GRANT'S
CELEBRATING 40 YEARS
INTEREST RATE OBSERVER®

Vol. 41, No. 8b | 233 Broadway, New York, New York 10279 • www.grantspub.com | APRIL 21, 2023

'Feeling in our bones'

Evan Lorenz writes:

Last week, Blackstone, Inc. closed on a $30.4 billion fund to invest in commercial real estate—its largest ever—as institutional investors lined up to buy buildings at bear market prices. Last month, retail investors, who had paid bull market prices, tried to redeem $4.5 billion from the private $70 billion Blackstone Real Estate Income Trust. Stephen Schwarzman & Co. granted only 15% of those requests to exit.

To avail themselves of the opportunity presented by lower prices, contrarians need more than cash and a bold spirit. They need a vehicle—a ticker—and one, preferably, without the Hotel California characteristics of Blackstone's unlisted "Breit." In preview, *Grant's* is bullish on Equity Commonwealth (EQC on the New York Stock Exchange).

According to Green Street, the price of institutional-quality commercial real estate plunged by 15.2% in the 12 months till March, outpaced not only by the problem-child office sector (down 25%), but also by the less-notorious apartment sector (down 21%). Industrial warehouses and shopping malls (off 13% and 15%, respectively) fared better.

Multifamily "was priced to perfection," Chad Littell, the national director of U.S. capital-market analytics at CoStar Group, Inc., tells me. "What was going on was investors were banking on rent growth, which, in certain markets, was increasing 8% to 15% year over year. Investors were saying, 'Look, I don't really care what the going-in yield is because my rents are growing so quickly. I can reset rents every year, so I'll pay a three cap rate today, but I can quickly be a mid-four or a mid-five cap in a couple of years.' "

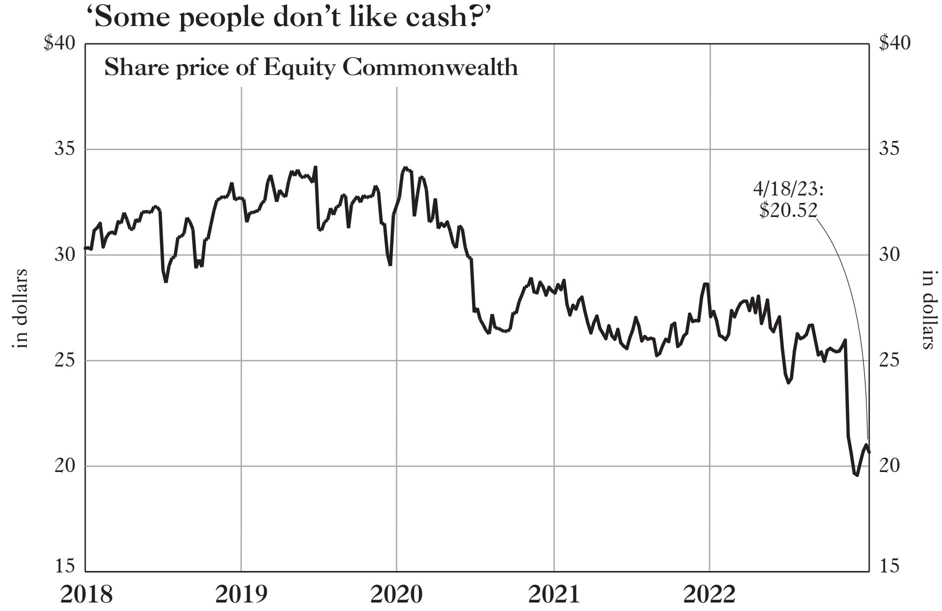
Perhaps, before very long, compelling absolute values will return to the commercial real estate market, but for now, according to Green Street, income-producing property remains overvalued, by 8% compared with Baa-rated bonds and by 9% versus the yields on offer from publicly traded real estate investment trusts.

Not surprisingly, property owners have been slow to accept the new, everyday low prices. According to CoStar, sales of multifamily buildings collapsed by 74% in the three months through March 31 from the year-ago period to the lowest level since 2012. Apartments led the decline in turnover, but other market segments also showed signs of paralysis. Thus, sales of retail properties fell by 38%, industrial by 47%, lodging by 54% and office buildings by 61%.

"Anytime you've had this gigantic shift in the cost of capital, it's just frozen the market," Michael Knott, the head of REIT research at Green Street, tells me. "The transaction market has become pretty ice-cold. It's going to take some time for the broader market to adapt to and accept that we are in a higher cost-of-debt market."

