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FedEx's little friend

Monmouth Real Estate Investment Corp. (MNR on the New York Stock Exchange) is a small REIT with a big dividend. Its story—featuring growth in e-commerce, the widening of the Panama Canal and the gift of scrawny interest rates—is the subject under discussion. To jump the gun, we're bullish.

"Fiscal 2014 was a good year for Fed Ex," Alan B. Graf Jr., FedEx Corp.'s executive vice president and chief financial officer, was quoted as saying in the company's June 18 earnings release, "and we expect fiscal 2015 to be even better." Monmouth, owner of industrial warehouse space that fits the age of digital retailing to a "t," not surprisingly sees the future in much the same cheerful vein as FedEx does. Some 42% of Monmouth's gross leasable space is tenanted by FedEx, including 28% by FedEx Ground, the domestic, truck-borne segment of Fred Smith's global delivery service.

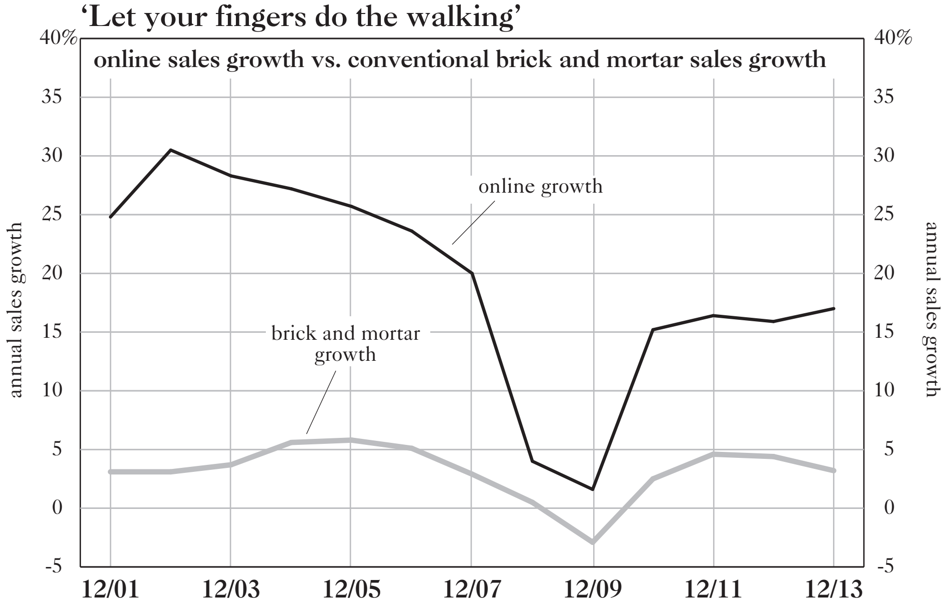
There was evidently no such business plan when Monmouth went public in 1968. The future CEO of the future FedEx was 24 years old, there was no e-commerce and the 10-year Treasury fetched 5.65%. Monmouth, founded by the father of the REIT's two currently serving senior officers, built and leased industrial real estate, pure and simple.

Forty-six years after its founding, Monmouth commands an equity market cap of $530 million and enterprise value (add debt and preferred to equity and subtract cash) of slightly more than $900 million. Considering the relatively large number of years and the relatively small sum of dollars, you may wonder what the business has been doing with itself all this time. No need to wonder about the past decade, though. Since June 2005, Monmouth shares have generated a total return of 128%, or 9.6% per annum. They have outperformed not only the MSCI US REIT Index, which has appreciated at an annual rate of 7%, but also the equity of the mighty FedEx, which has delivered but 6.6% a year.

Monmouth's letter to shareholders in the 2013 annual report, co-written by Eugene Landy, chairman of the board, and Mike Landy, president and CEO, talks about "our longevity in the cyclical asset class of commercial real estate." It mentions the company's unusual specialty in "single tenant, net-leased industrial properties on long-term leases to investment grade tenants." And it adds this: "When you purchase a share of stock in our company, you are effectively purchasing a fractional interest in the real estate that we own and manage. We do not have any off-balance sheet joint ventures. We do not have a development division, and we do not carry a large amount of non-income producing land on our balance sheet. What we do have is simply one of the best quality industrial property portfolios available in the public arena today."

