CAPITAL MANAGEMENT

EPR Properties

EPR Properties (EPR) focuses on experiential properties. The company was put in a terrible position when the lockdowns of 2020 pressured the cash flows of many of its tenants, as they simply could not operate with the restrictions.

Fortunately, business has rebounded and EPR has done an exemplary job managing the bankruptcy of some key tenants and collecting past-due rental payments. While the higher interest rate environment is increasing cap rates and financing costs for EPR, the stock valuation is overly pessimistic, creating a fantastic opportunity for both income and growth for prudent investors. I will outline a strategy that can enhance the yield quite significantly for income-oriented investors.

EPR's investment portfolio consists of 359 properties, with 99% of those properties leased excluding the properties EPR intends to sell, representing a total investment of $6.8B. The experiential portfolio consists of 93% of total investments, with 289 properties, leased by 50 operators. The company also has an education portfolio consisting of 70 properties and 8 operators, which is 100% leased. This non-core portfolio might be a potential source of liquidity as it doesn't really fit with the experiential theme of the company.

One of the big overhangs for the stock is that EPR has a great deal (37%) of exposure to the movie theatre industry, which was just devastated by the lockdowns in 2020, putting several operators into bankruptcy or near insolvency. I think these fears are a bit overblown as Theatre Coverage is at 1.7x, which is right around where it was at year-end 2019, despite box office revenues that are still down a few billion over the same time, despite growing by about 20% in 2023. The 1.7x coverage ratio in theatres reflects the strength of the portfolio, which is regularly being pruned of weaker assets, along with the improved operating efficiency of the theatres. Long-term EPR would like to get the percentage of theatres down to about 15% of the total portfolio. EPR's non-theatre coverage is a very healthy 2.6x, which is up from 2x at the end of 2019, while total portfolio coverage is now at 2.2x, versus 1.9x, respectively. Movie theatres have really been capitalizing on increased spending on food and beverages, which have helped offset weaker box office figures. Most of the movie theatres are nicely profitable, although the major operators such as AMC are still plagued by troubled balance sheets.

EPR is regularly investing to further diversify the portfolio and to bring in quality assets. In Q4, EPR invested $133.9MM, and for all of 2023 the company invested $269.4MM, with 100% of that being invested in the Experiential portfolio. In Q3, the company took a $20.9MM impairment related to the restructuring of Xscape Theatres, with whom EPR had four theatres. Pursuant to this agreement, EPR terminated a lease for one underperforming theatre in exchange for a $2.5MM termination fee and entered into a percentage rent deal with a recapture rate for another. For the remaining two theatres, EPR reduced rent and enhanced the percentage rent component, while requiring the exhibitor to spend a minimum of $1MM per theatre from its own funds to improve each theatre within one year.

Also, during Q4, EPR sold 2 underperforming Alamo Drafthouse locations and a vacant former Regal theatre. The company also sold the fourth of the five KinderCare properties, with the fifth vacant KinderCare location being under a signed purchase and sale agreement. Net proceeds for Q4 on these sales were $22.2MM, while for all of 2023 proceeds were $57.2MM. After year end, EPR has sold the third vacant former Regal theatre, which means that the company has either executed letters of intent or purchase and sale agreements for 3 of the remaining 8 locations. One remaining vacant AMC theatre is under a signed purchase and sale agreement. Lastly, EPR sold both of its Titanic museums at a 6% cap rate on in place income for combined $45MM of net proceeds and a gain on sale of $17MM.

In Q4, EPR also closed on a $9.4MM acquisition of its second Movement climbing gym and third overall climbing gym. After the end of the quarter, EPR closed on a build-to-suit financing of sixth carting location, with a total commitment of $35MM, and cap rates exceeding 8%.

In 2023, box office revenue was $8.9B, up 21% over 2022, with Q4 box office revenue of $1.9B. Hurt by the strike, EPR estimates a weaker performance in 2024 with box office revenue being in the range of $8-$8.4B, before jumping to $9-10B in 2025. EPR's resolution with Regal during their restructuring includes a percentage rent component, and EPR currently has seven self-owned but third-party managed theatres in its portfolio. These factors do make the company more susceptible to the ebbs and flows of box office revenues, but the success of movies such as Maverick, Oppenheimer, and Barbie show that people still enjoy going to the movies.

