Discrepancy between Recent NYC Office Sales and REIT Valuations Offers Tremendous Value Opportunity

Introduction

Recent events in the real estate and REIT industry have lead me to believe that the valuations of public REITs are not being made by reasonable people. In business school the efficient market theory is taught which in a nutshell says that the collective wisdom of the market is superior to that of any one person. This sounds quite convincing in theory but it is tough to accept this assertion when presented with recent circumstances in the REIT industry.

Valuation Background

If there is one metric that could be used to value stabilized commercial office buildings, it is the capitalization rate which is the income return generated by the property divided by its valuation. As with all valuation metrics, it is not perfect but is a very good metric to start with. For instance, income return generated by a 100% occupied building leased to a credit tenant for 20 years should be valued at a lower capitalization rate than a 100% occupied building leased to a tenant for 1 additional year with the knowledge that the tenant will be vacating the property. These are two ends of the capitalization rate spectrum and in practice for a REIT, the implied capitalization rate represents the income return of a pool of properties which in aggregate reflect average building stabilization. Generally properties that are sold are at their peak stabilization, which means they have longer than average lease terms and lower than market vacancy. This should warrant a lower cap rate than the implied cap rate of a pool of properties represented by a REIT but it is a judgement call to estimate what this spread should be.

Publicly Versus Privately Owned Real Estate

Large commercial properties are generally owned by either publicly traded REITs, in which the shares of the company are publicly traded, or privately by institutions. The returns achieved by public REIT investors are very straight forward in that the investor's returns are a combination of the capital returns associated with the REIT's stock price increases and the dividends paid by the REIT. The returns achieved by private real estate investment are the property level returns associated with the acquired property but in addition, asset management level fees need to be paid to the asset manager which diminishes the investors' returns. A reasonable estimate of these fees can be made by looking at the difference between NCREIF's NFI-ODCE annual gross and net of fee returns. Between 1987 and 2005, the difference between these was 1.07%. The ODCE returns represent equity returns and if we assume 50% leverage, the fee on an unleveraged basis would be half of 1.07% or 0.53% annually[1].

The implied cap rate of a REIT reflects both the property level revenue and expenses and the REIT's General and Administrative expenses which are equivalent to the asset management expenses incurred by a private real estate owner. Therefore if the implied cap rate of a REIT is 6.00%, a private real estate

[1] A robust explanation of these methods is described in detail in Jengbin Patrick Tsai's Masters Thesis at MIT titled "A Successive Effort on Performance Comparison Between Public and Private Real Estate Equity Investment" and linked to as follows: http://dspace.mit.edu/handle/1721.1/42016

investor would need to purchase a property at a 6.53% cap rate to get a 6.00% income return after the asset management fee is paid. Stated differently, a REIT with an implied cap rate of 6.00% is economically equivalent to a private investor purchasing the properties owned by the REIT at a 6.53% cap rate.

REIT Implied Cap Rate

This is a term that gets used often but does not have one agreed to definition. The way I calculate it is detailed in the graphic below but in theory, the NOI generated by the properties less the G&A expense is divided by the market's valuation of all of the assets owned by the REIT is taken to be the implied cap rate. Reasonable people can disagree on how to precisely calculate this metric but I find the method used to be reasonable and defensible.

The implied cap rate for SL Green that reflects its stock price at market close on July 14, 2015 is 5.05%. Per the discussion above regarding public versus private ownership of real estate, a private real estate investor would need to purchase a property at a 5.58% cap rate to achieve similar income return economics to purchasing a share of SL Green.

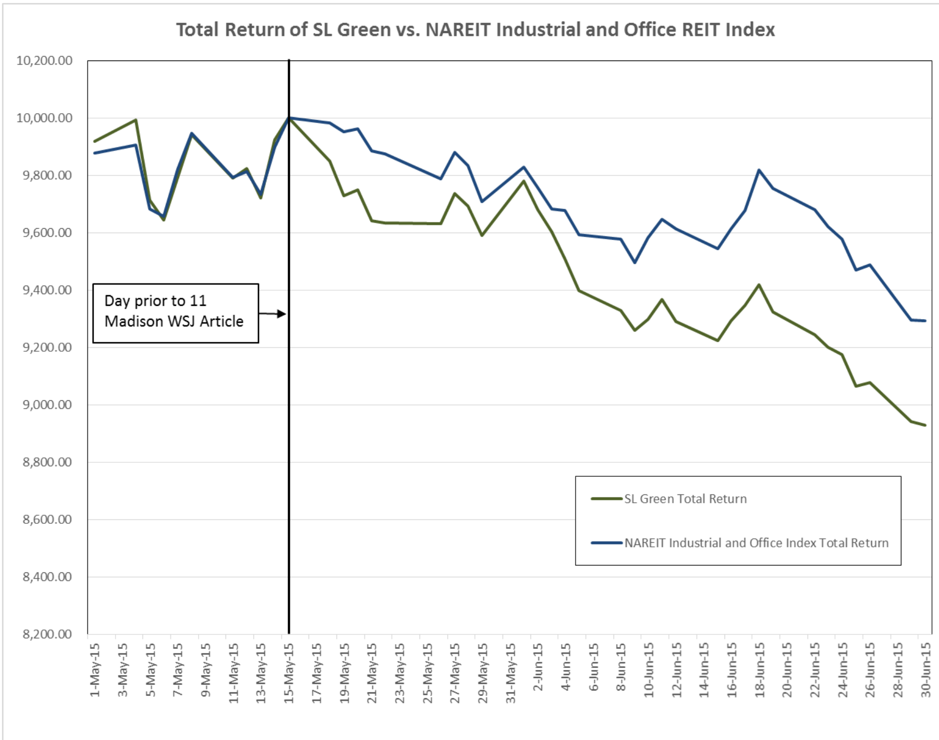
SL Green's Purchase of 11 Madison Avenue

