HCP, Inc: A Healthcare REIT For My Dividend Growth Machine

Aug 9 2013, 04:49 | 89 comments by: Dividend Growth Machine | about: HCP

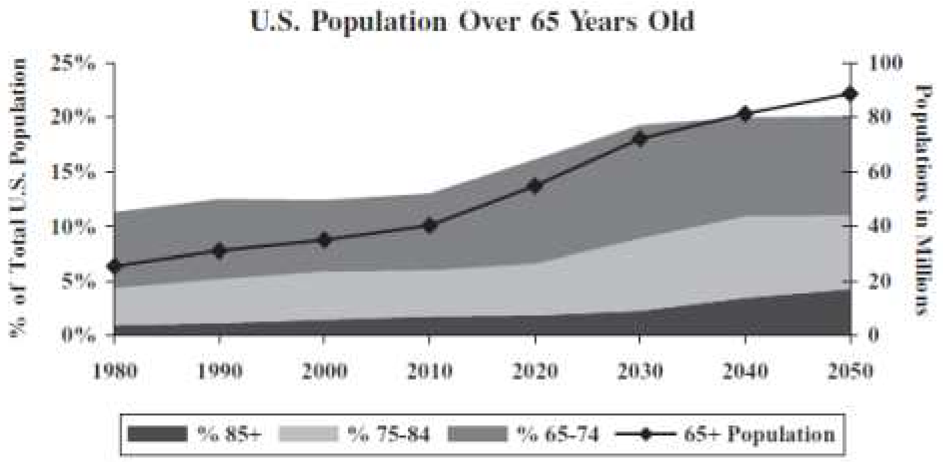
Disclosure: I am long HCP. **(More...)**

Introduction

My primary goal as a dividend growth investor is to build a sustainable and rising stream of dividend income that will eventually enable me to be financially independent. I plan to achieve this goal by regularly investing new capital in attractively valued dividend growth stocks and reinvesting the dividends received from those stocks. The combination of new capital investment, dividend reinvestment, and dividend growth over many years will facilitate the growth of my dividend income stream. To read about my dividend growth investing progress thus far, please see my latest quarterly review.

In my ongoing search for attractively valued dividend growth stocks, my attention has been drawn recently to real estate investment trusts [REITs]. Until now, my portfolio had zero exposure to real estate, partly because the highest-quality REITs often command premium valuations. However, there has been a strong sell-off among REITs since late May, mainly due to concerns about how rising interest rates will affect their operations when the Federal Reserve tapers its quantitative easing program. Due to the sell-off, several REITs have become fairly valued or undervalued, motivating me to look more closely at them.

I focused my search on healthcare REITs because I have been wanting to increase my portfolio's exposure to healthcare and this REIT category is likely to benefit from a favorable demographic trend. The figure below shows the projected population growth of individuals aged 65 years or older in the U.S. until 2050. As individuals get older, their healthcare needs often become greater, and this strong demographic trend bodes well for healthcare REITs.

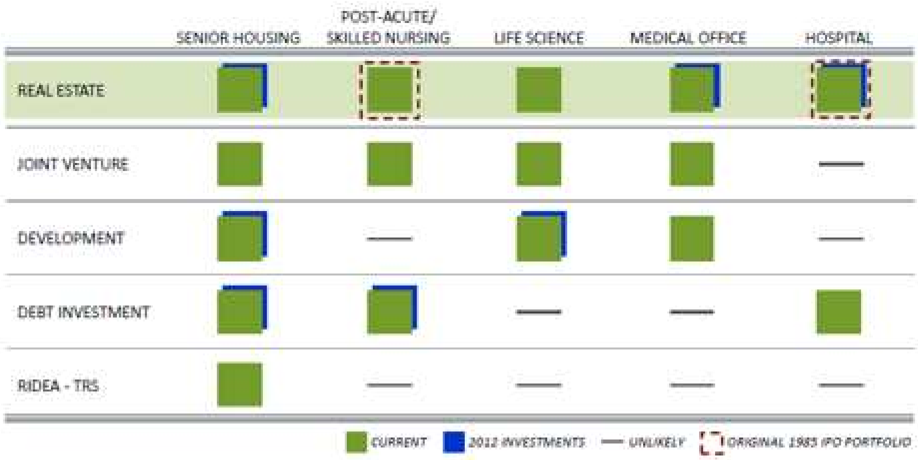


Source: U.S. Census Bureau, the Statistical Abstract of the United States.

