

GRANT'S

INTEREST RATE OBSERVER®

Vol. 34, No. 09c

Two Wall Street, New York, New York 10005 • www.grantspub.com

MAY 6, 2016

Sell New York

"Every time I've sold anything—and I've only sold at very high prices—five years later, I've thrown my hands up and said, 'I've done a dumb thing.'" So Larry Silverstein, the Brooklyn-born Manhattan property developer, preached to the choir of a New York real-estate audience in November. SL Green Realty Corp. (SLG on the New York Stock Exchange), the largest single owner of New York commercial real estate, is the subject of the essay now unfolding. With all due respect to Silverstein—who poured his capital, his lawyers' fees and his life's blood into rebuilding a portion of lower Manhattan after the Sept. 11 attacks—the *Grant's* verdict is "sell."

In so judging, we fly not only in the face of the wisdom of Silverstein, but also in the teeth of some bullish momentum. In June 2010, the average Manhattan office building changed hands at a 6.61% cap rate, the term meaning the ratio of a building's net operating income to the value assigned to its bricks and mortar. Today, that hypothetical structure commands a 4.42% cap rate.

Alternatively, one may describe this upside juggernaut in terms of rents plus other sources of income minus associated expenses, i.e., net operating income. In June 2010, according to Real Capital Analytics, \$1 million of NOI was worth \$15.1 million on the hoof; today, that million is worth \$22.6 million, up 49% in just over a half decade.

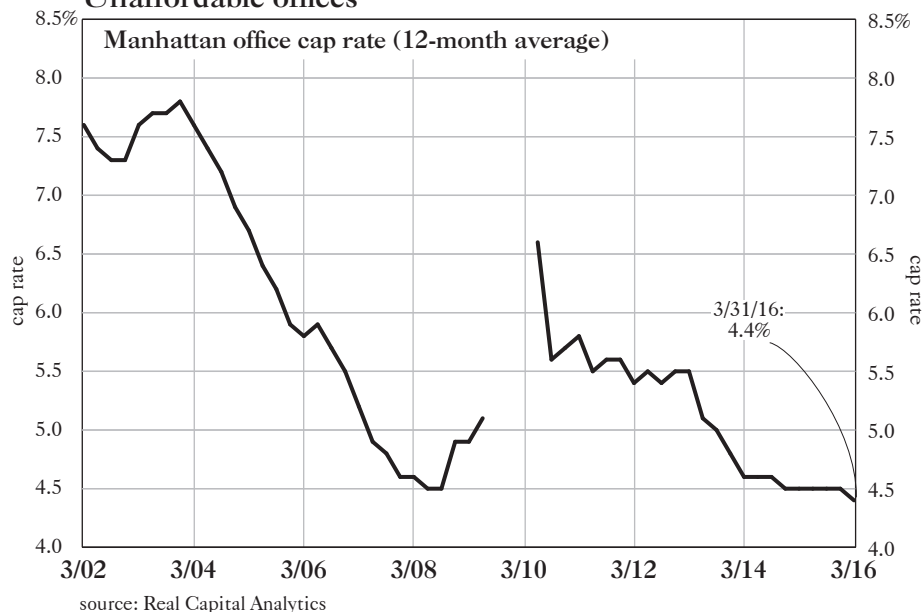
One may think of SL Green as New York City buildings with a stock ticker attached. It's a \$10.8 billion real-estate investment trust that de-

rives all but a few percentage points of its cash rents from the borough of Manhattan (the outer reaches of the greater New York metro area chip in the balance). Like so much that's for sale in New York, Green's shares are high-priced. They trade at 16.7 times trailing funds from operations (FFO) and are priced to yield 2.7%, compared with the average 15.3 times FFO multiple and 3.7% dividend yield on offer from office REITs as a class.

The stock is worth even more than its fancy price, the bulls contend. Only consider, they say, the historical strength and resilience of New York City real estate and the company's history of lucrative deal-making.

