AvalonBay Communities Inc. (AVB)

Updated August 8th, 2019 by Samuel Smith

Key Metrics

Current Price:	$206	**5 Year CAGR Estimate:**	2.1%	**Volatility Percentile:**	8.3%
Fair Value Price:	$168	**5 Year Growth Estimate:**	3.0%	**Momentum Percentile:**	78.3%
% Fair Value:	123%	**5 Year Valuation Multiple Estimate:**	-3.9%	**Growth Percentile:**	15.0%
Dividend Yield:	3.0%	**5 Year Price Target**	$195	**Valuation Percentile:**	24.2%
Dividend Risk Score:	F	**Retirement Suitability Score:**	D	**Total Return Percentile:**	11.0%

Overview & Current Events

AvalonBay Communities (AVB) is a $28.5 billion multifamily REIT that owns a portfolio of 270 apartment communities with over 73,500 units, and is developing 18 additional properties with over 7,200 units. The company's strategy consists of owning top-tier properties in the major metropolitan areas of New England, New York/New Jersey, Washington D.C., California, and the Pacific Northwest. It was formed by the 1998 merger of Avalon Properties with Bay Apartment Communities and has raised its dividend for seven consecutive years.

AvalonBay reported solid Q2 results on 7/31/19. Occupancy in the established portfolio rose by 10 basis points to 91.1%. Rental rate growth also came in at a solid 3.2% clip. Operating expense growth was 4.2%, however, which was a disappointment and resulted in net operating income growth that underwhelmed rental rate growth at 2.8%. Interest and general and administrative expenses also grew during the quarter, further pressuring profits. Core FFO was $2.27 and, despite the higher costs, the full year guidance midpoint was raised by $0.05 to $9.35.

Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
FFO	$3.89	$3.98	$4.64	$5.43	$6.23	$6.78	$7.55	$8.19	$8.62	$9.00	***$9.35***	***$10.84***
DPS	$3.57	$3.57	$3.57	$3.88	$4.28	$4.64	$5.00	$5.40	$5.68	$5.88	***$6.08***	***$7.22***
Shares	81	85	91	98	127	131	135	137	138	138	***138***	***140***

Over the past decade, AvalonBay generated very impressive annualized Core FFO/share growth of ~9.75% thanks to its growing scale and strong rental rate growth. However, this growth rate has slowed dramatically in recent years, coming in at 5.5% in 2017 and just 4.4% in 2018. This year should see this slowdown continue, with a 3.3% growth rate projected. This is due to rising margin pressures, thanks to inflation and plenty of competing new supply hitting key markets. AvalonBay also faces the threat of future rent control legislation in its West Coast markets, as this was already on the ballot in the 2018 mid-term elections. On the plus side, development spending is projected to rise in 2019 for AvalonBay and NOI and OpEx comps are expected to be steady, implying we are near a trough in the growth rate. As a result, we are projecting a 3% growth rate over the next five years. We expect the dividend to slightly outgrow FFO/share during this time span due to the low 65% payout ratio, as well as management's penchant for doing so in recent years as well. As a result, we think the dividend will grow at about a 3.5% rate.

Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/FFO	21.4	28.5	28.9	25.3	18.2	19.0	24.2	21.8	20.7	19.2	***22.0***	***18.0***
Avg. Yld.	4.3%	3.2%	2.2%	2.8%	3.6%	2.8%	2.7%	3.0%	3.2%	3.4%	***3.0%***	***3.7%***

The recent valuation multiple has hovered at or above 20x Core FFO/share, and the dividend yield has ranged between 2.7% and 3.4%. However, as discussed previously, the abundant new supply reaching markets combined with increasing inflationary pressures on margins - not to mention a challenging acquisition climate due to compressed cap rates – will lead to continued slowing growth. Therefore, the stock will warrant a low valuation multiple and a higher dividend yield.

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Therefore, we expect a fairly steep contraction in the valuation multiple towards 18x. This number is not without precedent either as it was seen back in 2013-2014, during a period in which the company's growth rate slowed.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout	91.8%	89.7%	76.9%	71.5%	68.7%	68.4%	66.2%	65.9%	65.9%	65.3%	***65.0%***	***66.6%***