As for Monmouth's diminutive size, observes colleague David Peligal, "let's just say that management has been very methodical about its business strategy. Since it focuses on long-term, net-leased industrial properties, leased overwhelmingly to investment-grade tenants, it has necessarily been

'Let your fingers do the walking'



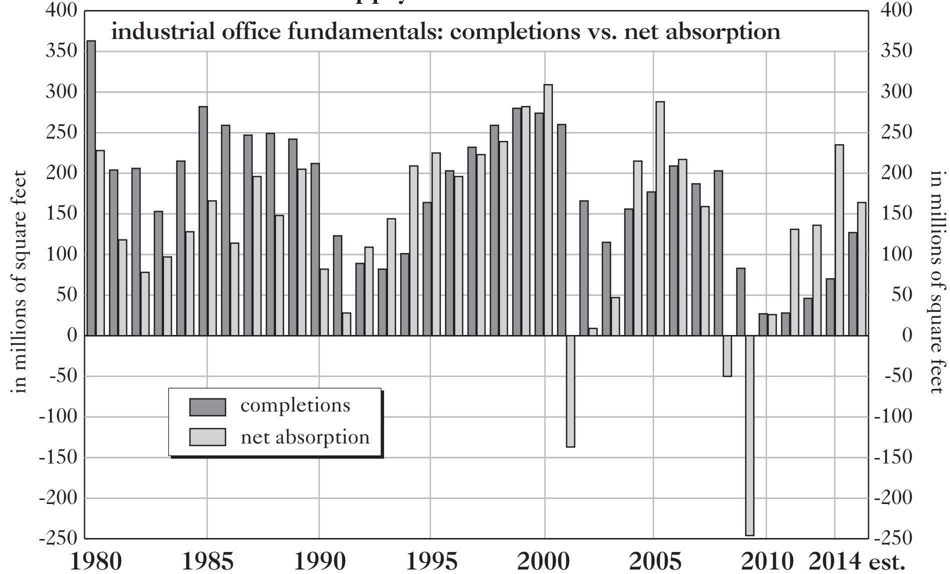
sources: CoStar Portfolio Strategy, U.S. Department of Commerce picky. In addition to FedEx, the roster includes Anheuser-Busch, Coca-Cola, Home Depot and Sherwin-Williams. This results in high-quality income streams that are reliable and predictable over the long term. During the credit crisis, Monmouth's occupancy never dipped below 95% and its dividend was never cut." Today's dividend yield towers at 6.3%.

Industrial REITs, like the office-building kind, are beneficiaries of the post-crisis drought in construction. Industrial REITs, unlike their office brethren, are heirs to the growth in direct-to-customer retailing. E-commerce sales may represent no more than 7% of U.S. retail turnover, but they're growing at double digits. "The contrasting results of Cyber Monday and Black Friday in 2013," according to a CBRE report on U.S. industrial real estate from May, "illustrates the degree to which e-commerce is changing the retail landscape and consumer behavior. Cyber Monday online sales totaled a record $2.3 billion, up 21% from 2012. Meanwhile, sales on Black Friday saw their first decline since 2009, dropping 2.9% compared to 2012."

Monmouth's warehouse assets, which are concentrated in Texas, Florida and up the eastern seaboard, may also stand to gain from the expansion of the work that Teddy Roosevelt thought was finished a century ago. "With the expanded Panama Canal, set for completion in the second half of 2015," Mike Landy tells Peligal, "we're going to see a wider array of our ports handling the goods flowing in and out of the country. Overall demand for industrial space will increase as a result of this because the Canal expansion represents a major enhancement to the entire global supply chain. The global supply chain will become less dependent on our western ports, which are increasingly becoming a bottleneck. We're going to see more goods moving through the Gulf of Mexico and up the eastern seaboard as the expanded Canal comes online. This will especially benefit Monmouth given our geographic footprint."

The inventory of American industrial warehouses measures 12.8 billion square feet. It would surely be larger today except for the post-crisis credit brownout. As a rule, industrial construction responds quickly to changes in business conditions; start to finish,

Demand outruns supply



source: CBRE Econometric Advisors

the construction cycle spans 12 to 18 months. Over the past five years, warehouse capacity has shown average growth of 50 million square feet a year. To accommodate economic growth and building obsolescence alike, more like 150 million square feet a year would have been needed.