EPR's Eat & Play portfolio saw revenue grow by over 5% in 2023, and EBITDARM up 6%. TopGolf completed a self-funded refresh of four of EPR's venues in 2023 and three more are scheduled for 2024. EPR's cultural portfolio also performed well in 2023, showing increased revenue and significant increases in attendance. EPR's Murrieta Hot Springs Resort opened to the public in early February and was recently ranked by Conde Nast Traveler as one of the best new wellness retreats in the world for 2024. The resort features 50 natural hot springs and water features, along with many historic buildings on 46 acres. The Springs Resort in Pagosa Springs is currently undergoing expansion with completion expected in mid-2024.

The Experiential Lodging portfolio saw revenue and EBITDARM increase YoY, with fantastic performance from EPR's Margaritaville Hotel Nashville, which is close to all of Nashville's famous downtown destinations. The Education portfolio performed well with YoY increases across the portfolio, including 6% growth in revenue, 15% in EBITDARM, and 2% in enrollment.

EPR ended 2023 with $2.8B of total debt, all of which is fixed rate or fixed through interest rate swaps at a weighted average of 4.3%. The weighted average debt maturity is 4.25 years, with $136.6MM of scheduled debt maturities due in 2024, which it plans on paying off using its credit line. Liquidity is very strong with $78.1MM of unrestricted cash, and no balance on the $1B revolver. Net debt to dross assets is 39%, and the debt service coverage is 3.8x. Net debt to adjusted EBITDA was 5.3x for the quarter. EPR's 2023 AFFO payout was a healthy 71%.

In Q4, EPR closed on the funding of a $77MM convertible mortgage financing for the Mirbeau Companies' collection of Inn & Spa resorts in Skaneateles and Rhinebeck, New York, and Plymouth, Massachusetts. EPR has the option to convert the mortgage financing to a traditional sale leaseback structure, and the deal also includes additional commitments of $47.1MM to finance future projects.

In Q4, EPR produced FFO as adjusted of $1.18 per share, down from $1.25 in the prior year, and AFFO of $1.16 per share, down from $1.27. The big difference was that out-of-period deferral collections from cash basis customers included in income were $.6MM versus $6.2MM in the prior year, resulting in a decrease of $.07 per share YoY. EPR has now collected all accrued deferred amounts related to the pandemic, which was over $150MM. The remaining off-balance sheet amount of $12MM relates to two tenants, one with a balance of roughly $26MM that has been paying an on an agreed-upon schedule which concludes in 2024, and the other with a balance of approximately $11.4MM with payment depending on exceeding an EBITDA threshold.

The biggest risks to EPR would be another Covid-Lockdown like event. I'm a firm believer that lockdowns were one of the biggest blunders in history and I do worry that the same social engineering that manufactured that outcome, could do so again to pursue whatever the intended agenda is at the time. Outside of that, a bankruptcy of AMC could cause some concern in the market pressuring the stock, but EPR has faired quite well in previous bankruptcy proceedings such as Regal, and has a very strong master lease agreement with AMC that was revised in 2020, which EPR's management says is even stronger than the one with Regal. EPR's management has actually mentioned that they would prefer it if AMC went bankrupt because it is a healthy business, but a bad balance sheet due to the all the debt. Another potential risk is that diversification leads EPR into some dud investments, as various experiential assets become fads, as opposed to truly lasting pastimes.

EPR's guidance of 2024 is for FFO of between $4.76 and $4.96. The company plans on spending between $200-$300MM on investments, while disposing of $50MM-$75MM of assets. The company plans to finance most of its investments with cash on hand given its increased cost of capital. G&A expenses are scheduled to be between $52-55MM for 2024. While FFO is expected to decline from 2023's $5.18 per share, $.48 or $36.4MM of that is due to less deferral collections.

When you adjusted the figures without including deferral collections, FFO will rise from $4.70 in 2023 to $4.85 in 2024, which is 3.2% growth. Excluding the deferred collections, FFO grew by nearly 6% in 2023, which is very impressive given the economic landscape.

At a recent price of $41.35, EPR trades at just 8.52x 2024 FFO, offering a 11.7% FFO yield. The annual dividend per share is $3.30, which equates to a roughly 8% yield, which combined with 3-4% FFO growth, gives us a double-digit total stockholder return right off the bat. I also believe that over time, EPR should rerate higher on a valuation perspective to maybe 11-13x FFO, which would put the fair value of the stock at between $53-63 per share. For investors that are more income-oriented, a covered call strategy could be advisable. One could buy the stock at $41.35, and then concurrently sell a January 25 $45 call for around $2.00. This would add roughly 4.8% of option premium to the 8% dividend, while still retaining a bit of upside through the $45 strike price. If interest rates do head downwards later in the year, real estate assets such as EPR should benefit, so investing when the sector is out of favor is quite opportunistic in my estimation.

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