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Towers of deflation

Times change and ideas tag along. Or is it the other way around? No matter. Inflation, once a scourge, is today a necessity, or so say the central bankers. Janet Yellen presented this paradoxical notion to an audience in Amherst, Mass., last week. The problem with "very low" inflation, she said, is that it "constrains a central bank's ability to combat recessions." And you thought that Yogi Berra had gone to heaven.

Now unfolding is a polite refutation of the Chair's worldview. It takes the form of a bearish analysis of the American office-building market and of a particular office real estate investment trust; Kilroy Realty Corp. (KRC on the Big Board) is the name. In preview, we judge that real estate values—especially the private values on which REITs derive their net asset value—are generally inflated; the Kilroy share price is specifically so.

We proceed from the observation that the effects of E-Z money are both inflationary and otherwise. On the one hand, stock and bond and real estate prices zoom higher. It's inflation of a kind. On the other hand, certain other prices—commodity prices, for instance—zoom lower. That's deflation of a kind.

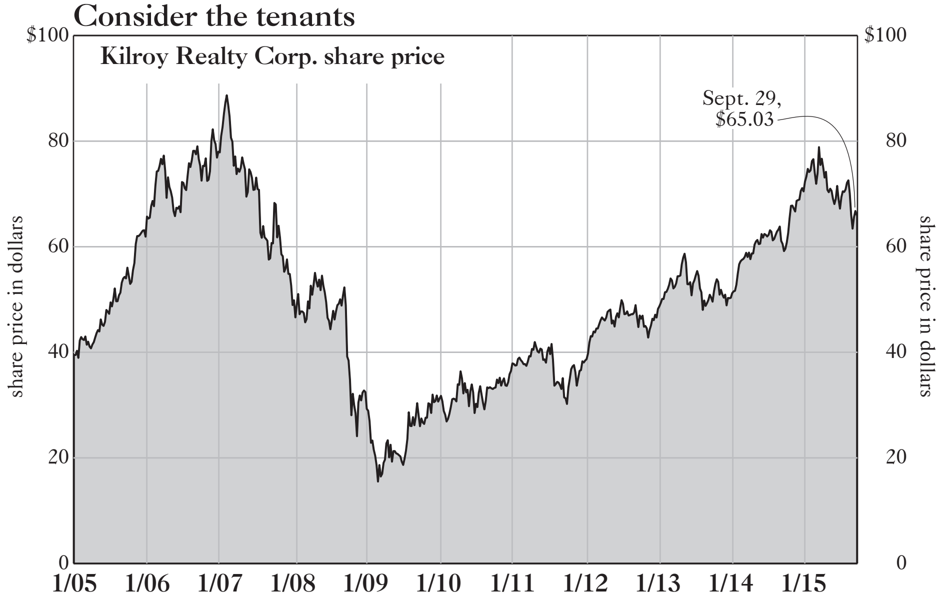
Through the techniques of zero percent interest rates and quantitative easing, the Fed set out to boost aggregate demand. Without necessarily achieving that objective, the central bank raised up aggregate supply. "Not much inflation, and isn't that a mercy?" is the approach that earlier generations of central bankers took to such a price situation as ours. "Not much inflation, and isn't that a worry?" is how today's central bankers read the newspapers.

Maybe the Yellens and the Draghis have a point, after all. There's nothing wrong with falling prices if the cause of the decline is wholesome gains in productivity. There's everything wrong with falling prices if the cause is unpayable debts. There was more than a whiff of this kind of deflation—the debt-induced real McCoy—in the Glencore-rattled markets of Monday. If anyone should be attuned to the baleful effects of excessive leverage, it's the central bankers who facilitated so much of it.

A glance at the August CPI report shows a year-over-year rise of 0.2%, an evident far cry from the Fed's preferred 2% rate of debasement. A longer glance reveals that, ex-food and energy, the index climbed by 1.8%, nearly matching the Fed's target (the one that Chair Yellen was pushing for as long ago as 1996). Chief source of the disparity was a 15% drop in energy prices, a collapse brought about both by human ingenuity and wide-open capital markets. The debt-financed fracking boom made possible the production of the marginal unit of energy that toppled the marginal price of energy. Whose fault is that, Chair Yellen?

Or one could bestow laurels. The nation's energy consumers might call the ZIRP-enhanced bear market in oil and gas an act of monetary statesmanship. So might the nation's commercial tenants be inclined to thank the FOMC for the prospect of cheaper office rents. Ultra-low interest rates

Consider the tenants



source: The Bloomberg

have fostered localized booms in office-tower construction.

