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Changing places

In 2016, venture capital funds raised $42 billion, the most since 2001. It was an ill omen, as 2001 was the first full year of what would come to be known as the Tech Wreck. Yet—also in 2016—the public absorbed just $3.5 billion worth of VC-sponsored IPOs, the fewest since 2009. One might say that either VCs are too optimistic or public investors are too pessimistic. An excess of optimism is the theme of this unfolding essay.

In the foreground of the analysis we place Kilroy Realty Corp. (KRC on the New York Stock Exchange) and—a newcomer in these pages—Hudson Pacific Properties, Inc. (HPP, also on the Big Board). In the contextual background, please find valuation, interest rates and real estate. Skipping down to the bottom line, we name Hudson as our new pick-not-to-click among West Coast office real estate investment trusts. We lift our fatwa on Kilroy.

Despite their massive intake of investor funds, the VCs consummated 22% fewer transactions in 2016 than the year prior, and the value of those deals dropped by 13%. "[T]he primary reason for the lack of tech IPOs," Renaissance Capital proposes in its Jan. 3 review of 2016 IPOs, "is the public-private disconnect on valuation, a tension that can only be remedied by VCs caving in to their growing urgency to sell aging vintages in their portfolios, or by time, as companies grow enough to justify their lofty private valuations." In all, VC exits fell to $47 billion in 2016 from a record high of $82 billion in 2014.

If venture capital has given all it has to give for this cycle, tech-sector job growth may have peaked. And if tech-related job growth has crested, so might have the demand for office space in tech-heavy markets.

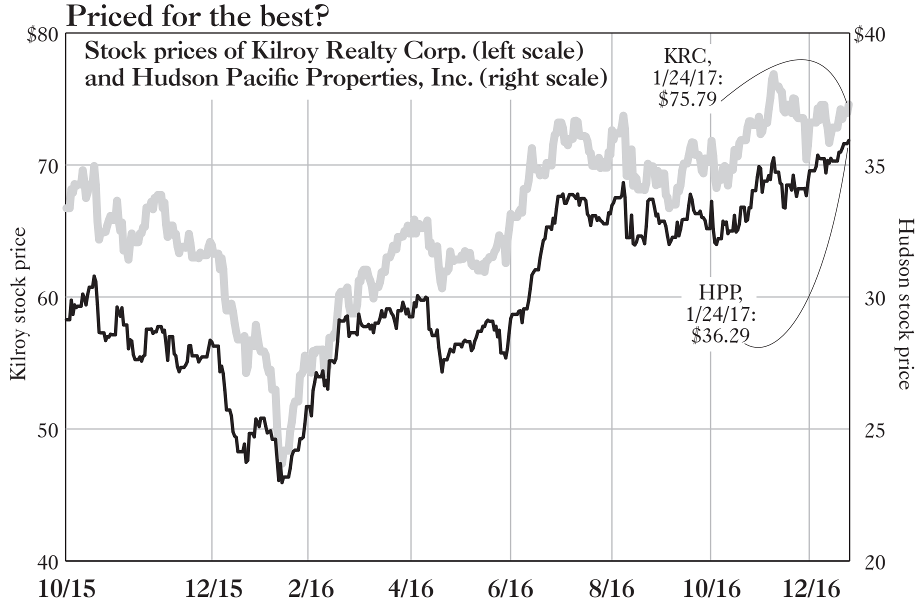
Kilroy first featured in *Grant's* in the fall of 2015, when the shares traded at $65. By February 2016, they had fallen to $47, only to rebound to $75.79 today. At 22.3 times funds from operations (FFO) and 33.5 times funds available for distribution (FAD), to deliver a yield of 2%, they are hardly cheap. Compare with the median office REIT, trading at 16.9 times FFO and 22.1 times FAD to yield 2.8%.

The original *Grant's* analysis proceeded from the observation that technology is cyclical. And if the cycle were turning (so we hypothesized in the Oct. 2, 2015 issue), "Kilroy will first feel the stress in the buildings it hopes to fill with solvent tenants. There will be fewer of them. If the downturn proves severe enough, some number of existing tenants will file for bankruptcy and, with a judge's permission, restructure their leases in Kilroy's legacy buildings."