On May 18, 2015, the Wall Street Journal published an article stating that SL Green is near a deal to purchase 11 Madison Avenue[2]. The article did not list the cap rate reflected by the purchase price but Omotayo Okusanya of Jefferies calculated a cash cap rate of 4.60%[3]. The implied cap rate of SL Green on May 15, 2015, the Friday prior to the WSJ article on May 18, 2015, was 4.84% meaning that a private investor would have had to purchase a property at a 5.37% cap rate to get a similar cap rate after the asset management fee of 0.53%. The premium paid for income return applying a 4.60% cap rate versus a 5.37% cap rate is 16.7%.

[2] http://www.wsj.com/articles/sl-green-nears-purchase-of-11-madison-ave-1431995675

[3] http://www.streetinsider.com/Analyst+Comments/Jefferies+Says+11+Madison+Avenue+Purchase+is+A+Nice+Get+for+SL+Green+Realty+%28SLG%29+and+Reiterates+Buy/10581543.html

The chart below shows the total return of SL Green versus the total return of the NAREIT Industrial and Office REIT Index with their values both set to 10,000 on May 15, 2015, the day prior to the WSJ article regarding SL Green's impending purchase of 11 Madison Avenue. It is quite clear that the market did not like this news as SL Green's stock value dropped significantly compared to the index the day of the announcement and has continued to underperform.



Interpretation

I believe there are two ways one could interpret the news of the purchase of 11 Madison Avenue but the market was quite clear on its interpretation. The first interpretation is that SL Green is the largest landlord in New York City and therefore its purchase of 11 Madison at a 4.60% cap rate reflects a market transaction and a cap rate comp of what properties in New York City should sell for. Therefore the valuation of SL Green should reflect an implied cap rate of what its underlying properties are worth as there should be a parity condition that exists between what the market is valuing a REIT's assets at and what they could sell for. If the purchaser of 11 Madison were a private investor, they would need to pay an annual asset management fee of 0.53% which would net income return of 4.07% after the asset management fee. Therefore for a parity condition to exist between SL Green and its underlying assets, SL Green's stock price would need to increase to reflect a similar implied cap rate of 4.07%.

The other way to interpret this news is that New York City office properties should be valued at a 5.37% cap rate and that by purchasing 11 Madison Avenue at a 4.60%, SL Green was overpaying by 16.7%. The underperformance of SL Green's stock upon the 11 Madison Avenue announcement is quite convincing that this was the market's interpretation.

SL Green Building Sales

On July 13, 2015, SL Green announced that they were selling Tower 45 and an 80 percent interest in 131-137 Spring Street to two separate buyers for a blended cap rate of 3.3%[4]. So here we have two separate buyers setting cap rate comps for properties that were in SL Green's portfolio of a 3.3% cap. The implied cap rate of SL Green at the close of trading on July 14, 2015 plus an estimate of an asset management fee of 0.53% was 5.58% so the buyers of these buildings paid a premium of 69.1% for income return over what they could have gotten by purchasing shares of SL Green's stock. As mentioned earlier in this article, properties that are sold are generally more stabilized than the average property but what the premium should be is hard to quantify. A reasonable guess may be 10% but the 69.1% premium is much larger than this.

The question is if SL Green has demonstrated that they can sell their properties at a 3.3% cap rate, why does the price of their stock imply their properties are valued at a 5.58% cap rate? Moreover, why are institutions paying a 70% premium for office income return in New York City by purchase properties directly when they could purchase shares of REITs that will give them liquidity and price discovery when direct property ownership cannot?

SL Green Valuation

If the market sets SL Green's price such that it values it underlying assets at a 3.3% cap rate, its stock price would be $288.49 versus $114.16 or a 153% premium. Stated another way, purchasing stock in SL Green at $114.16 per share is equivalent to buying equity at a 60.4% discount compared to SL Green's sale comps of Tower 35 and 131-137 Spring Street.

