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SLG: This is what free money looks like

Introduction

Anyone familiar with the efficient market hypothesis will likely also be familiar with the story about the efficient market adherent who walks by a $100 bill on the ground and does not bend over to pick it up because in theory it should not be there. The question I take away from this story is if there is if there were the equivalent of a $100 bill on the ground to be picked up in the market, how would it present itself? I contend it would look just like SL Green (SLG) currently does.

Implied Cap Rate

REITs are valued using numerous metrics including Funds from Operations (FFO) per share and dividend yield. The one I prefer is the implied cap rate which is how the market is valuing the operating income generated by the properties the REIT owns. The advantage of using this metric is that it is economically similar to quoting a capitalization rate for the sale of a property. It is calculated as the cash income return expected to be generated by the property in the subsequent year divided by its purchase price. This way REITs' valuations can be compared to private sales of properties on an "apples to apples" basis.

Earnings Call

On the 3Q15 earnings call[1] for SLG, Marc Holliday, the CEO and Director, stated the following:

> We had an enjoyable summer executing on nine different disposition transactions that were part of a designed and deliberate strategy to take advantage of favorable market conditions that exist currently… In total, these transactions aggregated to $1.7 billion of activity… and most importantly the Manhattan sales were transacted at an average cap rate of 3.3% on current cash NOI.

He also made this observation:

> I am always interested by the fact that at $120 a share roughly, where our stock price trades today, that's an implied cap rate on Manhattan assets of 5.3% and to get right to it, if you were to value that same portfolio of Manhattan assets at a 4% cap rate, that would be $153 share and at a 3.5% cap rate, that's $173 a share.

I was very happy to hear him address the large discrepancy between where there market is valuing SLG's stock and what they are getting on their asset sales. This comment is almost verbatim to what I said to my partners on our call the previous week. In addition, my model for SLG's implied cap rate showed a 5.30% implied cap rate at $120 a share so it confirms that the model I am using is similar to that of SLG. What I disagree with is the math on what the value of SLG's stock would be at different implied cap rates as the correct math tells an even more compelling story which is presented below.

[1] http://seekingalpha.com/article/3597446-sl-green-realtys-slg-ceo-marc-holliday-on-q3-2015-results-earnings-call-transcript

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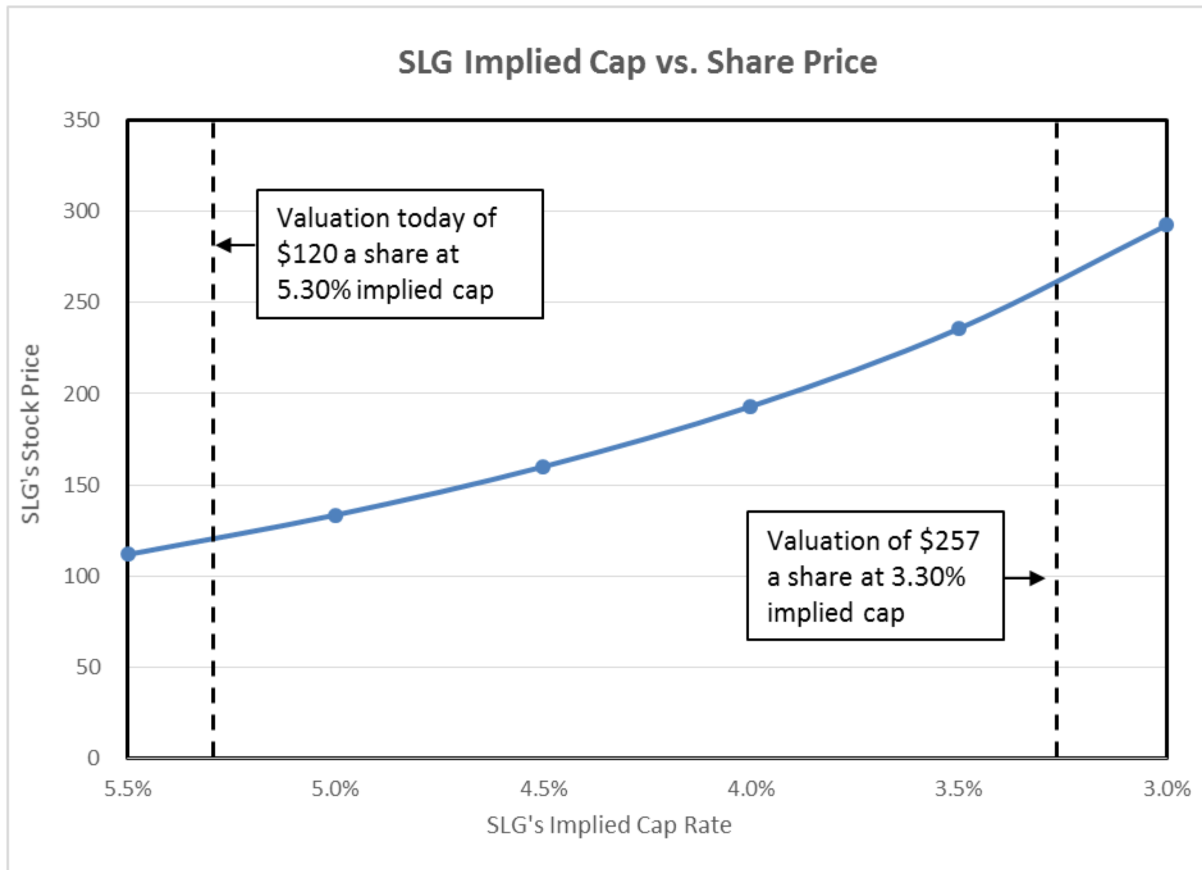
SLG's Implied Cap Rate Versus Share Price