Five of the 12 healthcare REITs listed by NAREIT appear on David Fish's Dividend Champions, Contenders, and Challengers list because they each have at least 5 consecutive years of dividend growth. These REITs are HCP, Inc. (HCP), Health Care REIT (HCN), National Health Investors (NHI), Omega Healthcare Investors (OHI), and Universal Health Realty Income Trust (UHT). After a comparative analysis, I decided that HCP was one of the more attractive investment opportunities.

HCP: A Diversified Healthcare REIT

HCP is a real estate company that invests primarily in healthcare-related properties. It was organized in 1985 when it was spun off from National Medical Enterprises (now Tenet Healthcare). The company acquires, develops, leases, manages, and disposes of healthcare real estate in the context of a "5 x 5" business model:



(click to enlarge)

Source: HCP 2013 Annual Meeting Presentation

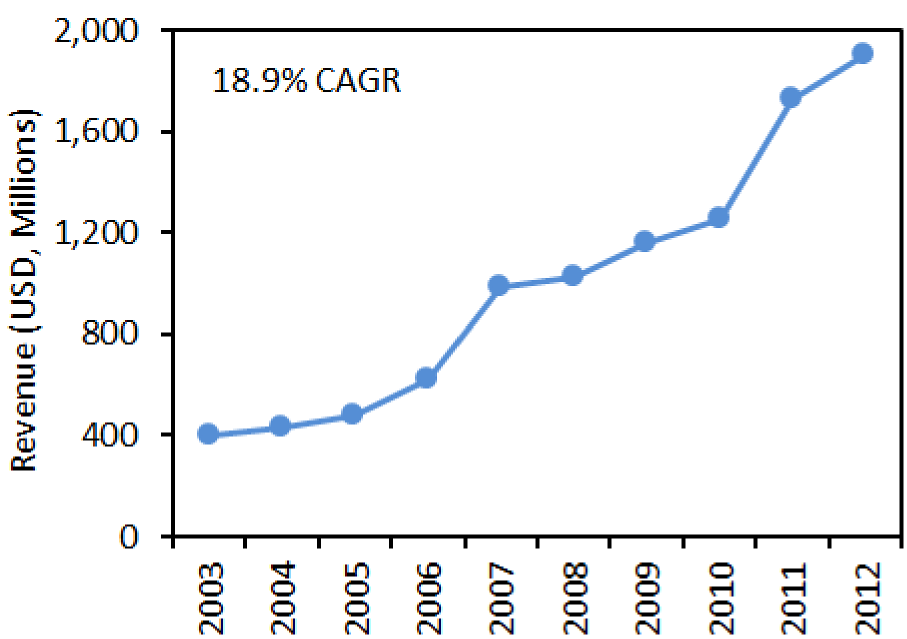
This business model gives HCP flexibility regarding the healthcare segments and products for its investments. As a result of this flexibility, the company has built a portfolio that is diversified by healthcare segment, geography, and operators/tenants, as indicated in the table below. Josh Peters of Morningstar referred to HCP as "arguably the best-diversified landlord in healthcare."

Assets Under Management	Geography	Operators/Tenants
Senior Housing (36%)	CA (23%)	HCR Manor Care (29%)
Post-Acute/Skilled Nursing (28%)	TX (10%)	Emeritus Corp. (13%)
Life Science (16%)	FL (8%)	Brookdale Senior Living (8%)
Medical Office (16%)	PA (7%)	Sunrise Senior Living (5%)
Hospitals (4%)	IL (6%)	HCA (3%)
	OH (5%)	Amgen (3%)
	Others (41%)	Genentech (2%)
		Others (37%)

(click to enlarge)

