REIT Market Insanity for Highwoods and Paramount Group!

Introduction

Upon the heels of my recent article, "Paying a 3.53% Cap Rate for an Atlanta Office? You must be Highwoods![1]" Paramount Group (ticker PGRE) released news[2] that they had purchased the remaining interest in 31 West 52nd Street for $230M. My thought was this gives me a terrific opportunity to compare PGRE's purchase to Highwoods' (ticker HIW) purchase.

HIW Purchase

HIW's purchase is very straight forward as their press release[3] gave all of the pertinent information to calculate the cap rate of their purchase and it is summarized below.

Summary of Highwood's Acquisitions

	Monarch Center	Suntrust Financial	Total
purchase price	303,000,000	124,000,000	427,000,000
year 1 cash NOI excluding free rent	13,000,000	8,000,000	21,000,000
year 1 cash NOI including free rent	10,700,000	7,500,000	18,200,000
cap rate on cash NOI excluding free rent	4.29%	6.45%	4.92%
cap rate on cash NOI including free rent	3.53%	6.05%	4.26%

PGRE Purchase

Paramount Group's purchase takes a bit of digging to determine the economics of the purchase but their supplemental filings provide enough information to get a very good picture of the economics of their purchase. Their press release included the purchase price of $230M in cash for the remaining 35.8% interest in the property. To calculate the cap rate this implies, a bit of leg work is required.

[1] http://seekingalpha.com/article/3546756-paying-a-3_53-percent-cap-rate-for-an-atlanta-office-you-must-be-highwoods
[2] http://www.snl.com/IRWebLinkX/file.aspx?IID=4323331&FID=31308643
[3] http://www.highwoods.com/Investor/Enhanced-BBD-Office-Focus-Presentation.pdf

Revenue

Per PGRE's 2Q15 supplemental disclosure, we see that the annualized rent for 31 West 52nd Street is $59.015M. We can then go to the note referenced which is excerpted below and states that the rent listed is the end of period "monthly base rent plus escalations" which implies that this is cash rent instead of GAAP rent. Furthermore if we are calculating the NOI in year 1 of the purchase, this rent is expected to grow as the vast majority of rents have built in rent escalations, usually 3%.

Property	Submarket	% Ownership	Square Feet [1]	% Occupied [2]	% Leased [2]	Annualized Rent [2] Amount	Annualized Rent [2] Per Square Foot [3]
As of June 30, 2015							
New York:							
1633 Broadway	West Side	100.0%	2,643,065	95.7%	95.7%	$ 160,808,000	$ 69.13
1301 Avenue of the Americas	Sixth Ave / Rock Center	100.0%	1,767,992	85.4%	91.2%	110,867,000	74.19
1325 Avenue of the Americas	Sixth Ave / Rock Center	100.0%	814,892	91.1%	94.2%	46,766,000	65.91
31 West 52nd Street	Sixth Ave / Rock Center	64.2%	786,647	100.0%	100.0%	59,015,000	77.44
900 Third Avenue	East Side	100.0%	596,270	96.0%	97.0%	40,818,000	72.11
712 Fifth Avenue	Madison/Fifth	50.0%	543,341	98.5%	98.5%	56,475,000	106.06
Subtotal / Weighted Average			7,152,207	93.3%	95.2%	474,749,000	74.38

Annualized Rent represents the end of period monthly base rent plus escalations in accordance with the lease terms, multiplied by 12.

Expenses

The excerpt from the 2Q15 Supplemental shows the total operating expenses for 2Q15 for 31 West 52nd Street being $6.105M. This must be a GAAP number because there is no adjustment later in the calculation to get to Net Income for a straight-line rent adjustment. Therefore this expense should not be seasonal and therefore can be annualized without being negatively affecting by the seasonality of major real estate expenses such as taxes.

	Quarter Ended June 30, 2015			
	Consolidated Properties			
	31 West 52nd Street	One Market Plaza	Real Estate Funds [1]	Total
Total revenues	$ 17,317	$ 28,848	$ 926	$ 47,091
Total operating expenses	6,105	7,017	318	13,440
Net operating income	11,212	21,831	608	33,651
Depreciation and amortization expense	(6,538)	(13,739)	(298)	(20,575)
Income from real estate fund investments	-	-	14,072	14,072
Unrealized gains on interest rate swaps	3,278	8,580	-	11,858
Interest and other income, net	21	34	-	55
Interest and debt expense	(5,218)	(13,280)	(793)	(19,291)
Net income before income taxes	2,755	3,426	13,589	19,770
Income tax expense	-	(39)	(3)	(42)
Net income	**$ 2,755**	**$ 3,387**	**$ 13,586**	**$ 19,728**

Stabilization

Another important item to consider when assessing the value of this partial sale is how stabilized is the rent roll for 31 West 52nd Street. For instance, if the building had one tenant whose lease was up in a year and was known to want to move out of the building, this would warrant a high capitalization rate as there would be significant anticipated capital costs to re-tenant the building along with the risk associated with re-leasing the building. We have presented data above that shows the building is both 100% leased and occupied but that does not tell us anything about the term remaining for the existing tenants. Unfortunately PGRE does not provide a rent roll for the building but we can do some investigating to determine the relative stability of the building. The screen show from Hines shows 31 West 52nd Street as Hines developed the building. We see that Clifford Chance, LLP is listed as a major tenant in the building.