SL Green, contends John Kim, a real-estate analyst for BMO Capital Markets, "has one of the best track records of selling assets, and within real estate that's not only a great source of capital but it's a great way to make return on capital." In the preceding 10 years, says Kim, "they've sold \$3.6 billion of office assets at a 62% return on cost." In upgrading Green in January to triple-B-minus from double-B-plus, Standard & Poor's invoked the pending sale of the company's 388-390 Greenwich Street property to Citigroup for net proceeds of about \$1.8 billion. "We expect them to continue to deleverage," Anita Ogbara, lead analyst for S&P's REIT unit, advises colleague Alex Hess. "That's very much a part of our expectation."

Unaffordable offices



That's one of the key assumptions that underlie[s] the upgrade."

The bulls draw confidence, too, from the early 2016 returns. "Same-store cash NOI," a metric used to track changes in the profitability of holdings in place for at least one year, rose by 10.2% in the first quarter from the year-earlier period, while the expedited sale to Citigroup prompted an upward revision in management's projection of this year's FFO.

To hear the front office tell it, the share price is nothing less than a travesty. They mean it's too low. "We've generally been able to sell into this market at numbers that are far, far in excess of people's models and everything, but consistent with our [net asset value]. . .," CEO Marc Holiday told analysts in January. "So, I think that the implied trading right now is somewhere around 7% to 8% cap [rates], which I think is somewhat absurd."

Management developed its case against Mr. Market's ostensibly fuzzy math before the Citi Global Property CEO Conference in March. The analysis began with a calculation of enterprise value minus unsecured debt, preferred equity and all assets outside the "Manhattan stabilized office portfolio"—effectively, Green's core office holdings. This summed to \$9.1 billion with the share price at \$94.89. Now then, said management, divide "cash NOI" in the amount of \$644 million by that curated enterprise-value calculation to derive a true implied cap rate. It's not 4% or 4.5%, as it should be, the company complained, but something on the order of 7%. At a supposedly more correct 4.5% figure, the stock would trade above \$145.

Very generous, to be sure. Alternatively, one could treat enterprise value more inclusively and conventionally. One could define it as market capitalization less cash plus the book value of consolidated debt *plus* the book value of Green's share of joint-venture debt *plus* the liquidation value of preferred interests. Enterprise value by this reckoning comes to \$22.8 billion. Based on trailing-12-month NOI of just over \$1 billion (likewise using consolidated and joint-venture figures), one would arrive at an implied cap rate of 4.5%. Maybe Mr. Market is on to something after all.

At that, we judge that the old gentleman is overly optimistic. Real es-

SL Green by the numbers

Free cash flow calculation

	<u>2015</u>	<u>2014</u>	<u>2013</u>	<u>Sum</u> <u>(2013–15)</u>
Cash from operations	\$526,484	\$490,381	\$386,203	\$1,403,068
Net real estate and joint venture investment	-\$1,499,599	-\$364,760	-\$474,534	-\$2,338,893
Property additions, improvements, and cash put in escrow	-\$507,442	-\$378,348	-\$204,243	-\$1,090,033
Net investment in debt and preferred equity	-\$236,721	-\$40,163	\$102,628	-\$174,256
Net distributions to noncontrolling interests	-\$107,110	\$23,656	-\$6,459	-\$89,913
<i>Grant's Free Cash Flow Metric</i>	-\$1,824,388	-\$269,234	-\$196,405	-\$2,290,027
Net change in consolidated debt	\$1,877,050	\$471,016	\$315,737	\$2,663,803
<i>Grant's Free Cash Flow, after borrowing</i>	\$52,662	\$201,782	\$119,332	\$373,776
Cash dividends declared	\$250,963	\$201,411	\$138,684	\$591,058
Funds from operations	\$661,825	\$583,034	\$491,597	\$1,736,456

source: company reports

tate is a cyclical business, and Green is a leveraged company. On March 31, debt totaled \$11.5 billion (from both consolidated and joint-venture holdings), up from \$6.7 billion at year-end 2009. At that March 31 reading, Green's net debt equaled 9.2 times trailing-12-month EBITDA (consolidated plus joint-venture) of \$1.2 billion, as the company defines it. By comparison, SLG's peer group averages a consolidated ratio of 6.6 times net debt-to-EBITDA.

