National Retail Properties (NNN)

Updated April 20th, 2018 by Aristofanis Papadatos

Key Metrics

Current Price:	$39	**5 Year CAGR Estimate:**	7.4%	**Quality Percentile:**	N/A
Fair Value Price:	$36	**5 Year Growth Estimate:**	4.0%	**Momentum Percentile:**	N/A
% Fair Value:	108%	**5 Year Valuation Multiple Estimate:**	-1.5%	**Total Return Percentile:**	N/A
Dividend Yield:	4.9%	**5 Year Price Target**	$44	**Valuation Percentile:**	N/A

Overview & Current Events

National Retail Properties is a REIT that owns single-tenant, net-leased retail properties. It owns more than 2,700 properties across 48 states. The REIT is focused on retail customers because the latter are much more likely to accept decent rent hikes in order to avoid switching locations and losing their customer base. Thanks to this strategy, NNN has offered consistent growth with markedly low volatility. At the moment, its lease contracts have an average remaining duration of 11.5 years, with only 4.6% of the leases expiring until the end of next year. NNN is also characterized by markedly high occupancy rates. Its 15-year low occupancy rate is 96.4% while its current rate is 99.1%.

In its last earnings report, in February, NNN reported record annual funds from operations (FFO) and raised its dividend for a 28th consecutive year. There are only two other REITs that have such a long dividend growth record. Therefore, this is a testament to the quality of its assets and the strength of its strategy and its execution.

On the other hand, NNN has slumped 26% since it peaked almost two years ago. The major reason behind its plunge is the environment of rising interest rates. As interest rates had remained near record-low levels for years, most REITs had rallied to overvalued levels. However, now that the Fed has begun to raise the interest rates aggressively, the valuation of REITs has come under pressure.

Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
FFO	$1.99	$1.61	$1.31	$1.57	$1.74	$1.93	$2.08	$2.22	$2.41	$2.52	***$2.62***	***$3.19***
DPS	$1.48	$1.50	$1.51	$1.53	$1.56	$1.60	$1.65	$1.71	$1.78	$1.86	***$1.94***	***$2.34***

It is more practical to focus on funds from operations (FFO) instead of earnings per share (EPS) with REITs, as the EPS include non-cash items, such as depreciation. NNN has more than doubled its FFO since 2008 but it has also doubled its share count in order to fund its acquisitions of properties. As a result, the REIT has grown its FFO per share by only 3.1% per year on average since 2008. While the negative effect of the extensive dilution on the growth rate is prominent, the dilution also has another, less obvious effect; it has greatly increased the financial burden of the dividend on the REIT. For instance, while the dividend per share has grown only 16% since 2013, the total amount that the REIT spends on dividends has jumped 45%, from $217 M to $315 M.

The management has provided guidance for 4% growth in the FFO per share for this year. Given that the REIT grew its FFO per share at approximately this rate last year, it is reasonable to rely on this guidance. The REIT had grown its FFO per share at a 7.7% average annual pace in the last five years but the rising rates are likely to limit this growth. Moreover, a recession may show up in the U.S. in the next five years amid rising interest rates and given its absence for nine years in a row. Therefore, it is prudent to assume 4% FFO growth for the next five years, from $2.62 this year to $3.19 in 2023.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/FFO	10.0	11.2	11.7	13.6	14.9	13.2	16.4	15.4	16.7	14.8	***14.9***	***13.8***
Avg. Yld.	7.4%	8.3%	6.4%	6.0%	5.4%	4.7%	4.6%	4.4%	3.8%	4.4%	***4.9%***	***5.3%***

Thanks to the record-low interest rates that prevailed for years, NNN enjoyed a lofty valuation until it peaked, almost two years ago. However, now that the interest rates are on the rise, the stock has lost 26% off its peak. Even worse, its current P/FFO of 14.9 is still higher than its 10-year average ratio of 13.8. As it is reasonable to expect the P/FFO ratio to revert towards its average level until 2023, the stock is likely to incur a 1.5% annualized drag in the next five years due to the contraction of its P/FFO ratio.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
GP/A	8.6%	8.9%	7.7%	7.1%	7.9%	8.4%	8.5%	8.5%	8.1%	8.6%	***8.6%***	***8.5%***
Debt/A	41.8%	39.6%	43.7%	41.7%	42.4%	37.7%	37.3%	38.8%	38.2%	41.5%	***42.0%***	***44.0%***
Int. Cov.	2.7	1.9	2.1	2.2	2.5	2.8	3.3	3.3	3.3	3.1	***3.1***	***3.0***
Payout	74.4%	93.2%	115%	97.5%	89.7%	82.9%	79.3%	70.0%	73.9%	73.8%	***74.0%***	***75.0%***
Std. Dev.	70.4%	55.5%	24.7%	22.0%	12.4%	23.1%	15.6%	20.1%	20.8%	18.3%	***19.0%***	***20.0%***

NNN has a healthy balance sheet, with a BBB+ debt rating. Its debt maturities are well-laddered and only $303 M of debt matures until 2021. As a result, the REIT can navigate through the current environment of rising interest rates while it will also be able to remain profitable whenever the next recession shows up. On the other hand, NNN is significantly affected by recessions. In the Great Recession, its FFO per share plunged 34%, from $1.99 in 2008 to $1.31 in 2010. Nevertheless, given that the financial crisis was triggered by the bubble in the housing market, the performance of the REIT in that crisis was satisfactory. However, investors should keep in mind that its downside potential will be significant whenever the next recession shows up, particularly given its current rich valuation.

Final Thoughts & Recommendation

Although NNN has lost 26% off its peak, its valuation is still rich, particularly given the rising interest rates. Therefore, in the next five years, the stock is likely to incur a 1.5% annualized drag due to compression of its valuation. On the other hand, the stock will also offer 4% growth in its FFO per share and a 4.9% dividend, for a total annual return of 7.4%. Given the meaningful downside risk of the stock and its negative momentum, investors should probably wait for a better entry point.

Total Return Breakdown by Year