When we search PGRE's 2Q15 Supplemental, we see that Clifford Chance, LLP is listed as a top 10 tenant with 328,992 sf leased until June 2024. So we can calculate that Clifford Chance is leasing 41.8% of the building until June 2024 for 8.5 more years. While this provides only a snapshot into the building's rent roll, it shows that the anchor tenant for the building is a global law firm with significant term remaining and therefore the partial sale price does not reflect a soon to be non-stabilized building.

Top 10 Tenants:	Lease Expiration	Square Feet Occupied	% of Total Square Feet	Annualized Rent (1) Amount	Annualized Rent (1) Per Square Foot	% of Annualized Rent
As of June 30, 2015						
The Corporate Executive Board Company	Jan-2028	625,062	6.0%	$ 31,709,000	$ 50.73	4.9%
Barclays Capital, Inc.	Dec-2020	497,418	4.8%	29,207,000	58.72	4.5%
Allianz Global Investors, LP	Jan-2031 (2)	326,457 (2)	3.1%	26,198,000	80.25	4.0%
Credit Agricole Corporate & Investment Bank	Feb-2023	313,879	3.0%	25,219,000	80.35	3.9%
Clifford Chance, LLP	Jun-2024	328,992	3.2%	24,925,000	75.76	3.8%
Commerzbank AG	May-2016	287,535	2.8%	24,422,000	84.94	3.7%
Kasowitz Benson Torres & Friedman, LLP	Mar-2037 (3)	302,213 (3)	2.9%	18,904,000	62.55	2.9%
Deloitte & Touche, LLP	Mar-2016	212,052	2.0%	16,853,000	79.48	2.6%
Google	Apr-2025	249,709	2.4%	16,310,000	65.32	2.5%
WMG Acquisition Corp. (Warner Music Group)	Jul-2029	293,487	2.8%	16,241,000	55.34	2.5%

Implied Capitalization Rate Calculation

Using the information provided in PGRE's press release and the information we pulled from PGRE's supplemental filings, we can calculate that the price PGRE paid for the remaining 35.8% of 31 West 52nd Street implies a 5.66% capitalization rate.

PGRE's Acquisition of Remaining 35.8% of 31 West 52nd Street		
SF	786,647	
	$	PSF
annualized cash rent per 2Q15 supp	59,015,000	75.02
3% updward adjustment for forward looking NOI	60,785,450	77.27
annualization of 2Q15 GAAP operating expenses	24,420,000	31.04
Estimated NOI	36,365,450	46.23
acquisition %	35.8%	
Acquisition Price	230,000,000	
implied total price	642,458,101	816.70
implied cap	5.66%	

Math Check

We can compare the price paid for 31 West 52nd Street in relation to its NOI to SL Green's purchase of 11 Madison Avenue[4] and the Tower 45 and Soho property sale[5] to determine the relative value of PGRE's purchase. What we see is that PGRE paid a 18.7% discount to the 4.60% cap rate that SL Green Paid for 11 Madison and a 41.7% discount to SL Green's sale of its Tower 45 and Soho properties. I am not naïve enough to think that the cap rates should be the exact same because there are always differences between properties such as the quality of the tenants, the perceived difference between the in-place rents and the market rents, and the average remaining lease terms. These certainly should be adjusted for but these adjustments should create much smaller differences than those shown here.

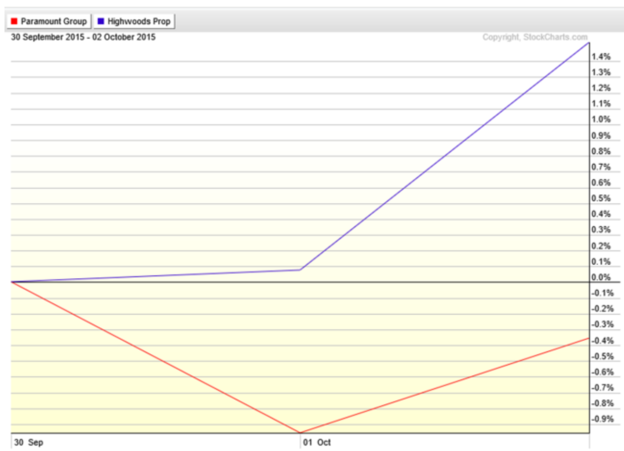
31 West 52nd Street Implied Cap Rate	5.66%
Value of $1,000 of NOI at cap	17,667
11 Madison Ave. Cap Rate	4.60%
Value of $1,000 of NOI at cap	21,739
31 West 52nd Street valuation discount	18.7%
Blended cap of Tower 45 and Soho Property	3.30%
Value of $1,000 of NOI at cap	30,303
31 West 52nd Street valuation discount	41.7%

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

[5] 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

REIT Market Insanity

We can look to the market to see how both HIW's and PGRE's news was received. Note that HIW's release was made on Sept. 30 (the time during the day is not known) and PGRE's release was made on Oct. 2. Certainly this is not the most scientific observation ever made because the scale of each purchase in relation to each REIT's enterprise value would come into play along with each REIT's leverage but a very qualitative observation is that the market seemed to like HIW's acquisitions better than PGRE's acquisition. I personally find this mind blowing considering SL Green sold two buildings in NYC earlier this year for a blended 3.3% cap rate and SL Green purchased 11 Madison Avenue for a reported 4.6% cap rate.



Conclusion

It appears that if anything, the market prefers an acquisition of properties in Atlanta and Tampa at a blended 4.92% cap rate over an acquisition of a partial interest in a property in Manhattan (in which the acquirer already had the controlling interest) at a 5.66% cap rate. I find this to be totally insane.

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.