Data source: HCP website

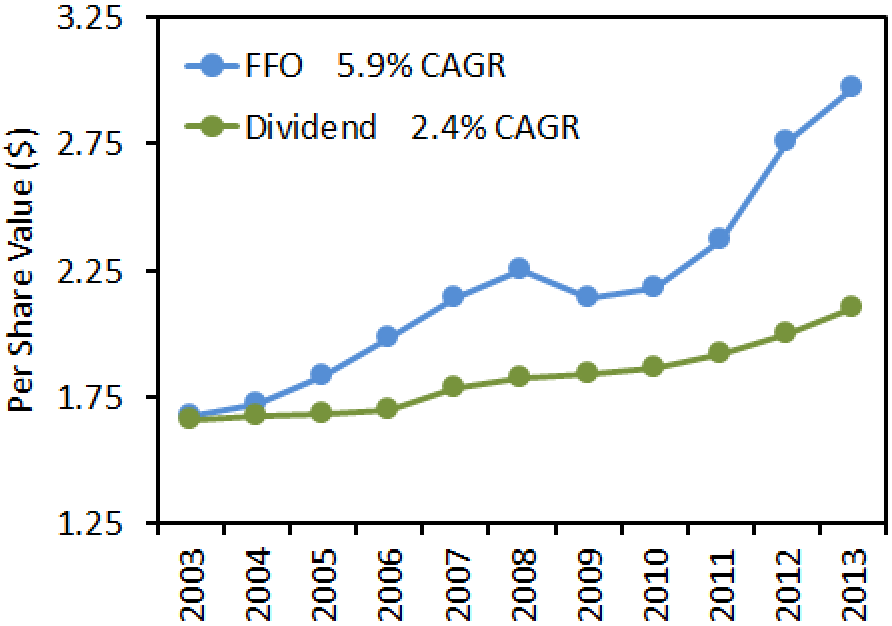
Revenue



Data source: Morningstar

HCP consistently increased its revenue over the past several years at a 18.9% compounded annual growth rate [CAGR]. However, as is the case with many REITs, much of the revenue growth coincided with the issuance of more shares. On a per-share basis, revenue growth was a much more modest 3.8%.

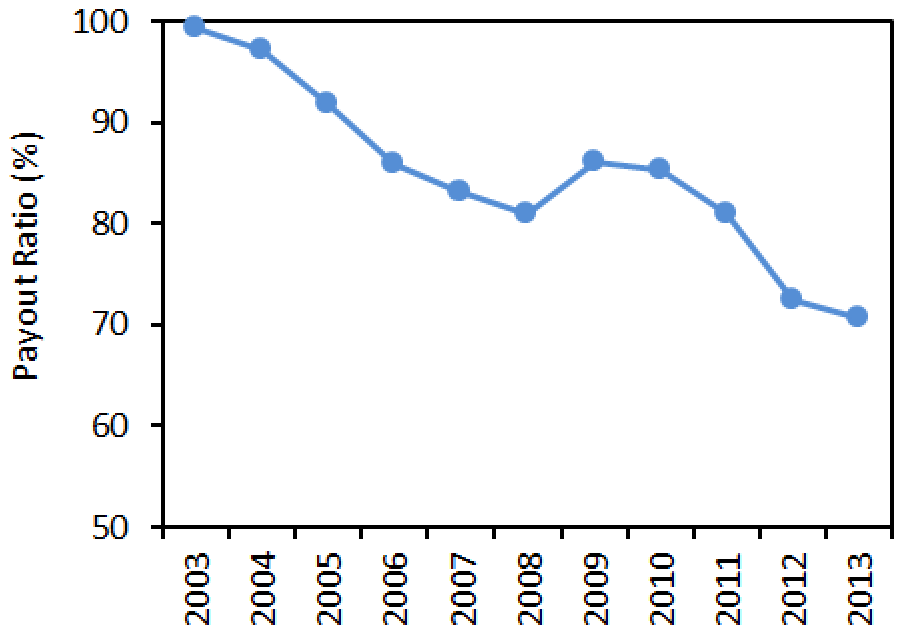
Funds From Operations and Dividends



Data source: Value Line

Instead of earnings, it is more appropriate to evaluate REITs on the basis of their funds from operations [FFO]. HCP increased its FFO at a 5.9% CAGR, which is satisfactory. HCP increased its dividend at a 2.4% CAGR, which is relatively weak but roughly in-line with inflation. The current dividend yield for HCP is around 5%. Notably, HCP is one of the only REITs that qualifies as a Dividend Champion, having increased its dividend for 28 consecutive years. It is also a member of the S&P 500 Dividend Aristocrats. This kind of steady and reliable dividend growth is a desirable feature for an investor such as myself.