The narrative laid weight on a large number of looming lease expirations and a sizeable pipeline of upcoming and anticipated developments. There would be too much space for too few bankable tech tenants, we contended.

In fact, the tech cycle has not yet turned. New tenants have neatly matched new development. In a Nov. 8 presentation, Kilroy disclosed it had pre-leased 84% of The Exchange and 100 Hooper Street—the two projects it is building in San Francisco—with

Priced for the best?



source: The Bloomberg

Adobe Systems, Inc. taking on 65% of the latter's space.

John Kilroy, CEO and chairman, came to the phone to talk to colleague Alex Hess. He addressed our view of the cyclical risks inherent in tech-centered real estate as follows: "The only way I know to insulate yourself as best you can is to have longer leases, which we do; with as many [creditworthy] tenants as you can, which we do; to have a best-in-class balance sheet, which we do; and when you have developments, to have a lot of it pre-leased, which we do."

Fair enough. We concede that we picked on the wrong West Coast tech-centered REIT. On, then, to a better short-sale candidate, Hudson Pacific Properties.

HPP went public as a collection of real estate assets acquired from its predecessor, Hudson Capital, as well as from Farallon Capital and Morgan Stanley. The 2010 HPP prospectus announced its corporate mission statement: "We believe current events in the financial markets, the credit crisis and the scarcity of available capital for commercial real estate have created significant market dislocation, thereby fostering a favorable acquisition environment." So far, so good. Shares have more than doubled while the company's square footage has zoomed to 14.6 million from 2 million square feet.

Hudson Pacific commands the same kind of fancy, boomtime, end-of-cycle valuation as Kilroy: 20.6 times FFO, 31.8 times trailing FAD and a dividend yield of 2.2%. The two companies are also similarly, and conservatively, levered: At Kilroy, debt totals 5.6 times trailing EBITDA and 35% of assets; at HPP, 7.3 times EBITDA and 38% of assets. (For the average REIT, debt runs at 9.0 times EBITDA and 46% of assets.) Each company pays its fixed charges with ease. Kilroy's EBITDA covers interest incurred—that is, the sum of interest expensed and capitalized—by 3.8 times. Hudson Pacific's trailing EBITDA covers interest by 4.7 times. Across all other REITs, EBITDA covers interest incurred by 3.2 times.

"Location" (you repeat the word three times to describe the essence of real-estate value) is what differentiates the two companies. To start with, Hudson Pacific was focused on Los Angeles. Then came its purchase, in April 2015, of a portfolio of Bay Area properties from Blackstone. HPP paid $3.9 billion—$1.75 billion in cash and the rest in shares—for 26 assets. In the process it more than doubled the size of its portfolio while shifting the geographic center of its holdings towards northern California. Before going public, HPP garnered 46% of its rents from a pair of Los Angeles film studios, Sunset Gower and Sunset Bronson. By the third quarter of 2016, the studios accounted for 5% of rents. Nowadays—i.e., as of Sept. 30 of last year—technology, media, entertainment and advertising tenants occupy some 57% of HPP's offices.

REITs by the number

	Implied cap rate	Office rent per sq. ft.	P/FFO	Dividend yield	Debt to EBITDA
Hudson Pacific Properties, Inc.	4.35%	$44.30	20.6x	2.2%	7.3x
Kilroy Realty Corp.	4.59	49.59	22.3	2.0	5.6
Average office REIT	6.16	37.33	17.2	3.5	9.0

source: The Bloomberg

"The Bay Area" covers a multitude of miles. At year end, according to data from real estate services company JLL, average asking rents were $73.65 per square foot in San Francisco proper, $58.02 on the mid-Peninsula and $47.84 in Silicon Valley. Vacancy rates were 8.2%, 10.7% and 12.4%, respectively. It matters, therefore, that the majority of Hudson Pacific's Bay Area properties are situated in the mid-Peninsula and Silicon Valley while Kilroy's are concentrated in San Francisco itself. In September, HPP's Bay Area offices were 4.5% vacant at an average annualized rent of $42.67 per square foot. For Kilroy, those figures were 1.7% and $49.65. In a tight market, both companies have been able to raise rents. Kilroy disclosed that, in the first nine months of 2016, it was able to re-lease existing space in its portfolio at 24% higher rates than the expiring tenant paid. For HPP, that number was even higher, at 52%.