It's evidently not impossible to forget that commercial real estate is a cyclical business. Already, many seem to have put aside the unpleasant lessons of 2007-09. "The office REITs entered the slump with over-stuffed development pipelines and over-leveraged balance sheets," colleague Evan Lorenz relates. "Now, after seven years of unconventional monetary policy, the office REITs have development pipelines just as outsize as they had in the depths of the crisis. Their balance sheets are even more encumbered than they were in the bad old days."

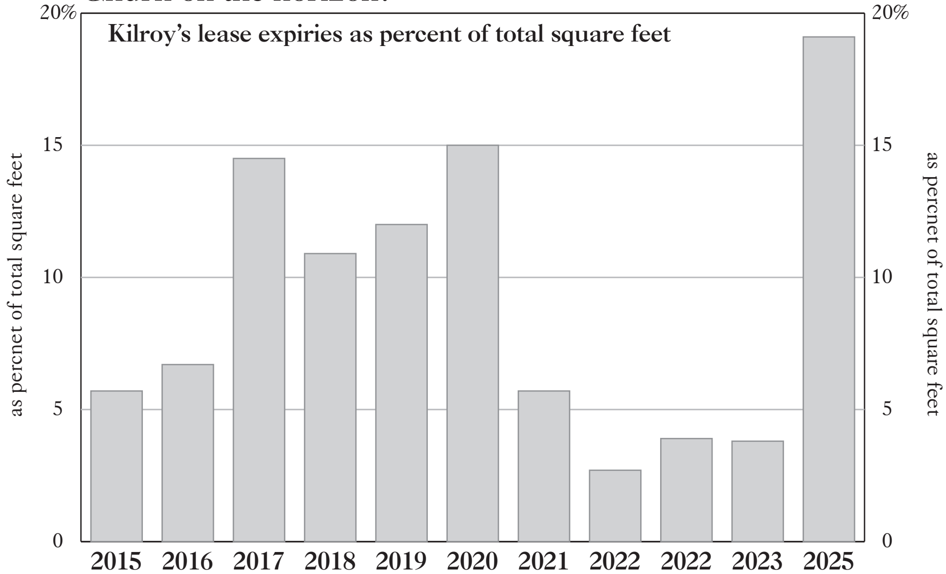
A value-minded reader may here cry halt. Office REITs certainly look cheap. On average, according to Green Street Advisors, they trade at a high teens discount to net asset value. Over the past 10 years, the mean discount to NAV was on the order of just 3%.

A discount there most certainly is. It's a discount to private-market values raised up by, among other things, the aforementioned monetary magic. Comparing cap rates to investment-grade bond yields (and factoring in a certain number of other nuanced variables), Peter Rothemund, analyst at Green Street, reckons that commercial real estate in private transactions is 10% overvalued. Commercial real estate in public REITs, it follows, must be more than 10% overvalued, because the REITs are leveraged.

Consider the case of $100 of assets overlaid on $40 of debt; your NAV is $60. Let us say that the value of your assets declines to $90. You still owe your creditors $40. Your NAV is no longer $60. It is rather $50. Anticipating the move to $50, the market has taken its pruning shears to the REIT share prices. The prevailing average 17% or 18% average discount might therefore constitute no bargain at all. It could be—we judge it to be—approximately fair value.

A real-estate owner may here cry halt. H. Dale Hemmerdinger, a real estate owner and developer based in New York City, in fact, has done just that. "Real estate is not a bond," he observes. "Real estate is an operating business. As soon as real estate starts trading where a bond is, people who invest in real estate are going to get beat up. . . . Real estate is full of surprises. Roofs need replacing. Elevators need replacing. Windows get broken. Things that you don't have to worry about with a bond, you have to

Churn on the horizon?



source: company reports

worry about with real estate. Anybody who doesn't buy real estate at a big spread over a bond, in my view, doesn't understand what they're buying." Well, then, let's call a 17%-18% discount fair value at best.

Reading Mr. Market's lips, we think we can discern a message to the management of the average office REIT: "Sell the buildings, reduce the share count, pay down debt." Or, more emphatically, "Sell the company." Do the managements listen? They do not. Development pipelines continue to grow. Even the most deeply discounted REITs are in no hurry to put themselves up for sale.