Sometimes there is a question as to whether a company's long-term dividend growth is primarily driven by earnings growth (or FFO growth for REITs) or an expansion of the payout ratio. For example, a company with flat earnings can maintain a dividend growth streak if it simply pays out more of its earnings year after year. In the case of HCP, it is clear from the previous figure that dividend growth has been supported by FFO growth. Moreover, the figure below shows that the payout ratio has actually decreased while the dividend increased:



Data source: Value Line

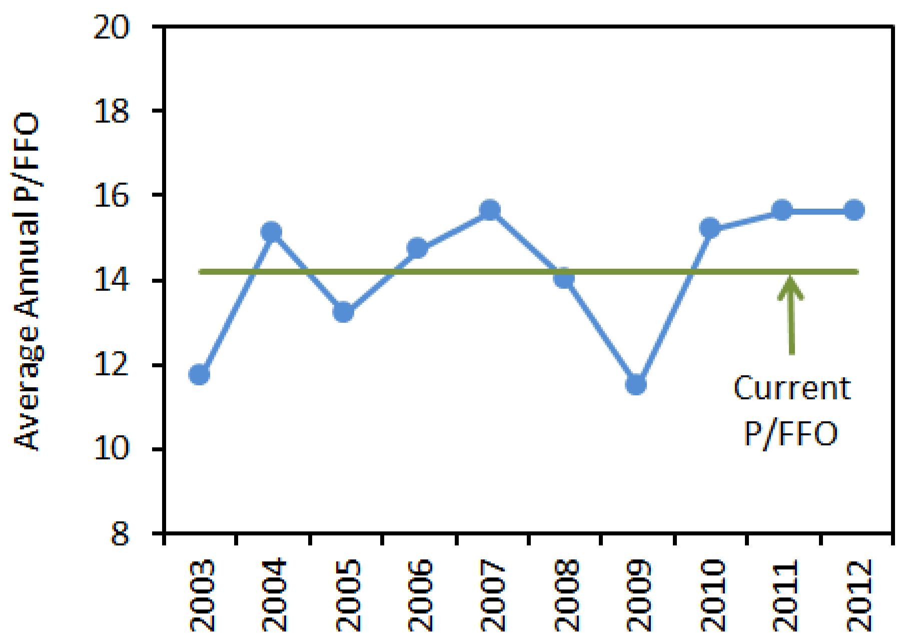
Thus, management has become more conservative in recent years, which is perhaps a prudent action because a lower payout ratio enables the company to maintain or continue increasing its dividend even in the context of sluggish FFO growth in the future.

Balance Sheet

HCP has a BBB+ credit rating, which is the highest among healthcare REITs. Its debt/capitalization ratio is 45% and its interest coverage is 2.8x. Value Line gives the company a safety rating of 3.

Valuation

As noted earlier, it is more appropriate to use FFO than earnings when evaluating REITs. For this reason, one should ignore the P/E ratio and look at the P/FFO ratio, which is about 14.2 for HCP. The figure below shows that this value falls in the middle of the range of average annual P/FFO ratios, which suggests HCP is fairly valued on a historical basis.



Data source: Value Line

The judgment of fair valuation is further supported by a P/B ratio of 1.8, which is near the 5-year historical average of 1.7. Moreover, using a Dividend Discount Model with a dividend growth rate [DGR] equal to the 5-year CAGR of 2.4% and a discount rate equal to the current yield plus the 5-year DGR, one gets a fair value estimate of around $43, which is near the current price of about $42. Interestingly, Morningstar gives HCP a much higher fair value estimate of $55, implying that the stock is undervalued by at least 20%. However, I think a more conservative judgment is that HCP is fairly valued at $42 per share.

Action

I am comfortable with paying fair value for a high-quality, "blue chip" REIT such as HCP, which is why I started a position in the stock at $41.80 per share on August 8, 2013. I bought the shares in my Roth IRA because REIT dividends would be taxed as ordinary income in my taxable account. By holding HCP in my Roth IRA I avoid taxes altogether. This purchase finally gives my portfolio some exposure to real estate and helps boost my portfolio's overall yield. I view HCP as a high-yield/low-growth holding that is unlikely to be a home-run stock, but very likely to continue hitting singles year after year.

Bookmarked

Problem with this article? Please tell us. Disagree with this article? Submit your own.
Articles that link to this one

- HCP, Inc: A Healthcare REIT For My Dividend Growth Machine by Dividend Growth Machine

More articles by Dividend Growth Machine »

- A Real Dividend Growth Machine: Q3 2013 Review Thu, Oct 10
- Wal-Mart Stores: A Retail Heavyweight For My Dividend Growth Machine Thu, Oct 3
- Exxon Mobil: The Energy Giant Joins My Dividend Growth Machine Fri, Sep 27
- A Real Dividend Growth Machine: Q2 2013 Review Tue, Jul 16

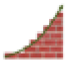
HCP's management discussing earnings

- HCP Management Discusses Q2 2013 Results - Earnings Call Transcript Tue, Jul 30 • Comment!