Location matters, too, in the scheme of business development. Kilroy expects to grow by completing such projects as the aforementioned 100 Hooper and The Exchange as well as the multi-purpose One Paseo project in San Diego County and the planned Flower Mart, a 2.2-million-square-foot, $1.5 billion office project in San Francisco—which on its own would expand the footprint of the Kilroy office portfolio by 15.6%.

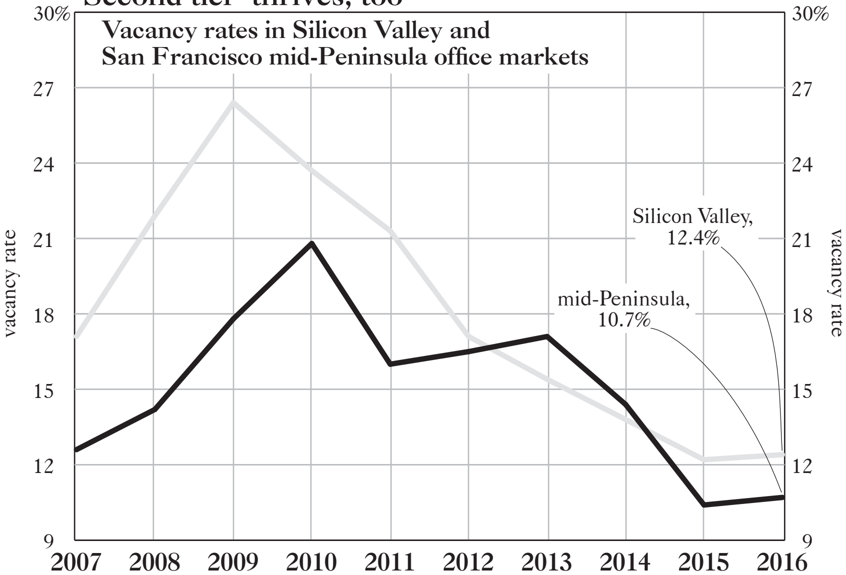
Hudson Pacific is pushing a two-prong growth strategy: developments that will shift more of the company's portfolio back to Los Angeles, and the continued lease-up of its Bay Area portfolio.

The first does hold promise, we acknowledge. In the latest quarter, there were 12.7 million square feet of office space in the HPP portfolio. For context, HPP last reported that its ongoing development and redevelopment pipeline would add another 852,453 square feet of office space, equal to 6.7% of the existing assets.

Like Kilroy, Hudson Pacific can make a strong case that its development portfolio will help it land quality tenants and create value. For example, Netflix is slated to rent two new HPP office developments in Los Angeles—called ICON and CUE—alongside 99,250 square feet of studio space at Sunset Bronson, for a total of more than 500,000 square feet. As of Sept. 30, HPP forecast a combined total cost of $201 million and a return on cost of 8.8% for a fully occupied ICON and CUE. Assuming that the REIT could sell the two assets at a 5% cap rate, or for approximately $353 million, HPP would generate a return on its investment of 76%. Should HPP's other developments replicate its success with Netflix, the company could decide to continue developing. HPP last reported a "shadow pipeline"—that is, real estate it may elect to develop or redevelop in the future—of 2.76 million square feet, 52% of which would be in Los Angeles.