Cycle to cycle, the story line is always a little different, of course. In the mid 2000s, overbuilding of office towers was generalized. So great was the momentum of construction on the eve of the Great Recession that, between the start of 2007 and the close of 2008, an average of $5.6 billion per month of new office space sprang into being. Seven years on, the rate of completion of new office towers has still not returned to that frenzied pace. At the post-recession high, which occurred in July, paint was drying on just $4.9 billion worth of new office space (the comparison is in nominal dollars; inflation-adjusted readings would make the contrast all the more stark).

This time around, visible excess is concentrated. You can see it in New York, and you can see it in Austin, Houston and Dallas, which are set to add a cumulative 12% to 19% of new office inventory by 2019. Houston, especially, has reason to wish that it were otherwise. "Energy companies are reducing head count and cutting office-space requirements," Jed Reagan, a Green Street analyst, tells Lorenz. "Vacancy rates are going up in Houston and rents are going down. Coupling with that, a lot of supply is hitting the market, including some speculative supply where there is no preleasing. You have vacant buildings being delivered, or soon to be delivered, and that is creating a nasty one-two punch for that market."

No mystery, then, why Cousins Properties Inc. (CUZ on the New York Stock Exchange), an office REIT that draws 42% of its net operating income from Houston, has suffered a 31% loss in share price over the past year or why its stock trades at a 26% discount to the Green Street-tabulated NAV.

Whereas energy was hot, technology *is* hot. The tech-driven office markets of San Jose, San Francisco and Seattle are expected to add between 11% and 18% in new office inventory by 2019. Which facts begin to define the opportunity in Kilroy Realty Group. Founded in 1947, Kilroy is a West Coast centered and technology-focused owner of 101 buildings in San Francisco, (which accounted for 38% of first-half net operating income), San Diego (23%), Los Angeles and Ventura counties (19%), Seattle (18%) and Orange county (2%). More than simply present in tech-heavy markets, Kilroy caters to a tech- and media-heavy tenant roster. At the end of 2014, those tenants contributed 45% of the REIT's revenue—in Kilroy's San Francisco portfolio, tech and media chipped in 65% of revenue.

The market thinks the world of Kilroy Realty—you can conjecture as much by the fancy valuation of the stock. Its management gets high marks for steering clear of fatal error in the run-up to 2008 (though the slump was anything but painless for the shareholders). And when the worst was over and prices were right, Kilroy bought heavily in San Francisco and Seattle. "Coming out of the cycle," David Rodgers, the analyst who covers Kilroy at Robert W. Baird & Co., tells Lorenz, "some have said they got lucky with the recovery in San Francisco, but they made very calculated investments regarding the assets in San Francisco, which had become very cheap. The cash flow pricing of some of their initial assets was extremely strong. I think they took a calculated investment risk by moving back into San Francisco and up into Seattle." It was a triumph.

And now? Kilroy, with one of the largest development pipelines in the office REIT industry, continues to push. If all goes according to plan, $1.5 billion of office-tower plantings will sprout in the years to come, all but 31% of them in and around San Francisco. No more than half these projects are under rental contract.

It must be admitted that the bears will have their paws full if nothing changes. In San Francisco, rents have more than doubled since 2010. Another measure of the strength of the San Francisco market is that, in the second calendar quarter, Kilroy lifted rents on renewing tenants by 20%. Still another favorable sign: On June 30, by management's estimate, in-place rents were 13% below market rents. For the portfolio as a whole on the same date—101 buildings containing 13.1 million square feet spread across California and Washington—the vacancy rate stood at 2.8%, management says. In the city by the Bay, vacancies were essentially zero.

Attested Kilroy COO Jeffrey C. Hawken on the July 30 earnings call: "In northern California, the San Francisco Bay area's unemployment rate fell to 3.4% on a 4.1% year-over-year increase in jobs. In Silicon Valley, unemployment fell to 4.1% and net new jobs increased by an impressive 5.5%."

Tenants read the papers, too. In such landlord-friendly markets as these, the likes of Uber Technologies Inc. and Salesforce.com have taken to warehousing square feet to accommodate employees yet unhired (and of profits yet unturned). "In San Francisco, for the first time in a number of years," Rodgers advises Lorenz, "we are speaking with brokers who say tenants are taking space for future commitments, but they don't necessarily have a need for that space today. . . . This isn't our opinion; this is the brokers we are speaking to. That is the depiction that we are getting of the market overall."

Tomorrow is always the point, of course. The question is what will tomorrow bring? More of the good things, is the creed of the optimist. More of the good things—and maybe some of the bad things, too, is the creed of the realist. A realist is an optimist who once had a margin call.

