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INNOVATIVE
Industrial Properties

Innovative Industrial Properties - IIPR (7/10/19)

Description: Innovative Industrial Properties Inc. is a self-advised Maryland corporation focused on the acquisition, ownership and management of specialized industrial properties leased to experienced, state-licensed operators for their regulated medical-use cannabis facilities. Innovative Industrial Properties is a real estate investment trust that was founded in December 2016.

Ticker: IIPR
Price: $132.29
Market Cap: $1.30B
Performance: +194.4% YTD

Analysis

IIPR is without a doubt the best performing REIT this year and much, if not all, of that has to do with the company capitalizing on an industry before others. The stock is up nearly 200% YTD and 640% since going public in late 2016.

IIPR is the only public marijuana focused REIT on the markets right now and they simply play landlord to the marijuana growers which is what makes this such a unique and attractive investment. Here's how it works: IIPR buys freestanding properties from medical marijuana growers licensed by their respective states. It then leases the properties back to the growers. This gives those growers an infusion of capital to expand their operations and increase production. In return, the REIT receives regular rent payments under a long-term lease with is usually NNN (Triple Net). If you haven't read our other REIT reports, NNN leases are ones in which the landlord doesn't really do anything but collect rent. The landlord does not pay for any kind of maintenance or repairs or anything and simply sits back and collects the monthly check.

What makes IIPR also very compelling is that most of their properties are obtained on the following terms:

- Targeted deal size is $5 million to $30+ million
- Additional expansion capital available
- Lease term – 10 to 20 years
- Initial base rent – 10% to 16% on total investment (based on property underwriting)
- Annual base rent escalations – 3% to 4.5%
- Security deposit and corporate guaranty based on credit underwriting
- Transaction timeline – closing 30 to 60 days from signed purchase and sale agreement

IIPR is able to grab 10-16% returns on capital and as of their last quarter were able to average 14.7%. This means that after approximately 7 years, the property is paid for in whole by the rent. Furthermore, they're able to bump *rent up 3.0-4.5% every year.*

Innovative Industrial Properties	Financial Statistics
Annualized base rent, including property management fees as of 6/21/19[1]	$42.0 million
Capital raised (net proceeds), including equity and exchangeable notes	$407.0 million
Capital committed/invested[2]	$286.8 million
Current yield on invested capital as of 6/21/19[3]	14.7%
Debt to total gross assets[4]	33.8%
Annualized common stock dividend per share[5]	$2.40
Long-term targeted dividend payout ratio	75 to 85% of AFFO[8]
Shares of common stock outstanding[6]	9,806,194
Estimated 2019 cash general and admin. expense[7]	$5.5 – $6.5 million
Common stock ownership (directors and officers)[6]	5.2%

As of June 24th, the company invested about $287M and they are showing zero signs of slowing down. Since January 1, 2019, IIPR has acquired eight properties in three states, representing an aggregate investment of approximately $74.8 million, which includes committed capital that IIPR expects to deploy for the completion of development, redevelopment or tenant improvements at certain properties.

Innovative Industrial Properties	Portfolio Statistics (as of 6/24/19)
Properties	22
Rentable Square Feet(1)	1,658,000
States	Arizona, California (6), Colorado, Illinois, Maryland, Massachusetts (2), Michigan (2), Minnesota, New York (2), Ohio (2) and Pennsylvania (3)
Total Invested Capital(2)	$286.8 Million
Average Yield on Invested Capital(3)	14.7%
% Leased	100%
Weighted Average Lease Length (4)	Approximately 15.3 years

Just yesterday, IIPR acquired their 23rd property, a 145K-square-foot industrial space in Lansing, MI, for $4.8M and entered into a long-term triple-net lease agreement with a subsidiary of Ascend Wellness Holdings.

As far as numbers go, those are moving in the same direction:

- IIPR generated rental revenues of approximately $6.6 million in the latest quarter, representing a 146% increase from the prior year's first quarter.
- IIP recorded net income available to common stockholders of approximately $3.3 million for the quarter, or $0.33 per diluted share, and adjusted funds from operations of approximately $5.3 million, or $0.54 per diluted share. AFFO represented an increase of *275% from the prior year's first quarter*
- IIPR paid its eighth consecutive quarterly dividend of $0.45 per share on April 15, 2019 to common stockholders of record as of March 29, 2019, representing an approximately 29% increase from IIP's fourth quarter 2018 dividend and an *80% increase over the first quarter 2018's dividend.*
- IIP's operating partnership subsidiary completed a private offering of $143.75 million aggregate principal amount of 3.75% exchangeable senior notes due 2024,

At this point, it makes so much sense for IIPR to keep borrowing money at 3.75% if they can turn around and buy a property that will pay them 14.7% every year. Lower rates for

longer will only serve as a tailwind for IIPR and other REITs. With AFFO rising 275% Y/Y, IIPR is in full-blown growth mode.

