned in and relative to other assets within the submarket they operate in. As seen in the chart below[3], while a fairly large number of assets pass the initial triage for investment consideration, very few make the cut for purchase after passing the company's strict evaluation criteria.



Even with its disciplined due diligence process, STAG Industrial remains confident in the strength of its acquisition pipeline and has provided a stabilized acquisition guidance of $700 - $850 million for the year 2019. Historically, the company has always been active in the M&A space and has

[3] STAG Investor Presentation Spring 2019

already made acquisitions worth $185 million in Q1 2019, which is the largest first quarter acquisition volume in the company's history.

As seen in the table below[4], the company has been opportunistic when it comes to disposition of assets and has historically made a positive return on investment from the sale of its properties.

LOCATION	SOLD	BUILDING SIZE (SF)	PURCHASE PRICE ($)	DISPOSITION PROCEEDS ($)	ABSOLUTE PRICE RETURN	UNLEVERED IRR
Gresham, OR	Q1 2016	420,690 SF	$14.3 million	$22.3 million	56%	17%
Orangeburg, SC	Q1 2016	319,000 SF	$4.6 million	$8.8 million	91%	38%
New Berlin, WI	Q2 2016	80,665 SF	$4.3 million	$5.9 million	37%	22%
Georgetown, KY	Q4 2016	96,680 SF	$3.8 million	$5.2 million	37%	13%
Pittsburgh, PA	Q4 2016	148,065 SF	$7.4 million	$9.3 million	26%	10%
Chicago, IL	Q4 2016	87,380 SF	$4.9 million	$5.8 million	18%	11%
Piscataway, NJ	Q3 2017	228,000 SF	$10.3 million	$17.8 million	73%	18%
Springfield, OH	Q3 2017	350,500 SF	$9.7 million	$11.0 million	13%	11%
Charlotte, NC	Q1 2018	491,025 SF	$20.1 million	$31.9 million	59%	14%
Longmont, CO	Q1 2018	159,611 SF	$13.9 million	$18.5 million	33%	12%
Charlotte, NC	Q2 2018	104,852 SF	$6.5 million	$7.5 million	15%	18%
Dallas, TX	Q3 2018	101,500 SF	$3.7 million	$6.0 million	62%	11%

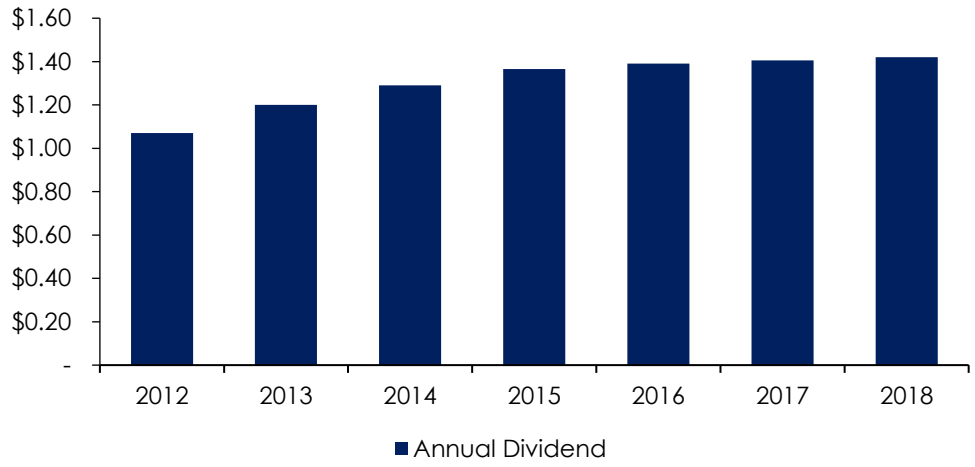
Growing Demand for Warehouses

Warehouses account for 83% of STAG Industrial's total number of properties. The demand for warehouses in the US has snowballed driven by the exponential growth of e-commerce. E-commerce currently accounts for 10% of US retail sales and is projected to grow to 23% by 2025. Warehouse occupancy rates are close to their peak levels and the pressure of increasing demand for warehouse space is expected to accelerate supply. For every $1 billion increase in e-commerce sales, an estimated 1.25 million sq. ft. of warehouse space is needed to keep up

[4] STAG Investor Presentation Spring 2019

with demand. Thus, e-commerce generated warehouse demand could grow by an additional 191.2 million sq. ft. from 2018 to 2020[5].

Dividend Safety



STAG Industrial was publicly listed in 2011, and its annual dividend has increased every year since. The company's dividend yield is significantly higher than the industrial REIT peer average.

Credit Worthiness of a Few Tenants is a Concern

Stag's focus on single tenant warehouses generally results in larger tenant sizes compared to a multi-tenant strategy. Due to the binary risk related to receipt of rent from these large tenants, the company has a dedicated credit team which conducts in-depth, initial and ongoing quantitative and qualitative analysis for each tenant and assigns every tenant an internal credit rating with daily to annual monitoring protocols. The team also maintains internal watchlists of tenants who are more likely to default in comparison to others.