Real estate and technology are given to cycles of flourishing and unflourishing. Real estate that houses technology businesses is, we propose, especially prone to cyclical gyrations. The cycles of real estate are actually visible. Just crane your neck. Standing on Mission Street between First and Fremont Streets in San Francisco, you will see the rising skeleton of Salesforce Tower, a projected $1.1 billion, 1,070-foot-tall monument, which, upon its expected completion in 2018, will lord it over every other structure in the city and stand as the second tallest building west of the Mississippi, just behind the (also projected) Wilshire Grand Tower in Los Angeles.

Salesforce Tower is not a Kilroy building. Nor, in spite of its name, is it the property of the cloud computing giant that has not turned a GAAP net profit since 2011 (Boston Properties, rather, owns the brick and mortar). We mention the building as a cyclical marker. It was conceived in 2007, on the eve of the bust. Not until 2013 was ground broken. Not until 2014 did the developer secure an anchor tenant, Salesforce. In planning and execution, this is a bull market undertaking.

Maybe the market is turning. Layoff announcements have quickened, with Microsoft (8,000), Hewlett-Packard Co. (35,000) and Qualcomm (4,500) all dropping the HR ax in the past two months. "The big-cap tech companies are laying off people as the result of the weak global economy, slow capex spending falling, PC/tablet sales (double-digit volumes year-over-year) and a significant slowdown in smartphone growth," Fred Hickey, editor of *The High-Tech Strategist*, advises Lorenz. "The unanticipated sales slowdown has led to an inventory buildup of components that is weighing on semiconductor makers. Most of them are cutting back capacity.

"So where is all the demand for office space coming from?" Hickey goes on. "The answer is the money-losing social media/cloud/Internet sector (again). It's a function of easy money from the Fed. So we have 135-plus non-public 'unicorns,' i.e., companies with billion dollar-plus imputed valuations (some in the tens of billions). That doesn't include all the startups with imputed valuations in the hundreds of millions of dollars. Many of these companies have questionable business models. But because of the free-flowing cash, they can hire like crazy, lease expensive office space . . . and waste money partying like it was 1999 all over again."

(In the Sept. 1 issue of Vanity Fair, Nick Bilton observes that many unicorns—Uber, Lyft, Sidecar, Luxe, Instacart, SpoonRocket, TaskRabbit, DoorDash, Shyp, etc.—are really glorified delivery companies, trying to do with algorithms what Domino's Pizza mastered with the internal combustion engine in the 1980s.)

The average American office REIT, Kilroy excluded, trades at a price to yield 3.5%; Kilroy delivers just 2.2%.The average U.S. office REIT, Kilroy again excluded, changes hands at 14.2 times trailing adjusted funds from operations, or AFFO (operating income minus routine capital expenditures, straight line rent, and such one-time items as gains or losses on land sales); Kilroy commands a trailing multiple to AFFO of 19.7. Office REITs, excluding Kilroy, trade at an 18% discount to NAV; Kilroy trades at a 9.7% discount.

Bulls may observe, correctly, that only 5.6% and 6.7% of Kilroy's so-called "stabilized" buildings—i.e., the tenanted ones—are up for re-leasing in 2015 and 2016. The lease renewal rate thereafter jumps to 14.5% in 2017, and to 10.9% in 2018 and 12% in 2019. How much comfort can one draw from those data? If the tech cycle is, indeed, turning, 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.

To those who say that "bubble" is a debased word and that 2008 was as rare as a sighting of Halley's Comet, we say, perhaps. The world has never been dosed with money as it has been dosed these past seven years. For seven glorious years the reciprocal of niggardly passbook savings rates was free-and-easy venture funding. It would be rash to underestimate the effects of this unique experiment. Let us therefore compare the 2007 model Kilroy with the company today.

At year-end 2007, Kilroy's debt amounted to 41% of its assets; today, the figure is 29%. In 2007, debt to EBITDA registered 8:1; today, it stands at 6.8:1. In 2007, operating income covered interest expense by a factor of 2.1:1; today, that ratio is 2.9:1. So far, so good.

The wrinkle this time around is Kilroy's commitment to new building. The company ended 2007 with a development pipeline equivalent to 5% of its rent-earning assets. Today, that figure weighs in at 22% of assets-in-place.

"Kilroy's shares made their all-time high on Feb. 13, 2007," Lorenz points out. "The price was $89.80. Next thing you knew, the price was $15.40. This was on March 9, 2009. To recapitalize its not-so-obviously over-leveraged balance sheet, Kilroy had diluted the shareholders by 30% by issuing stock at $20 per share in May 2009. The price today: $65.03 a share."

It's too high, we think.

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