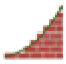
Comments (89)
Track new comments on this article

Register or Login to rate comments »

-
  robertlgriffin Comments (190)

  DGM: Great article. I've been watching this one for awhile and will buy today. At 62, I've quite trying to hit homeruns and am just trying to stay in the ballgame, and this dividend grower will do just that for me.
  9 Aug, 08:22 AMReply! Report AbuseLike2
- 
  Dividend Growth Machine Comments (1285)

  Author's Reply Robert: Thanks for your comment. I think a slow but steady dividend growth stock like HCP is a great way to stay in the ballgame, especially for investors in or near retirement.
  9 Aug, 09:06 AMReply! Report AbuseLike0
- 
  dbchambers Comments (139)

  great company - been buying monthly for over 2 years via their Drip ....aging economy is a plus !
  9 Aug, 09:56 AMReply! Report AbuseLike0
- 
  Dividend Growth Machine Comments (1285)

  Author's Reply dbchambers: Nicely done -- I bet all those monthly purchases and reinvested dividends have led to a good-sized position in HCP.
  9 Aug, 12:26 PMReply! Report AbuseLike0
- 
  David Allen Comments (74)

  At the risk of appreciating something because "great minds think alike", I recently reached the same conclusion

and began investing in HCP. Great article!
9 Aug, 10:09 AMReply! Report AbuseLike0

- [Dividend Growth Machine](#) [Comments (1285)](#)

  Author's Reply David: Thanks! I think when it comes to certain styles of investing, great minds do think alike.
  9 Aug, 12:28 PMReply! Report AbuseLike0

- [Dividend Disciple](#) [Comments (187)](#)

  "After a comparative analysis, I decided that HCP was one of the more attractive investment opportunities."

  I would be interested to see this commentary expanded. Any additional thoughts on being compelled to purchase HCP over the other 4 healthcare REITS mentioned in the article? I am also looking at this niche part of my portfolio and there have been some interesting articles on the other companies. Thanks for the article.
  9 Aug, 10:13 AMReply! Report AbuseLike1

- [Dividend Growth Machine](#) [Comments (1285)](#)

  Author's Reply DD: Earlier this week I posted a quantitative comparison of those 5 healthcare REITs on my blog:

  http://bit.ly/19gRunK

  Regarding the alternatives to HCP, I consider OHI to be an attractive investment opportunity, but with a higher risk/reward ratio due to it being a "pure play" REIT for skilled nursing facilities. For my first REIT investment, I decided it would be safest to go with a diversified "blue chip" REIT, hence my purchase of HCP.
  9 Aug, 12:33 PMReply! Report AbuseLike2

- [COBeeMan](#) [Comments (370)](#)

  DGM - I too am struggling with comparing HCP and OHI. Was the 5yr total return a factor at all? My calculator shows OHI getting 18.40% annualized gain over the past 5 years while HCP came out to 8.67%. I'm ok with the risk you mentioned given that much difference in total return. Are there other factors I should be concerned with?
  9 Aug, 05:34 PMReply! Report AbuseLike0

- [Dividend Growth Machine](#) [Comments (1285)](#)

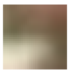
  Author's Reply COBeeMan: OHI could very well continue to give a higher total return than HCP, although it is important to remember that past results are no guarantee of future returns. I think OHI has a higher risk profile due to lower-quality assets (according to folks like Brad Thomas) and its lack of diversification among healthcare segments. If there is a change in healthcare legislation that negatively affects skilled nursing facilities to a greater extent than other segments, then OHI could be impacted more than HCP or other healthcare REITs. Also, it is worth noting that prior to its current dividend growth streak, OHI suspended its dividend from 2001 to late 2003 (NHI also had a dividend suspension during that time period). Just something to keep in mind.