Nor is the cost of capital the only sticking point in the commercial real estate world. Demand for space is starting to weaken, despite the reportedly still-growing GDP (at a real annual rate of 2.5% in the first three months of

'Some people don't like cash?'



source: The Bloomberg

Equity Commonwealth at a glance
all figures in $ millions except per share data

	2022	2021	2020	2019	2018
revenues	$63.1	$58.0	$66.3	$127.9	$197.0
net interest income	46.9	6.8	20.6	63.5	20.2
funds from operations	46.9	-6.8	15.8	89.7	73.4
shares	112.8	121.4	126.6	126.3	123.4
FFO/share	0.42	-0.06	0.12	0.71	0.59
cash	2,582.2	2,801.0	2,987.2	2,795.6	2,650.4
debt	0.0	0.0	0.0	25.7	275.0
preferreds	119.3	119.3	119.3	119.3	119.3
total assets	2,854.9	3,081.4	3,277.7	3,319.4	3,530.8

source: company reports

the year, according to the Atlanta Fed's GDPNow model). The March employment report showed that employers cut 11,800 warehouse and storage jobs, bringing the cumulative reduction in such employment to 50,000 workers from the June 2022 peak and to the lowest level in 15 months.

Apartment rental rates, meanwhile, climbed by just 2.5% in the 12 months through March (while rates in the cities of Phoenix, Ariz., Austin, Tex. and San Francisco, Calif. registered actual declines, according to CoStar)—a mere flicker compared with the 11.4% surge in the 12 months through March 2022. Even so, reports the U.S. Census Bureau, hard hats are busily constructing 941,000 multifamily units, the most on record since at least 1970.

Then there's the looming refinancing wall. "There's about $1.4 trillion in maturities that are coming due in 2023 and 2024," says Littell. "That's almost one-third of all outstanding commercial real estate debt. It's primarily concentrated in office and hotel and, in terms of lender profile, it's primarily concentrated in banks." There's a good chance that new loans will be costlier than the ones they replace.

The latest credit-related straw in the wind was last week's default on a $230 million floating-rate loan secured by four Houston apartment buildings; the owner, Applesway Investment Group, had purchased the property, which consists of 3,200 units, in 2021. Blackstone, Brookfield Corp. and RXR Realty are among the other boldface real estate names to have recently chosen to mail in the keys rather than to continue servicing a burdensome debt.

Property lenders were already stepping back before the rash of commercial mortgage defaults and the March failures of Silicon Valley Bank and Signature Bank. In January, 57.5% of senior loan officers reported tighter standards on loans secured by nonresidential properties, a level typically seen during recessions.

On the bright side, as Samuel Ashner, a managing director at distressed real estate investment firm Winthrop Capital Partners, puts it to me, the recent banking turmoil is accelerating the process of price discovery. Ashner relates that a bank approached his firm with an offer to sell a loan on a New York City asset. "When we initially had a conversation with them six weeks ago, they said, 'We'll sell it, but we're pretty comfortable with our basis, so $96–$97 on par,' which then turned into $90, and I didn't even say anything."

The lender subsequently cut the price to the high $80s but refused to provide vendor financing. Today, says Ashner, the bank is offering the loan for $80 *with* vendor financing. "They have another piece of debt on this building on their balance sheet and have said, 'We'll vote however you want us to vote,' essentially giving us servicing rights."

. . .

Equity Commonwealth began life as the Health and Rehabilitation Properties Trust in 1986 with a focus on those namesake property types. Over time the REIT's focus shifted: to retirement centers in 1994 and to office properties in 1998. Industrial properties joined the mix in 2003. The company's name itself was in flux until 2010, when the C-suite settled on Commonwealth.

While prior management may win plaudits for intellectual flexibility, those pivots did not enrich shareholders. From a peak in February 2007 to January 2013, Commonwealth's investors endured a 71% drop in the share price even as the company's external manager, REIT Management & Research, LLC (RMR), treated itself to a 40% raise. In February 2013, investors Related Cos. and Corvex Management, L.P. started an activist campaign to give RMR the boot.

With real estate great Sam Zell running as chairman of the board, the activists achieved their goal in May 2014. The "situation, I felt, was extraordinarily egregious," Zell said at a REIT conference that year. "I thought it was very bad for the real estate industry." Zell brought the REIT's external management in-house, installing a former co-president of Zell's Equity Group Investments, LLC, David Helfand, as CEO.

The next act was to clean out the portfolio. "When we took this thing over, there was a whole bunch of dreck," Helfand tells me, including such oddments as vineyards, theaters and a Hawaiian storage facility. "When we started our first earnings calls, people would ask us what our priority was. We would say, 'Well, the stuff we're most scared of we are selling first.' And we got out of office buildings in New Orleans, Greensboro, upstate New York. Real garden spots."

Since taking over in 2014, Zell and Helfand have liquidated $6.2 billion's worth of real estate, paid out $1.3 billion in dividends and repurchased $629 million's worth of stock. Today, the balance sheet is a model of simplicity: On the asset side, Commonwealth owns eight office buildings in Austin, Tex., Denver, Colo. and Washington, D.C. (with an undepreciated book value of $408 million) and $2.1 billion in cash (adjusted for a $4.25 per share special dividend paid in March, a detail we unfortunately omitted in the original version of this article). The only debt, or quasi-debt, consists of the 6.5% Series D preferred shares, of which $119.3 million's worth is outstanding.