This is not a phenomenon that is unique to SL Green. Empire State Realty Trust also owns all of it properties in New York City and I estimate that 79.0% of Paramount Group's and 70.2% of Vornado's properties are located in New York city and the stock prices of each of these REITs implies that the properties underlying each of these REITs are valued at market caps of 5.57%, 5.73%, and 5.70% respectively.

Historical SL Green Valuation

Time will tell if the REITs or building comps provide a better value estimation but we can look historically to see how well the market has valued SL Green. The chart below shows the total return of SL Green versus the Vanguard REIT VIPER. I will readily admit that I cherry picked the time period to emphasize how bad the market is at valuing SL Green but even so, it is quite clear that the market does a terrible job of valuing SL Green. What is even more amazing is that SL Green is not some startup technology company with no assets or revenue. SL Green is the largest office landlord in New York City with tens of billions of dollars of assets.

[4] http://investor.shareholder.com/slg/releasedetail.cfm?ReleaseID=921758

PerfChart: SLG,VNQ

Adult Supervision

It seems obvious that there should be a parity condition that exists between what office buildings are selling for and how the market is valuing REITs that own similar office buildings. While valuing income return may not be a perfect valuation metric, for stabilized buildings in a similar location, it provides a good estimate of value. Yet what we see is that there is an extremely large discrepancy between office building sale comps and REIT valuations when using cap rate as a valuation metric. This discrepancy will only disappear when investors start to question why they are buying buildings at a 3.3% cap rate when they can buy into a pool of similar buildings at a much higher implied cap rate via REIT investments. This should have the effect of lowering the implied cap rates on REITs that own properties in New York City and raising the cap rates on office property sales until the move much closer to parity.

Conclusion

History has shown us that the market has done a terrible job of valuing SL Green and the gigantic discrepancy between its implied cap rate and office building sale cap rates leads credence to the argument that it is similar poorly valued today. The same poor valuation likely also applies to Empire State Realty Trust, Paramount Group, and Vornado as their implied cap rates are even higher than SL Green's.

Calculation of SL Green's Implied Cap Rate

		Per Share	Source
Equity			
Comon Stock			
Share Price 7/14/2015		114.16	Yahoo Finance
Share Outstanding 7/14/2015	99,580,000		2Q15 10Q
Market Capitalization	11,368,052,800	99,580,000	
Preferred Stock	221,932,000	2.23	2Q15 10Q
Preferred stock coupon	6.50%		2Q15 10Q
Payout on preferred stock	14,425,580	0.14	
Liabilities			
Debt Outstanding	8,176,428,000		2Q15 10Q
Weighted average cost of debt	3.93%		average cost of debt per 2Q15 10Q
Debt service	321,333,620	3.23	
Total of Equity and Liabilities	19,766,412,800	198.50	
Assets			
Market Implied Total Assets (market cap+debt+preferred)	19,766,412,800	198.50	
Cash	253,520,000	2.55	2Q15 10Q
Real Estate Assets (total assets - cash)	19,512,892,800	195.95	
Off Balance Sheet Debt			
Pro-rata debt of unconsolidated JVs	1,693,470,000	17.01	2Q15 10Q
Weighted cost of debt on unconsolidated JVs	4.38%		2Q15 10Q
Debt service for debt on unconsolidated JVs	74,173,986	0.74	
Real Estate Assets on balance sheet	19,512,892,800	195.95	
Pro-rata debt of unconsolidated JVs (real estate assets off balance sheet)	1,693,470,000	17.01	
Total	21,206,362,800	212.96	
Sources of property level operating income			
FFO 2016		6.65	NAREIT REITWatch June 2015
Debt Service for on balance sheet debt		3.23	calcualted above
Preferred Stock Dividend		0.14	calcualted above
Debt Service for on balance sheet debt		0.74	calcualted above
Total		10.77	
Implied Cap Rate for SL Greeen		5.06%	

Mr. Bollinger is the founder and CEO of Magnolia Realty Advisors. Prior to founding Magnolia, he was an analyst at KBS Realty Advisors in Atlanta, GA for 5 years where he worked on a 2 person asset management team overseeing a $500M portfolio of commercial real estate. Prior to KBS, Mr. Bollinger worked in the CMBS industry in New York City as a consultant for 3 years supporting clients such as Merrill Lynch and Bear Stearns. He earned an MBA from Vanderbilt University and a BS in Industrial Engineering from Virginia Tech.

Mr. Bollinger developed Magnolia's strategy while working at KBS and observing that the commercial real estate industry did a poor job at using the data available to it to value both individual buildings and REITs. As such, Mr. Bollinger developed a valuation methodology that incorporates all pertinent data into the valuation process. Testing this valuation method showed that it would have provided significantly better valuation estimates than the market did. This superior valuation method is the basis for Magnolia's investment strategy.