Debt matters, of course—as does the discount or premium of a share price to its corresponding NAV per share. The Great Recession was one month short of its (not then identified) terminal point when, in May 2009, Green was obliged to cut its quarterly dividend to 10 cents a share per quarter from 37.5 cents a share and issue \$387 million in new equity, in that fashion diluting its share count (in comparison to a new-year 2009 start date) by 34%. Leverage makes its own necessity.

As management declined to come to the phone to discuss the cash situation, we'll have to do our own supposing. The front office is on record as targeting between \$1 billion and \$1.5 billion of gross acquisitions and \$850 million in dispositions for 2016—figures which exclude the aforementioned projected sale of 388-390 Greenwich Street, the expected proceeds of which are earmarked for debt reduction. Green has

announced that the apple of its eye, One Vanderbilt, a super-tall Midtown skyscraper that will presume to look down on even the Chrysler Building following its planned completion in 2020, will cost some \$3.1 billion, of which \$937 million is projected to be contributed by the end of 2016. And the sum total of tenant improvements, leasing commissions, redevelopment costs and the like added to \$47 million—equivalent to a \$189 million run rate—in the first quarter.

Now, then, if dispositions and acquisitions net to \$150 million, half-financed with debt, the company would need an additional \$75 million to pay for budgeted purchases. It would need another \$820 million for One Vanderbilt (assuming it was able to secure its targeted \$1.5 billion in construction financing and \$820 million JV-partner contribution). Subtract the \$228 million carrying value, recorded at cost, of One Vanderbilt as of December 31, and SL Green's outlay comes to \$592 million. Lastly, add in the \$189 million for various capital expenditures, and total additional cash requirements foot to \$856 million.

"Access to a line of credit, flexibility in the development timeline of One Vanderbilt and alterations to the planned structure of gross acquisitions and dispositions may well make all these simultaneous plans possible," Hess observes. "However, SL Green's recent track record is one of

demanding ever more capital, rather than repaying what it has from operations. Constructing a measure of free cash flow by taking reported cash from operations, and subtracting all building improvements, investments, property purchases and distributions to non-controlling interests, I find the company to be nearly constantly scratching for cash. By my measure, the company's free cash flow was negative in each of the past three years to the tune of \$196 million, \$269 million and \$1.8 billion in 2013, 2014 and 2015, respectively. Debt, it then appears, funds the dividend: Add all that the company has borrowed, net of what it has repaid, and free cash flow is \$53 million in 2015 and \$374 million over the past three years. By contrast, dividends declared totaled \$251 million in 2015 and \$591 million over the past three years. At the current share count, and if the sell-side analysts are on the beam, dividends

will total an additional \$297 million in 2016 and \$329 million 2017."

All this assumes continued prosperity for the local real-estate market. Green itself seems ambivalent on that score. Management's cautionary remarks on the January earnings call triggered an immediate 8% decline in the share price. Three months later, on the April earnings call, the CEO waxed nearly rhapsodic ("by far the most compelling, diversified and resilient commercial property market in the country, possibly the world. . ."), which remarks were good for a 3% rally. Watch what you say.

By now, constant readers may be recalling Kilroy Realty Corp. (KRC on the NYSE), another premium-priced REIT with a concentrated geographical presence and a checkered history in 2007–09. According to data from Green Street Advisors, Kilroy has a development pipeline requiring investment equal to 16% of the value of its

real estate in place; for SL Green, the corresponding figure is 11%. Again, according to Green Street, Kilroy would be looking at an 18% bump-up in NOI if its leases in place were marked to currently percolating market values; for SL Green, the corresponding figure is 16%. Both companies surrendered to the gods of leverage at roughly the same time, and on roughly the same terms, in the latest big down cycle. At what proved to be the precise cyclical bottom, in June 2009, Kilroy executed a 30% dilution on its reeling shareholders, only a month after Green's capitulation (in the shape of the previously mentioned 34% dilution).

Never sell, says Larry Silverstein, meaning never sell a New York building. As for the shares of a certain New York-centric real-estate investment trust, the insiders of SL Green have unloaded nearly \$22 million of stock in the past 12 months. There were no buys.

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