Shown below is a table showing the share price of SLG for various implied cap rates followed by a chart of the data. The chart shows the current valuation of SLG and what the valuation would be if SLG were valued similarly to its recent sales. It should be evident that there is a gigantic disconnect between SLG's stock valuation and how much SLG is getting for the properties it is selling.

SLG Implied Cap vs. Share Price	
Implied Cap	share price
3.0%	292.56
3.5%	235.74
4.0%	193.12
4.5%	159.97
5.0%	133.46
5.5%	111.76



Arbitrage Opportunity

One of the advantages REITs have is that its assets are readily marketable. Therefore if there is a disconnect in pricing between how the market values the REIT's equity and how the market values the underlying properties, there is an opportunity to sell into to the market that more highly values the assets. This is the present case with SLG.

Effect of Asset Sales on Equity

If SLG's stock price does not change as they sell off assets at a significantly lower cap rate than their implied cap rate, then the implied cap rate of SLG will increase in proportion to the assets sold off as a percent of all of their assets. If the implied cap rate of SLG does not change as SLG sells off assets, then the stock price must increase in proportion to the percentage of assets they sell off.

Constant Implied Cap Rate

To give a rough estimate of how this math would work if SLG sold off assets and their implied cap rate stayed constant, we can look at the chart presented previously and see that if SLG's implied cap rate dropped from 5.30% to 3.30%, their equity would increase in value by 114%. This would mean 100% of SLG's assets would be valued at a 3.30% implied cap rate and if we assume this is a linear relationship, then for every 1% of assets that SLG sells off at a 3.3% cap rate, the value of their stock will increase by 1.14% if its implied cap rate stays constant.

Other Possibilities

There is a possibility that a company such as Blackstone, which is placing money for its current real estate fund, could purchase a large portion of SLG's asset in a portfolio or possibly buy SLG. Blackstone has already agreed to purchase Stuyvesant Town[2] in New York City which indicates they are bullish on the market. If they were to purchase office properties directly, they would be buying in the neighborhood of the 3.3% cap rate where SLG has been selling their properties. Blackstone could instead purchase a large portfolio from SLG or the company in its entirety for a price that reflects an implied cap rate of 4.5%. This would be beneficial to SLG as it would get them a significant premium over their present implied cap rate and Blackstone could acquire office properties in New York City at a large discount to where they would likely trade in a private transaction.

It is also possible that one of the large institutions that is contemplating buying an office building in New York City will realize that they will get much more value by purchasing a large portion of SLG's stock at a 5.30% implied cap rate as opposed to buying a building directly at a 3.30%. Similarly, existing owners of New York City office buildings may also identify this arbitrage and sell their currently owned New York City office buildings at a 3.30% cap rate and use the proceeds to buy the equity of SLG at an implied cap rate of 5.30%. Both of these possibilities would put upward pressure on SLG's stock.

[2] http://www.wsj.com/articles/stuyvesant-sale-typifies-boom-in-real-estate-1445388300

Conclusion

There is a very large discrepancy between the market's valuation of SLG's stock and what SLG's assets would likely sell for in a private transaction. The management of SLG is actively exploiting this arbitrage by selling their assets. As this continues, SLG's stock will either need to rise in value to keep the implied cap rate constant or not rise in value in which case the implied cap rate of SLG will increase, making it more attractive. This arbitrage opportunity could also be exploited by a large intuition choosing to pay a premium for SLG' stock as it would represent a significant discount to the direct purchase of property. A wise investor will be able to identify this mispricing and pick up that $100 bill by investing in SLG's stock and waiting for the market to exploit this arbitrage opportunity.

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.