As I mentioned in a previous comment, I do consider OHI to be an attractive investment opportunity, and at some point it might find a spot in my portfolio. However, I've decided to be more conservative at the moment and start with diversified REITs before investing in pure play REITs.
9 Aug, 06:02 PMReply! Report AbuseLike1

- 
  Chester the Income Investor Comments (332)

  I solved the quandary and purchased both HCP and OHI

  problem solved! :)
  10 Aug, 04:15 AMReply! Report AbuseLike2

- 
  COBeeMan Comments (370)

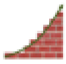
  Thanks DGM and Chester - I think I'm going to add both as well.
  10 Aug, 11:32 AMReply! Report AbuseLike1

- 
  maybenot Comments (1184)

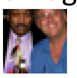
  Thanks for article.

  I recently looked at HCN, O, HCP. Decided on HCP for the following reasons:
  1. Due to its long history of maintaining its dividend growth over the years (compared to HCN, which had some hiccups).
  2. Seemed to be at a good value at this time (compared to O especially).

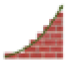
  Just my thoughts and actions :)
  9 Aug, 11:59 AMReply! Report AbuseLike0

- 
  Dividend Growth Machine Comments (1285)

  Author's Reply maybenot: Thanks for your comment. The two reasons you mentioned are among the reasons why I invested in HCP, too. I wouldn't mind starting a position in O, but I prefer a better valuation.
  9 Aug, 12:36 PMReply! Report AbuseLike0

- 
  billinsd Comments (897)

  As 10,000 US citizens turn 65 each day,I cant help but to love this reit sector
  I own HCN,UHT,OHI
  With or without Obamacare,we are aging
  9 Aug, 12:46 PMReply! Report AbuseLike0

- 
  Dividend Growth Machine Comments (1285)

  Author's Reply bill: Indeed, I think healthcare REITs (and companies involved in other aspects of healthcare)

stand to benefit from the aging U.S. population. That's why healthcare stocks make up a good-sized chunk of my portfolio (current weight is 18.5%).
9 Aug, 01:02 PMReply! Report AbuseLike0

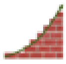
- 

  richjoy403 Comments (7570)

  DGM -- Enjoyed your article, as it hit the primary d-g considerations...CAGRs for earnings & dividends; the credit rating & debt:capitalization ratio; and valuation.

  According to M*, HCP has a 'spotty' record for total returns, as its best recent years were 2003, 2006, and 2010 -- each returning >25%, and providing the heavy lifting to its 10-yr annual average of 11%. HCP also has a -19% total return for the last 3 months, and -0.5% YTD.

  However, due diligence, including delving into the huge price decline ($54 to $41 since May) may suggest HCP is mispriced, and a worthy investment for conservative REIT investors.
  9 Aug, 01:42 PMReply! Report AbuseLike4

- 

  Dividend Growth Machine Comments (1285)

  Author's Reply richjoy: Thanks for your comment. This was my first time writing an article focused on an individual stock, as well as my first time investing in a REIT, so I'm glad I managed to hit some of the important considerations.

  It is worth pointing out that most REITs have experienced negative total returns over the last 3 months, suggesting a sector-level issue rather than a specific issue with HCP. As noted near the start of my article, the REIT sell-off seems to reflect concerns about rising interest rates when the Fed eventually tapers QE. Even though this will likely have some effect on HCP, I don't see the company being affected to a greater extent than other REITs.

  I agree with you that investors need to conduct due diligence and reach their own conclusions regarding whether HCP is a worthy investment. Hopefully this article provides a starting point for those efforts.
  9 Aug, 02:01 PMReply! Report AbuseLike2

- 

  maybenot Comments (1184)

  richjoy -- yeah I noticed those down years too but then also noticed that they continued on with their DGR -- which was a nice indicator of what they try to do for their shareholders.

  It was one of the things that moved me to buy HCP.

  richjoy -- I must say, when I see one of your comments I know it will be based on fact. Thanks always for that. :)
  9 Aug, 02:40 PMReply! Report AbuseLike4

- 

  richjoy403 Comments (7570)

  DGM -- Agreed as to the connection to both the taper-talk and the actual 100+ basis point rise in interest rates. Furthermore, I am of the opinion the trend for rates is most likely a continued rising (and also note recent events in Europe and China reinforce that notion).

Hopefully, and without appearing argumentative, I can expand upon my comment, as for myself, it is not enough that all REITs may sink together as you indicated in your comment.

I read a very well constructed article--I also see at least two types of investors reading it. Those investors may look at the same data and reach different conclusions...

