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Redheaded stepchild REIT

Donald Trump may be getting in at the ground floor of something after all. On Oct. 7, Parkway, Inc. (PKY on the New York Stock Exchange) began its life as a publicly traded office real-estate investment trust. A spinoff, or castaway, Parkway owns 19 buildings with 8.7 million rentable square feet in the unflourishing city of Houston, Texas. Here is a REIT that has yet to declare a dividend, has published no annual report and has never held an earnings call. It carries zero "buy" recommendations from sell-side analysts (four rate it a "hold" and one a "sell"). Despite these facts—to some degree because of them—*Grant's* is bullish.

In real estate, you buy the worst building on the best block. In Parkway, you're buying OK buildings on a depressed block. "Amid a steady drumbeat of layoffs, mergers and bankruptcies in the oil-and-gas sector," reported the Nov. 9 edition of *The Wall Street Journal*, "Houston landlords are being hammered by vacancies and sagging rents that are plunging the office market into its worst state since the oil bust of the 1980s." Figures from Colliers International put third-quarter vacancies at 17.1%, up from 14.5% in the third quarter of 2015 and higher than that of any other major metropolitan area (Manhattan's, for one, is 6.4%). More than 5% of Houston office space was available for subleasing.

Parkway was born the redheaded stepchild of the union of Parkway Properties, Inc. and Cousins Properties, Inc. The two combined, in part, for the purpose of offloading their Houston assets. That cull completed, the thinking went, the new Cousins (which absorbed the old Parkway) could become the "Premier Sun Belt Office REIT."

Parkway—the new, Houston-only Parkway—has a market cap of $875 million and an enterprise value of $1.5 billion. Total revenues were (or would have been, had the company existed in today's form) $298 million in 2015 and $147 million in the first six months of 2016. Parkway divides its properties across five assets, all of which it appraises Class A, meaning they occupy prime locations, command high rents and attract large tenants (higher and larger than the underclasses). Parkway's properties are 87% leased at an average net rent of $18.57 per square foot. Greenway Plaza, the largest of the five, has 4.3 million square feet, 50% of the total portfolio. Two others, CityWestPlace and Post Oak Central, contribute 1.5 million square feet (17%) and 1.3 million square feet (15%). The final two properties, San Felipe Plaza and Phoenix Tower, account for the remaining 18%.

You can't see through them: Greenway Plaza in Houston

"Just walking and driving around, as I did on Monday, you wouldn't guess that Houston is in a bad way," colleague Alex Hess reports. "When visiting office complexes in Greenway during lunch hour, I saw scores of people bustling in and out of buildings, even in one building where the majority tenant is an offshore driller. Several people discussed how much competition there is for top engineering talent, even today. I noted an absence of cranes when I had a chance to get elevated views of the city and suburbs. 'I don't think you'll be seeing anyone put up an office building any time soon,' Lisa Bridges, director of market research at Colliers in Houston, tells me. 'I think we probably have enough office space to last us for 15 years.'

"The buildings that are going up are mainly apartment buildings," Hess continues. "One office property I visited is being renovated in anticipation of a market rebound—which rebound, observes Alexander Goldfarb, who covers REITs for Sandler O'Neill, will eventually come. 'The challenge is,' he says, 'you don't know when that is going to be. Doubtful it's in the next 12 months.'"

What you can't know about the newborn Parkway would make a short book. It has filed no audited 10-Ks, and its only 10-Q covers a period before the company had any assets. Parkway has held no earnings calls and produced no quarterly press releases. Such financial data that do exist come from the filings that the SEC requires for registering a publicly traded company, as well as piecemeal figures that predate the spinoff and a Parkway presentation dated Nov. 15. Still, with shoe leather and application, you can come away with a pretty good sense of the value proposition.

A tower at Post Oak Central

Parkway vs. the field

	Parkway, Inc.*	Average office REIT
Market cap.	$874.7 million	$2.7 billion
Enterprise value	$1.5 billion	$4.6 billion
Implied cap rate	10.7%	6.1%
Price/FFO	7.2x	16.5x
Net debt/EBITDA	4.1x	9.7x
EBITDA/Interest expense	7.5x	3.3x
Dividend yield	N/A	4.72%

*Figures for Parkway are annualized based on the latest available data.
sources: company filings, the Bloomberg

The essence of that proposition is that Parkway owns good assets in a terrible market and trades at a great multiple. The buildings may be Class A, but the tenantry is worse for cyclical wear. As of the third quarter, energy companies delivered 54% of base rents. Investment-grade tenants contributed just 49% of those rents (though some of the occupants are unrated). The top three tenants—Occidental Petroleum, Apache Corporation and Statoil—fill up 26.5% of Parkway's rented square footage. Through the first nine months of 2016, Occidental and Apache each reported operating losses; Statoil was alone among the three in covering interest expense through operating income.

"They'll probably lose some occupancy. At least you need to be prepared for that," Bruce Garrison, managing director at Chilton Capital Management (he is long Parkway), tells Hess, who picks up the analytical thread: "That is despite the fact that none of its top-10 tenants has a lease expiring before 2019. Assume momentarily that none of Parkway's tenants default. Now imagine that not none of its tenants elect to renew their leases and Parkway also fails to attract a single new tenant. In such a scenario, Parkway would lose just 3% of its contractually agreed-upon revenues between 2017 and 2019." Garrison observes, "From a rental-income perspective, we think positive leasing spreads will make up for any occupancy loss." Based on its own recent leasing activity, Parkway estimates that market rents are 18% higher than current levels.