TENANT PROFILE AS OF MARCH 31, 2019 [1]	
Number of Tenants	359
Average Tenant Size (Square Feet)	207,274
Average Annualized Base Rental Revenue Per Square Foot	$4.29
Average Annualized Base Rental Revenue Per Tenant ($000s)	$889

CREDIT PROFILE AS OF MARCH 31, 2019 [1]	
Tenants Publicly Rated	54.7%
Tenants Rated Investment Grade	30.4%
Tenant Revenue > $100 million	86.8%
Tenant Revenue > $1 billion	60.9%

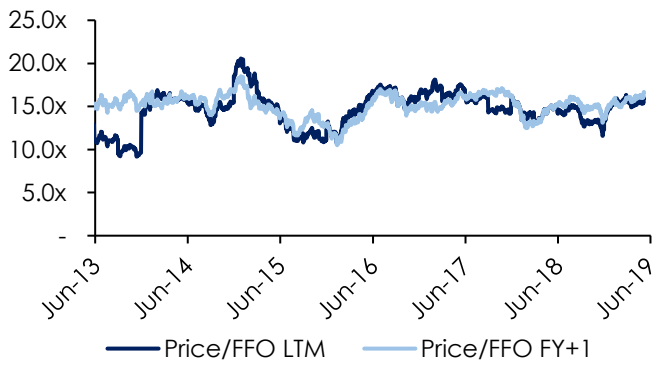
Even though the company has an effective credit monitoring policy, the company remains exposed to the risks associated with non-payment. As seen in the table above[6], only 30.4% of the company's tenant base have been rated investment grade by credit monitoring agencies. Additionally, 13% of the company's tenants have revenues less than $100 million, and thereby are more likely to not be able to cover their annualized base rent (which averages at ~$900 thousand per tenant at the company level) in times of distress.

[5] CBRE Research
[6] STAG Investor Presentation Spring 2019

STAG Industrial however, maintains a provision to account for possible losses due to default. According to management during the most recent Q1 2019 earnings call:

"During the quarter, we've received notice that Ditech, a tenant on our watch list operating in a non-core flex/office building, had formally rejected their lease in bankruptcy and has vacated their space. This specific tenant was on our watch list in Q4 2018, and this loss of income was factored into our credit loss guidance of 50 basis points for the year. We took an impairment charge of $5.3 million related to this non-core flex/office building during the quarter, and we plan to dispose of this asset this year. We continue to closely monitor our dynamic watch list and are currently not adjusting the 50 basis points of credit loss guidance for the year."

Valuation



	Price/FFO LTM	Price/FFO FY+1
Min	9.2x	10.5x
Max	20.6x	18.5x
Average	14.7x	15.2x
Current	16.0x	16.7x

As seen in the graph above[7], the company is currently trading at a P/FFO LTM and P/FFO FY+1, which is slightly above the historical average of the last 6 years. However, when compared to its industrial REIT peers, the company is trading at an attractive valuation[8].

FFO is expected to increase over the next couple of years, as seen in the table below[9], primarily driven by the company's strong acquisition pipeline.

At an average, analysts believe the stock is undervalued by 4%[10]. We share the market's opinion and believe that the higher cap rate used to discount the company's mispriced properties

Funds from Operations

FY Ending	Dec '17	Dec '18	Dec '19E	Dec '20E
Q1 (Mar)	0.41	0.43	0.45	0.47
Q2 (Jun)	0.41	0.45	0.45	0.48
Q3 (Sep)	0.43	0.45	0.46	0.48
Q4 (Dec)	0.44	0.46	0.47	0.49
Fiscal Year	**1.69**	**1.79**	**1.82**	**1.92**
P/FFO (x)	16.2	13.9	16.1	15.3

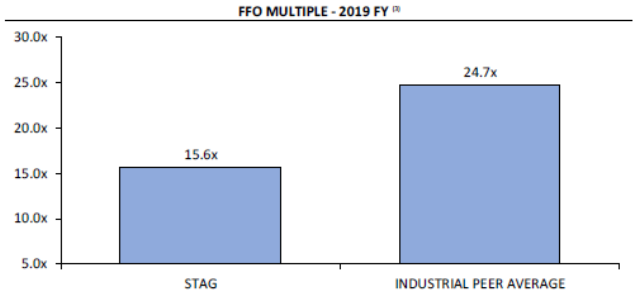
contributes to the undervaluation of the stock.

7 Factset

8 STAG Investor Presentation Spring 2019

9 Factset

10 Factset



Market Cycle Sensitivity

Worth mentioning, STAG has a higher sensitivity to the market cycle as compared to other REITs as measured by its beta risk (STAG's recent beta was around 1.0, whereas most REITs generally have betas below 1.0). This higher beta makes sense considering STAG operates in the industrial sector, especially considering the higher default risk for some properties during times of distress as a result of STAG's single tenant property approach. Relative to other REITs, this higher beta rightfully suggests that STAG may perform better than other REITs when the market is strong, but worse than other REITs when the market turns south. Nonetheless, we believe STAG's strategy of acquiring attractive single tenant higher cap rate properties and then diversifying away some of the risk by buying a lot of them across varying industries within their portfolio is attractive over the long-term.

Conclusion

STAG is an attractive industrial REIT with a big-dividend yield and the potential for higher growth due to its higher cap rate properties relative to other industrial REITs. However, the higher cap rate comes at the cost of higher volatility and beta risk, whereby STAG would likely sell-off more than other REITs during times of market distress thanks to its single tenant strategy. STAG is basically a higher-octane REIT compared to many of its peers, and thanks to its strategy we have ranked it #10 in our recent report, **Top 10 Big-Dividend REITs Worth Considering**. If you are looking for a little more income and growth power from a REIT to add to your diversified income-focused portfolio, STAG is worth considering as a long-term investment.