MAGNOLIA REALTY ADVISORS

Paying a 3.53% Cap Rate for an Atlanta Office? You must be Highwoods!

Introduction

Highwoods (ticker HIW) announced yesterday[1] that they have acquired Monarch Center in Atlanta and SunTrust Financial Center in Tampa. Below is an economic summary of their acquisitions. Monarch Center is currently 88% occupied and Suntrust Financial Center is currently 89% occupied. These occupancies represent stabilized properties in these markets and therefore the NOI represents stabilized NOI.

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%

Ed Fritsch, President and CEO of Highwoods stated, “These transactions provide substantial NOI upside through lease-up, rent growth, Highwoodtizing and operating efficiencies.” I particularly like Ed’s ability to “verb-ize” his company’s name and as such, think an inspection of what Highwoodtizing really means is in order.

[1] http://www.snl.com/Cache/1500076450.PDF?Y=&O=PDF&D=&FID=1500076450&T=&IID=103169

Highwoods' Same Store Statistics

Highwoods along with other REITs publish "same store" statistics which are for properties they have owned for at least two years. HIW publishes these numbers annually which allows for the chaining together of these statistics over multiple years. HIW publishes both GAAP and cash NOI growth numbers with advantages and disadvantages to each metric.

GAAP Accounting

GAAP accounts for leases on a "straight line" basis meaning that if a lease starts at $50 psf and ends 5 years later at $60 psf, the GAAP rent would be $55 psf for 5 years. If there is a free rent period at the beginning of the lease term this would also be calculated into the straight line rent figure which means that in a tenant's free rent period, there would be a large discrepancy between the GAAP and cash NOI number.

Cash Accounting

The cash accounting is exactly what its name implies in that only cash rent received is booked as cash NOI. The advantage of this is that this makes a REIT's cash implied cap rate an "apples to apples" measure to compare to a property sales comparable as property sales cap rates are quoted to reflect cash NOI.

Basis Creep

Along with NOI growth, HIW's basis creep is shown. Basis creep is defined as the annual total of cash tenant improvements, cash leasing commissions, and cash building improvements on existing buildings divided by HIW's enterprise value. It is equivalent to saying that if HIW purchases a building for $100M they can expect to have to put on average $2.42M in capital into the building each year. As shown in the last 4 years, this number is quite consistent owing to the law of large numbers.

Highwoodtization

The table below shows the same store NOI growth statistics HIW has published historically since 2007 (2007 was chosen as these statistics were not published in 2006). It also shows HIW's basis creep since 2011. So we can conclude that a building that gets a "Highwoodtization" can expect to grow its cash NOI by 0.72% while consuming 2.42% of its value a year in capital.

HIW Same Store NOI Growth					
	GAAP		Cash		Basis Creep
2006		1,000		1,000	
2007	1.8%	1,018	4.2%	1,042	
2008	0.5%	1,023	2.3%	1,066	
2009	-3.8%	984	-2.8%	1,036	
2010	-0.1%	983	-2.9%	1,006	
2011	-0.9%	974	-0.6%	1,000	2.26%
2012	2.8%	1,002	3.6%	1,036	2.20%
2013	-0.1%	1,001	1.7%	1,054	2.51%
2014	-0.2%	999	0.5%	1,059	2.70%
		-0.02%		0.72%	2.42%

Effect of Highwoodtization

If both Monarch Center and Suntrust Financial experience Highwoodtization, here is the economic performance to expect. The blended cash NOI excluding free rent (we will give HIW the benefit of the doubt and assume neither of these buildings will ever give free rent after year 1) is 4.92% which means the income return on these buildings will be 4.92% in their first year. We can expect a positive capital return of 0.72% owing to the increase in NOI (assuming no movement in cap rates) and a negative 2.42% capital return as a result of the capital that the buildings will consume. We can add these up to get a total return of 3.22% on these buildings.

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G&A Expense

The other expense to consider is the general and administrative expense of Highwoods and we can calculate that this was 0.62% of HIW's enterprise value in 2014 so an estimate of 0.62% on the buildings' value is a reasonable assumption. Therefore the 3.22% total return on these buildings will be reduced by an estimated 0.62% of G&A expense going forward making the total return on these buildings after G&A expense of 2.60%.

Cost of Debt

We can find the weighted average cost of HIW's debt in their supplementary 2Q15 filing. Below is an excerpt from the filing which shows their weighed average cost of debt as 4.06%.

Balances Outstanding:	**6/30/15**
Secured:	
Conventional fixed rate	$ 290,101
Unsecured - Fixed:	
Fixed rate bonds and notes	1,124,927
Bank term loan 1/	225,000
Unsecured - fixed total	1,349,927
Unsecured - Floating:	
Bank term loan	200,000
Bank term loan	125,000
Credit facility 2/	159,000
Unsecured - floating total	484,000
Unsecured total	1,833,927
Total	$ 2,124,028

End of Period Weighted Average Interest Rates:	
Secured:	
Conventional fixed rate	5.82%
Unsecured - Fixed:	
Fixed rate bonds	5.03%
Bank term loan 1/	2.78%
Unsecured - fixed total	4.66%
Unsecured - Floating:	
Bank term loan	1.38%
Bank term loan	1.29%
Credit facility 2/	1.29%
Unsecured - floating total	1.33%
Unsecured total	3.78%
Weighted Average	4.06%