Then, again, pinched supply supports rising rents. While industrial rents nationally have risen by only 50 cents from the 2011 bottom, to a little under $5.50 per square foot, the next couple of years may smile on the landlords. "Clearly," Peligal observes, "upon lease renewal, you can generate rent growth, and 10% of Monmouth's assets roll each year. In addition, Fed Ex is expanding a lot of properties, and that expansion results in additional lease term and higher rents."

Peligal asked the CEO for his thoughts. "While industrial is known to be a slow grower as far as same-store growth in net operating income," Landy replied, "what's good about industrial is the stability of the income streams. You tend to have lower volatility in occupancy and earnings, and therefore very predictable income streams. But the biggest point going forward is that we're not building shopping centers and we're not building malls in the U.S. anymore. Consumer spending, the lion's share of our nation's economy, is migrating from Main Street to cyberspace and we're seeing tremendous demand for industrial properties as a result of this secular shift. It's a game changer if ever there was one. Therefore, looking at rental-rate trends in the past is not as relevant in considering the potential increases going forward. Going forward, the bigger driver in total returns may not come from the income component but in the rise in property values. Commercial real estate is known to be one of the best safe harbors in an inflationary environment and with the industrial property sector becoming the new retail sector, we are anticipating appreciation well in excess of inflation."

Landy, 52, who succeeded his father at the head of the company early in 2013, is bringing a zest for growth to the job. In the five years ended in 2015, Monmouth expects to have doubled its size through the acquisition of brand-new, Class A, build-to-suit properties. As might be imagined, investing in net-leased industrial properties is very much a yield spread business.

Peligal asked about interest rates. "In our first quarter of fiscal 2014, which began on Oct. 1, we did $74 million in new acquisitions," Landy said. "Our average cap rate was 7.4%, while the average interest rate was 3.95%. So we were getting a 345 basis-point spread. A 345 basis-point spread is highly accretive, and it enabled us to grow our earnings per share by 26% year-over-year. We've been at this for 46 years, and I can tell you that over that period the normal range is a 200 basis-point spread. The normal numbers, historically, are you borrow at 6%, you invest at 8%, resulting in a 200 basis-point spread. Now, interest rates have recently been going back up and cap rates have continued to come down, and therefore investment spreads have contracted accordingly. However, because Monmouth has approximately $222 million in new acquisitions under contract that we'll be closing over the next six quarters, we have been able to lock in a 270 basis-point spread thus far. While this is not the substantial 345 basis-point spread we saw in the first quarter, it is still 70 basis points above the historic norm, and it is still highly accretive."

Debt was the next item on the agenda: Peligal invited the boss to extoll his balance sheet. "On each individual new acquisition, we can apply 65-70% leverage," Landy replied. "Because these loans are fully amortizing, usually over a period of 10 to 15 years, coupled with the fact that many of our existing properties are owned free and clear, Monmouth's overall leverage is only 30%. It's a very holistic approach to financing our assets in this way, as we're paying down $30 million to $35 million in principal every year, and we're ending up with properties that we own free and clear. We have been building up our unencumbered asset pool as the ratings agencies like to see a substantial amount of gross assets unencumbered. With 87% of our revenue derived from investment-grade tenants, one of our goals is to achieve an investment-grade rating ourselves."

It's a winning story, but Monmouth trades at a discount. The symbiotic relationship with FedEx is one reason why. Size introduces a host of other difficulties: The shares trade only a few million dollars' worth a day, research coverage is sparse, the weighting in the MSCI US REIT Index is low, etc. "Monmouth's 6.3% dividend yield is not just high," Peligal observes, "it is shockingly high given the excellent quality of Monmouth's assets. Prologis (PLD on the NYSE) trades with a 3.2% dividend yield, Duke Realty (DRE on the NYSE), at a 3.8% yield. STAG Industrial (STAG on the NYSE), a $1.5 billion market-cap company, is perhaps most similar to Monmouth since it also focuses on single-tenant, net-leased industrial properties. STAG, which went public in 2011 and whose top 10 tenants account for only a little more than 16% of its net operating income, trades at a 5.5% dividend yield.

"A bull on Monmouth must hope that FedEx, or at least the Monmouth-FedEx relationship, never steps in front of a bus," Peligal winds up. "Then, again, management owns roughly 15% of the company. In a yield-starved world, and with the perception of the company slowly starting to change (as evidenced by that 26% surge in earnings growth), Monmouth might be getting a little better with age."

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