As of the third quarter, Parkway rents out office space at its largest asset, Greenway Plaza, at an average price of $16.46 per square foot. The company estimates that the net market rate today is 26% higher. "There's one new building that came up [nearby]. It's 50% leased, and they're trying to lease it at net rents in the high twenties," says Matt Werner, portfolio manager and a colleague of Garrison's at Chilton. Parkway's asset, by comparison, is 90% occupied.

Matt Kent, property manager at Greenway Plaza, gave Hess a tour of the 10-building site. Asked to describe what made the property compelling, Kent had this to say: "You've got a little bit of something for everyone. If I want $17 space and a Greenway Plaza address and all the amenities that come with that, I can get that. If I have a need for 250,000 square feet and a trophy-looking tower, then I can [get] that, too."

Having issued no public debt, Parkway is unrated, though it is well-capitalized in comparison to its office REIT peers. As of June, debt totaled $804 million, amounting to 38% of balance-sheet assets. Parkway's November investor presentation provided an updated debt total of $801 million as well as a 4:1 ratio of net debt to EBITDA.

"Based on the disclosure provided," Hess relates, "we can calculate that EBITDA covered interest expense 7.5 times in the quarter. These measures are conservative for the office REIT sector which, excluding Parkway, averages a 50% debt-to-assets ratio, a 9.7 net-debt-to-EBITDA ratio and EBTIDA coverage of 3.3 times interest expense."

"Pro forma financials and company presentations highlight Parkway's profitability as well," Hess continues. "Parkway's net operating income (NOI), which is calculated as rental revenues less property expenses, was $157 million in fiscal 2015 and an annualized $162 million in the first half of 2016. Parkway investor materials likewise show NOI at a $161 million run rate for the third quarter. Another measure, cash NOI, which deducts any non-cash rental revenues that accrue to Parkway, was an annualized $137 million in the third quarter."

NOI is a handy figure. Dividing it by enterprise value produces a market-implied capitalization rate. Annualized third-quarter NOI suggests such a cap rate on the order of 10%. (Attention, Chartered Financial Analysts: This would be a blended cap rate, averaging cash and non-cash NOI.)

Real Capital Analytics figures show an average cap rate of 7.28% for all Houston office properties as of October. Using a cap rate of 8% (on cash NOI), Parkway's Class A properties might be worth $1.7 billion and its net asset value something close to $1 billion, or $20.48 per share. At a 7% cap rate, that figure rises to $25.38 per share. As we go to press, shares trade at $17.81.

Parkway is likewise cheap on the basis of funds from operations, a non-GAAP measure that eliminates gains or losses on property sales and adds depreciation and amortization to GAAP net income. The appeal of FFO is that depreciation is usually a large GAAP line item for REITs, but the value of REIT assets tends not to decline in a straight line, as the accountants would have it; market conditions rather determine the value of the buildings. From Parkway's filings we can calculate that, in the first half of 2016, FFO was an annualized $2.25 per share. Similarly, we can estimate from recent materials that FFO was approximately $2.48 per share, annualized. Parkway thus trades somewhere between 7.2 times and 7.9 times annualized FFO, depending on the number used. The average company in the office REIT sector trades at a ratio of 16.5 times trailing-12-month FFO.

While REIT buyers are income investors, Parkway has yet to announce a dividend. REITs have a statutory minimum ratio for dividends equal to 90% of taxable net income excluding gains on property sales, which is what Chilton Capital believes the company will choose to distribute. Most REITs set payouts based on measures of cash flow such as adjusted funds from operations. AFFO subtracts non-cash revenues as well as recurring capital expenditures from FFO. At this stage, "AFFO is anyone's guess," says Chilton's Werner, "because no one knows what straight-line rent or above- and below-market rent amortization is going to be." Three analysts have AFFO estimates for Parkway for 2017, averaging $1.06 per share but ranging between 83 cents and $1.23. Barclays analysts estimate the average office REIT pays out 72% of available cash flows. If Parkway decides a more aggressive dividend policy is needed to attract investors, a 72% payout ratio would imply a dividend between 60 and 89 cents, or a dividend yield in the range of 3.4% to 5%.

It's easy to imagine what could go wrong with Parkway—perhaps Trumponomics proves slow to achieve its destined state of perfection, or the central banks lose their battle with debt and oil bottoms out some years hence in the mid-single digits. We rule out nothing with the president-elect but, in the case at hand, lean to the bullish outcome. Say that leasing activity in the Houston market accelerates and occupancy in the most distressed submarkets perks up. Assume that office buildings start to change hands at cap rates that flatter the value of Parkway's portfolio.

"Uncertainty may also give Parkway opportunities to create additional value by growing its portfolio," Hess winds up. "One way REITs can do so, without issuing equity or debt, is by selling a stake in stable assets at a relatively low cap rate in order to buy comparable-quality distressed properties at a higher rate ahead of a potential recovery." There is already chatter that Parkway is looking to make a deal. "We've got some good color that they're marketing a 49% joint venture interest in Greenway Plaza," Chilton's Werner tells *Grant's*. Proceeds could be reinvested in additional Houston assets. Parkway spokesman Thomas Blalock said the company would not comment on any specific rumors but noted, "We would consider joint ventures as a strategy in the future, particularly at assets where we feel like there is some stability. It would be a way to get some capital, at an attractive pricing, and use that capital as future growth money."

Asked for any concluding thoughts in her conversation with Hess, Colliers' Bridges offers the following on-the-ground observation: "New York needs to know the sky is not falling in Houston."

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