According to analysts, demand is just getting started. For example, the ArcView Group believes sales of state-regulated cannabis in the United States are expected to grow from $8.6 billion in 2017 to $22.2 billion in 2022. States have authorized numerous medical conditions as qualifying conditions for treatment with medical-use cannabis, which may include, among others, treatment for cancer, glaucoma, HIV/AIDs, wasting syndrome, pain, nausea, seizures, muscle spasms, multiple sclerosis, post-traumatic stress disorder (PTSD), migraines, arthritis, Parkinson's disease, Alzheimer's, lupus, residual limb pain, spinal cord injuries, inflammatory bowel disease and terminal illness. ProCon.org estimates that, as of May 2018, an estimated 2.1 million people were registered as patients in states with regulated medical-use cannabis programs. From the look of it, this trend will only continue upwards and perhaps even at a faster pace.

The Chairman, Alan Gold, is someone we are also a fan of. He has extensive experience in REITs and was previously the CEO & Chairman of BioMed Realty (formerly BMR) who sold the company to Blackstone (BX) for $8B back in 2016. He was also the Co-founder and President of Alexandria Real Estate Equities (ARE) which is valued today at $17.4B.

While it looks like everything is positive there are some downsides.

Risks involved:

1. If marijuana becomes completely legal everywhere, these growers will have much more access to capital and therefore won't need to pay such a high cap rate to IIPR as banks and other lenders doors open and cheaper capital enters. Plus, competition will enter the space with much less risk knowing growers will be around for the long haul. We have to keep in mind that what IIPR is doing right now is buying the properties from the medical growers themselves. Whether the property is being bought at the going market price or above is hard to say but in a way there is a serious possibility that IIPR is buying the properties for more than they are worth as a means of loaning more money to the growers that need that capital and are willing to pay it via rent. This is pure speculation and at the same time power to them if they are!
2. On the flipside, if marijuana turns around and becomes completely illegal, growers close up shop, and IIPR is forced to use their units as normal industrial properties with considerably less returns. As opposed to a 15% ROIC, IIPR may be looking at 1/3rd of that with normal tenants.
3. IIPR is pricey at its current valuation. Adjusted funds from operations is expected to be around $2.40 which puts IIPR at about 55x AFFO while the average REIT is in the lows 20s.

4. Over time, the 15% ROIC will have to come back down to Earth as it's simply unsustainable. Either growers will find that it's too difficult to pay or competition comes in and the pushes the ROIC down considerably as the spread at which IIPR is borrowing and making money with is extremely high.
5. Let's assume regulation remains constant. Are the growers even able to sustain themselves right now? According to SEC filings from IIPR, *"Many of our existing tenants are, and we expect that most of our future tenants will be, start-up businesses that have little or no revenue when they enter triple-net leasing arrangements with us and therefore, may be unable to pay rent with funds from operations. Many of our current tenants are not profitable and have experienced losses since inception, or have been profitable for only a short period of time. As a result, many of our current tenants have made, and we expect that most our future tenants will make, initial rent payments to us from proceeds from the sale of the property, in the case of sale-leaseback transactions, or other cash on hand."* The company is young and does have a 100% occupancy rate to-date, perhaps this could change in the future as the cash from the proceeds of the sale of the property for growers dwindles down.
6. Due to the high price, the yield of 1.7% isn't too competitive as others easily pay well over double that

Technical Analysis

If we look at the chart above, the stock is consolidating and the bears are putting up a fight for the first time in a while. What's happening here is the stock has resistance at $132.50 and some support at $119. If either one breaks it will most likely gain momentum in the continued direction. A break above $132 could cause the stock to approach its next fibbonaci extension level which is $146.54. A break below $119 could see the next fibbonaci retracement level of $114.14. Right now, there is a tug of war going on and if you look at the two diagonal lines I made, it is going to either break upwards or downwards soon as the trading range has been getting tighter and tighter before the eventual breakout.

Looking at the chart above here we see that on RSI and W%R, the stock is considered overbought but not so much on the MFI. Since volume has been a bit weaker as of late, I'm siding with a greater possibility of a near term pullback vs. another leg higher in the short-term. In order to break this long-term trend, the stock would have to plummet which probably won't happen at this point in time for a couple of reasons. One, the company is growing rapidly and any future announcements of acquired properties will add fuel to the fire and secondly the craze behind an alternative way of playing marijuana is something that many investors will support.

Right now, I think there will be a short-term pullback followed by a continued move higher if the company continues to execute on their growth story. The stock is pretty expensive right now and is also much riskier than your standard REIT as there are a ton of uncertainties around regulation and the quality of their tenants but it could definitely fit in nicely as a piece of a larger REIT portfolio as it will help diversify holdings with not only growth but a completely different business segment.