Assuming the typical "income investor" is primarily interested in the growing dividend stream. He may also agree (as we have) income stocks have recently demonstrated an inverse price reaction to rising rates. He may also agree that inverse reaction is likely to be repeated as rates continue rising (the benchmark is now only 2.6%, and may move upward to 4%, 5%, or higher, before next receding significantly). Nonetheless, he may decide to buy HCP now to capture the attractive 4.9% current yield from a REIT having a 19-year streak of annual dividend increases.

OTOH, the typical "total return" investor who prefers d-g stocks (like myself) may look at the same HCP data, be impressed by its 19-year dividend record, and reach a different conclusion--he may decide to seek more attractive opportunities. Those opportunities are likely to have lesser yields, but also greater earnings growth rates so as to produce greater total returns.

I am NOT suggesting your article was in any way lacking, or incomplete--I am only adding that when delving into the recent -18% price decline, investors can reach different conclusions as to their best going-forward investment.
9 Aug, 04:59 PMReply! Report AbuseLike4

Cigar-Trader

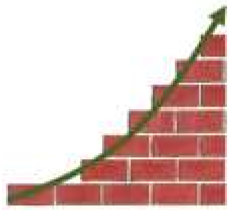
Before you comment, why not tell people something about yourself?
Add Your Comment:

CHECK SPELLING
Publish

HCP vs. ETF alternatives

ETFs	Today	3 Mths	1 Yr	YTD
SPY	-0.1%	1.6%	18.6%	19.9%
RWR	-0.3%	-5.4%	3.4%	2.3%
RWX	-0.6%	3.0%	6.7%	3.1%
RWR	-0.3%	-5.4%	3.4%	2.3%
SSO	-0.2%	3.4%	42.6%	44.6%
RWL	0%	1.8%	24.9%	24.1%
SDY	-0.3%	0.3%	19.6%	20.0%
PRF	-0.1%	1.8%	24.1%	23.3%
EPS	0.7%	1.6%	19.6%	20.8%

SEEKING ALPHA PRODUCT UPDATES



Dividend Growth Machine

- Articles (19)
- Instablog (1)
- StockTalks (8)
- Comments (1,286)
- Profile

1,025 Followers
10 Following

- Examining The Alpha Of Alpha-Rich Ideas by SA Product Team

Follow
Send Message

Alpha-Rich Ideas

1. Genel Energy Has Another 30% Upside Potential by Street Smart Investor
2. CBOE Holdings: Strong Growth, Large Moat, And A Call Option On Volatility by Bishop Research and Analytics
3. Cabela's Inc.: Growth + Value = 50% Upside by Shaun Currie, CFA
4. Cherokee: Headwinds Create Opportunity; Earnings And Corporate Action Highlight It by Alpha Bet

Dividends & Income

1. Ventas Is 'Pound For Pound' One Of The Best REITs Around by Brad Thomas
2. American Capital Agency's Upcoming Q3 2013 Income Statement Projection (Part 2) by Scott Kennedy
3. 14 Dividend Aristocrats With High Income For Retirement Investing by Avi Morris
4. Nothing Is Simple, Especially Mortgage REITs by Brad Thomas
5. DIY Dividend Investors Club (Part 6): Picking The Best Consumer Discretionary Stocks by Parsimony Investment Research

ETFs & Portfolio Strategy

1. Thoughts On Nobel Prize Winners Fama, Hansen And Shiller by Cullen Roche
2. Taleb Versus Reality by David Merkel
3. Dividend Aristocrats + Equal Weighting > S&P 500 Update by Ploutos
4. MTUM: Profiting From The Madness Of Crowds by Morningstar
5. A Rational Approach To Portfolio Construction And Diversification by Ray Merola

Macro View

1. Wall Street Breakfast: Must-Know News by Wall Street Breakfast
2. A New View Of Future Expectations For The S&P 500 by Ironman at Political Calculations
3. Einhorn Vs. Buffett: Is It Time To Buy The Gold Miners? by Cameron Swinehart
4. Patterns Fitting: Stocks Go Higher At The End Of 2013 by Danny Riley
5. Wall Street Breakfast: Must-Know News by Wall Street Breakfast

TOP AUTHORS: The Opinion Leaders
TOP USERS: StockTalkers | Instablogs
Like 8k
Follow @sa_popular

Mobile Apps | RSS Feeds | About Us | Contact Us