The second growth initiative—the lease-up agenda—seems more problematic. Seventeen of the 26 former Blackstone properties were designated as being in "lease-up" status (that is, less than 92% occupied) in the second quarter of 2015, shortly after the Blackstone purchase was consummated. By the third quarter of 2016, nine were still in lease-up, three had been sold and five upgraded to full-occupancy status. Occupancies across the 14 retained properties have risen by eight percentage points on average, to 84% from 76%, over the five calendar quarters. However, for the nine properties that still remain in lease-up, the average occupancy rate has slipped to 76.3% from 77.3%. Nor are those build-

'Second tier' thrives, too



source: JLL Research

ings a corporate afterthought: They accounted for 3.5 million square feet, or 28%, of HPP's 12.7-million-square-foot office portfolio as of Sept. 30. On the Nov. 6 earnings call, an analyst mentioned rumors that Cisco might exercise an early termination option in its lease of 471,580 square feet at Campus Center—one of the now fully occupied properties acquired from Blackstone. This option would allow the company to exit its lease two years early. The response of Victor Coleman, Hudson Pacific's chief executive, put no anxious mind at ease. "Candidly," he said, "they've been fairly quiet. And as a result, I think, it would be challenging for them to get out by 2017. . . . My guess is they'll be there through 2019 and then at that point between 2017 and 2019, we'll see what happens."

Getting the laggards among the Blackstone 26 to full occupancy would increase HPP's rent-generating office space by 7.8%, to 12.2 million from 11.3 million square feet. It will be easier said than done.

"If there is some sort of [tech] slowdown, there will be another flight to quality," says David Bergeron, managing director of T3 Advisors, corporate real estate brokers and advisors. "All the folks that are talking about going to Oakland or down in San Mateo—people that are opting for the Tier 2, yet accessible, locations—once the market starts to fall enough, they're going to rush back into the city."

As of Sept. 30, 17.8% of Hudson Pacific's portfolio leases were slated to end between the first quarter of 2017 and the third quarter of 2018. Of those leases, 69% pertain to Silicon Valley and the mid-Peninsula; together, they answer Bergeron's description of "Tier 2," at least in comparison to San Francisco. Thus, in Silicon Valley, leasing activity totaled 4.3 million square feet in 2016, down 28.8% from the year prior, according to JLL. Net absorption fell by 47%, to 1.5 million square feet in 2016, the lowest level since 2010. Year-end vacancies rose to 12.4% from 12.2%, the first increase in eight years. In the mid-Peninsula last year, net absorption fell by 36% and leasing activity by 46%; year-end vacancies rose to 10.7% from 10.4%. At a glance, then, it would appear that the markets to which HPP is most exposed have begun to droop.

Not so, Wall Street sentiment: 10 sell-side analysts rate HPP a buy, one a hold and none a sell. The consensus holds that HPP will report $1.78 in FFO per share for 2016, growing by 10.6% to $1.97 in 2017. One research analyst names HPP his "best idea" among office REITs for 2017, citing the company's large rental hikes on new leases and the lease-up of its under-occupied Blackstone assets. Perhaps.

But much could go wrong for HPP in the near term as well: Imagine that venture funding dries up further and the tech sector's demand for office space keeps declining. Money-losing VC funding startups begin to shutter; larger tech firms start bracing for the downside by cutting office-space needs. Vacancies and sublease space rise dramatically. The remaining creditworthy tenants choose not to renew their leases at HPP's lesser properties, and especially not at fat increases to their old rents. Instead, seeing a bargain, they take space at a discount in San Francisco's toniest markets. Suddenly, Wall Street's near-term price targets no longer look achievable. A decrease of 10 percentage points in occupancy rates across the board in HPP's Bay Area portfolio, for example, might cut annualized FFO per share to $1.31, or 34% below consensus for 2017.

The best-informed people appear to be willing to consider downsize risk. Kilroy insiders sold 231,235 shares for $16.7 million in the past 12 months, including 150,000 shares by John Kilroy himself, for a consideration of $10.8 million. (After the sale of $50.8 million worth of stock in the past four years, he's left with 666,181 shares—or 1.45 million if Kilroy partnership units, each convertible into a share, are included. Kilroy, son of the founder, is either 68 or close to it.) At HPP, insiders were bullish through May, buying 73,500 shares for $2.1 million at prices ranging from $26.03 to $28.83. Since then, they have bought no additional shares. On Jan. 10, HPP priced an offering at $35 per share that cashed its institutional partners, Blackstone and Farallon, out of their positions. The two sold the equivalent of 18.7 million shares, resulting in $654 million in proceeds before fees. Note to venture capitalists: *That* is a well-timed exit.

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