Effect of Leverage

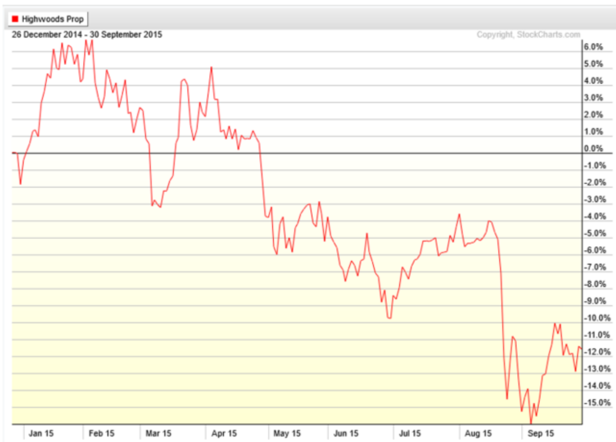
If we compare our estimated total return of these newly acquired buildings of 2.60% after G&A expense to the weighted average cost of debt of 4.06% we see that the buildings are expected to return 146 bp less than the cost of debt. This means that the return on HIW's equity will be less than their total return on these two building owing to the negative leverage.

Market Timing

Perhaps part of "Highwoodtization" is being able to effectively time the market to exploit pricing inefficiencies between publicly traded REITs and the properties owned by REITs. To examine this possibility, we can compare the performance of HIW's equity in 2015 compared to the performance of commercial properties.

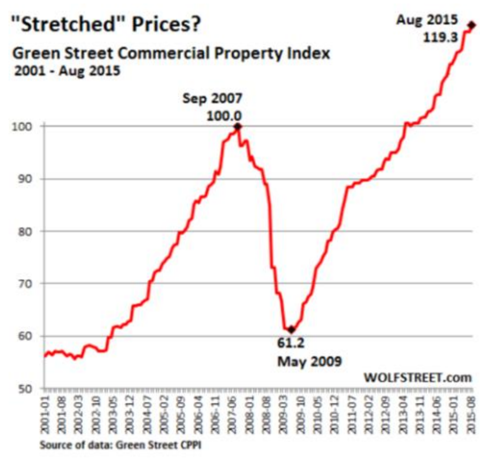
HIW's Equity Performance in 2015

Below is shown the total return of HIW's equity in 2015. It should be noted that the time period starts on December 26, 2014 instead of January 2, 2015 but that is a function of the limitation of free stock chart websites as opposed to imprecision. Nevertheless, it is quite obvious that HIW's equity value has been on a rather steep downward trend in 2015, creating a total return of around -11% in 2015.



Green Street's Commercial Property Index

Below is shown Green Street's Commercial Property Index over time. What it shows is that in 2015 the index has been on a significant uptrend. It should be pointed out that this index reflects the property level so equity values would be increasing more dramatically owing to the effects of positive financial leverage.



Buy High Sell Low

It does not take a financial genius to get the picture that REIT values have been falling while commercial property values have been increasing in 2015 so HIW's timing of the purchase of these buildings would have been better at the beginning of the year prior to the run up in property prices and the draw down in their own equity value. But that in itself does not mean that this was a bad decision, just that it would have been a better decision at the beginning of the year. What is important is what HIW paid for income return in comparison to how the market is currently valuing their income return.

Implied Cap Rate

To determine where the market is valuing HIW's income return, the total property level cash NOI attributable to HIW can be projected for the next 13 month by using the trailing 12 months of the same metric, making a growth assumption, and dividing this by the enterprise value of HIW less the estimated value of their non-income return producing assets (land and properties under development). Reflecting HIW's closing stock price of $38.78 per share on 10/1/15, I calculate this as 6.64% which means that the market is valuing all of the properties HIW owns at a 6.64% capitalization rate.

Cap Rate Comparison

We can then compare this market implied capitalization rate to the blended capitalization rate of the two acquisitions of 4.92%. Show in the chart below is the two cap rates applied to 1,000 in NOI which shows that a 35.0% premium is paid for NOI when a 4.92% cap rate is applied compared to a 6.64% cap rate. Therefore HIW paid a 35.0% premium to where the market was valuing their income return. This is what makes this a bad purchase for HIW and as REIT values and commercial property values move closer to income return price parity in the future, this acquisition will likely be viewed as being timed quite poorly.

NOI	Cap Rate	Value
1,000	6.64%	15,060
1,000	4.92%	20,325
purchase premium		35.0%

Conclusion

HIW paid a premium for both Monarch Center and Suntrust Financial Center. If HIW's future NOI growth and capital utilization continues at their historical rates, HIW's total return on these properties will be less than their cost of debt thereby causing negative financial leverage. HIW would need to growth their cash NOI above trend or lower their capital below trend or a combination of the two by 146 bp just to make a total return on these acquisitions equal to the cost of their debt let alone a premium over their cost of debt. This acquisition is not likely to be looked back on as a successful timing play as HIW is paying a 35.0% premium for the income return generated by these properties compared to how the market is currently valuing the income return generated by their currently owned properties.

Perhaps Highwooditization means purchasing a building and having its future economic performance have no relationship at all to the long term trend of similar buildings owned by the same owner? If this were the case, I would think these two acquisitions would be a great for HIW. Because we live in the real world and can do math, we should not be swayed by the "location, location, location!" argument to justify a ridiculous purchase price. When applying a reasonable amount of analytical rigor, we can see that it is unlikely that these buildings will return the cost of debt let alone a premium to justify the risk of making an equity investment.

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.