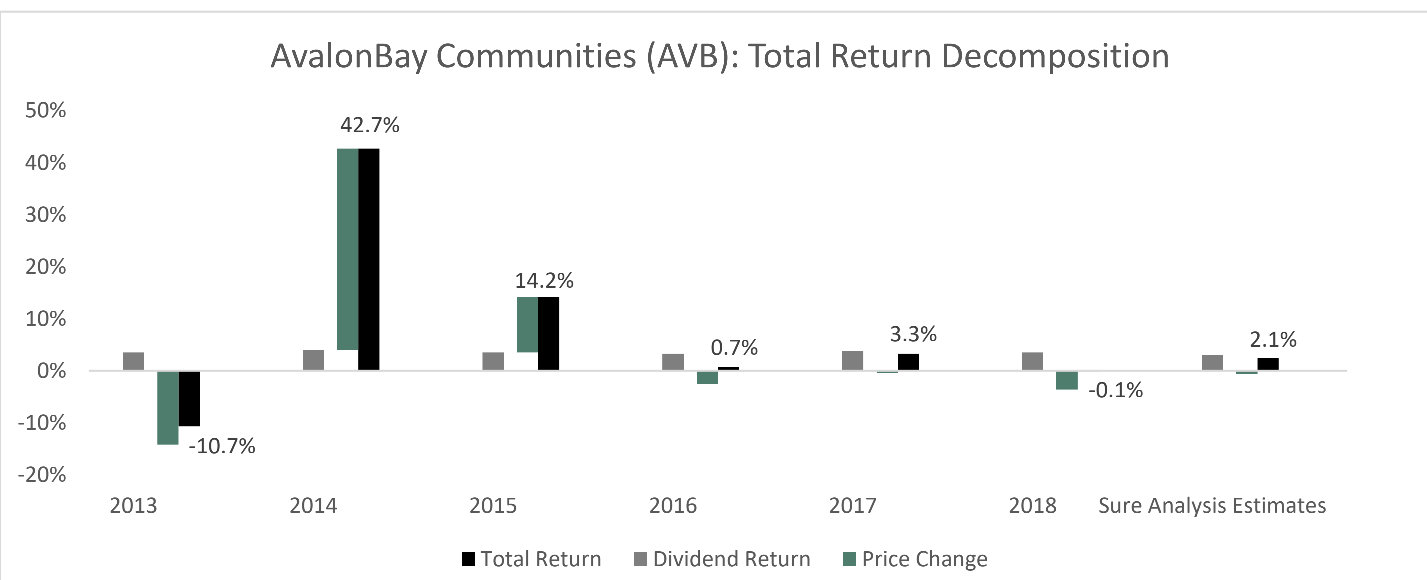
AvalonBay significantly outperformed the S&P 500 during the Great Recession due to the defensive nature of the multifamily sector. However, it still experienced a sizable decline in FFO/share (from $4.61 in 2007 down to a low of $3.89 in 2009). Additionally, multifamily apartments lack a strong competitive advantage due to the ease of creating new supply, as well as the alternative sources of affordable housing in large metropolitan areas in which AvalonBay operates. Given that, AvalonBay's investments are essentially plays on the economic strength of its core markets. Furthermore, the fact that most of its assets are high-quality "A" apartment units makes it even more levered to the state of the economy, as these apartments are in high demand during strong economic conditions, but are less affordable during a recession. AVB does have considerable economies of scale, low cost of capital, operational and marketing expertise, and a brand name advantage, which enable it to compete effectively against competitors.

The trust's balance sheet is also very strong, as its sector-leading A- credit rating makes clear. With nearly $1.75 billion in liquidity at the end of 2018, a fairly low Net Debt-to-EBITDA of 4.6x, and a mere 65% payout ratio, AvalonBay has plenty of resources to invest in its development projects and sustain the dividend during a downturn while also reacting opportunistically to opportunities that may become available.

Final Thoughts & Recommendation

AvalonBay has an excellent track record and a stellar balance sheet. That being said, its dividend yield is quite low (3%) and its growth rate has been slowing considerably over the past several years, with further slowing projected for this year (3% expected annual growth over the next half decade). Without a strong moat protecting its earnings power and the economy appearing poised for a general slowdown, AvalonBay appears overpriced at this time and likely to deliver underwhelming (2.1% annually) total returns over the next several years once we factor in expected FFO multiple contraction of 3.9% per year. We view the stock as a sell at current prices.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue	830	843	900	1001	1463	1685	1856	2045	2159	2285
Gross Profit	502	509	564	644	952	1096	1214	1362	1433	1522
Gross Margin	61%	60%	63%	64%	65%	65%	65%	67%	66%	67%
SG&A Exp.	29	27	29	34	40	41	43	46	51	56
D&A Exp.	218	221	227	244	560	443	478	531	584	N/A
Operating Profit	269	261	308	366	352	612	693	785	798	834
Operating Margin	32.4%	31.0%	34.2%	36.6%	24.1%	36.3%	37.3%	38.4%	37.0%	36.5%
Net Profit	156	175	442	424	353	684	742	1034	877	975
Net Margin	18.8%	20.8%	49.1%	42.4%	24.1%	40.6%	40.0%	50.6%	40.6%	42.7%
Free Cash Flow	-210	315	379	514	698	834	1019	1087	1182	N/A

Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Assets	7458	7821	8482	11160	15328	16141	16931	17867	18415	18380
Cash & Equivalents	106	304	617	2734	281	509	401	215	67	92
Total Liabilities	4402	4492	4080	4319	6728	7094	7091	7696	8027	7748
Accounts Payable	50	34	37	53	95	102	99	101	85	N/A
Long-Term Debt	4009	4007	3599	3851	6134	6490	6457	7031	7329	7040
Shareholder's Equity	3050	3311	4395	6837	8596	9046	9841	10171	10388	N/A
D/E Ratio	1.31	1.21	0.82	0.56	0.71	0.72	0.66	0.69	0.71	N/A

Profitability & Per Share Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Return on Assets	2.1%	2.3%	5.4%	4.3%	2.7%	4.3%	4.5%	5.9%	4.8%	5.3%
Return on Equity	5.2%	5.5%	11.5%	7.5%	4.6%	7.7%	7.9%	10.3%	8.5%	N/A
ROIC	2.3%	2.4%	5.8%	4.5%	2.8%	4.5%	4.7%	6.2%	5.0%	N/A
Shares Out.	81	85	91	98	127	131	135	137	138	138
Revenue/Share	10.30	9.96	9.92	10.21	11.50	12.84	13.79	14.88	15.63	16.52
FCF/Share	-2.61	3.72	4.18	5.25	5.48	6.35	7.57	7.91	8.56	N/A

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.