In 2022, the office holdings generated $39 million in net operating income. At a 10% cap rate, a punitively higher rate than the 6.9% at which office buildings are theoretically valued in the private market, the portfolio would be worth $389.6 million. Add $2 billion in net cash, and you get an overall value of $2.4 billion versus the current market cap of $2.3 billion.

Office buildings are capital-intensive and low-return structures—and were, say Commonwealth executives, even before the work-from-home movement. "You can buy, fix and sell," COO David Weinberg tells me. "That works. Buy, fix and hold—that can be challenging. Having said that, where office is trading has given us some pause and caused us to revisit that thesis."

The M.O. today is to buy good assets at a good price, though not just any assets. For instance, according to Helfand, EQC is giving wide berth to distressed situations, though "right now things are getting interesting from a distress point of view." For another, the company avoids multifamily and manufactured housing, leaving those segments to other Zell-managed REITs. Neither does it want a hodgepodge of disparate, analytically complex assets. "We are likely to be a single asset-owning entity," says Helfand. "That is REIT orthodoxy. There isn't really a history of REITs doing more than one thing and being successful."

(On that note, Office Properties Income Trust and Diversified Healthcare Trust, two REITs managed by RMR, announced a merger on April 11. Since then, they have declined 36% and 20%, respectively.)

"We're a public REIT," Helfand reminds me. "And what we want is to avoid being a sort of irrelevant, small public REIT. So our plan is not to sort of pick a time and do serial acquisitions. We generally don't pick timing. We let the market dictate when we see a deal that, on a risk-adjusted basis, is attractive. Then we act. We really don't have a plan about the market bottom or timing. We really just try to react to the environment. And we want to do something of scale, rather than a number of smaller deals, because we remain committed to maximizing value for our shareholders. And that includes a potential liquidation of our remaining assets [and returning] the cash to shareholders."

In May 2021, Commonwealth nearly became an industrial warehouse–focused REIT. An old favorite of ours, Monmouth Real Estate Investment Corp. (*Grant's*, June 27, 2014), was the apple of its eye, but Industrial Logistics Properties Trust made off with the prize.

"It still feels early," Helfand cautions when the conversation turns to bargain-hunting. "Our experience is that when [large increases in the cost of capital] work through the system, that creates opportunities. People are starting to give properties back. We're getting calls about opportunities to rebalance capital stacks, whether it be a property portfolio or a company."

Despite its massive net cash balance, Commonwealth does not regard higher interest rates as an unalloyed blessing. To qualify as a REIT, a company must derive at least 75% of its gross income from properties or mortgages. In 2022, EQC generated $63.1 million in property-related income out of $110 million total income (including $46.9 million in interest income). Thus, only 57.3% of the total was property-derived. Management worked around the rule by shifting assets to a wholly owned REIT subsidiary, which triggered a mark-to-market gain for the purposes of the income test.

"We have that option again this year and next year," says Helfand. "I think the clock will run out for our patience before the issue becomes an existential one for us."

Commonwealth, which, as noted, has spent the past nine years liquidating its portfolio, does not pay a regular dividend. Its returns are all the more striking, then. Since May 2014, it has generated a 33.9% gain versus a 28.1% loss for the 15 office REITs in the S&P 1500, both figures including reinvested dividends.

Barely acknowledging EQC's existence, the Street assigns it two holds and one sell. Such analytical neglect notwithstanding, Commonwealth trades an average of 1 million shares, or $21.6 million's worth of value, per day. Over the past 12 months, insiders sold 50,000 shares for proceeds of $1.3 million, though management still owns 5.7 million shares worth $118.5 million. Short interest as a percentage of the float increased to 4.5% on March 15 from 2% on Nov. 30, 2022.

The size of the short interest is a bit of a mystery. "I'd like to ask one question that might be a little odd," I addressed Helfand and his colleagues on the phone, "but I'm looking at Bloomberg right now. I think you have a $2.3 billion market cap-you have $2 billion in cash, $100 million in preferred. And you do have some value in those offices, which are generating a little under $40 million in net operating income. It looks like you have a fairly negative enterprise value, and very little real estate risk. But I have noticed that short interest has increased to 4.5% from 2% in November. Is there a bear case for your stock?"

"I couldn't tell you," Helfand replied. "Maybe some people don't like cash?" Or, maybe not: Short interest has subsequently slipped by 1 percentage point.

Helfand had this to say, too: "The opportunity appears to us to be potentially very good looking forward. We don't know the timing, but just given what's in the air and our experience and the feeling in our bones, we might get a shot here to make a deal to acquire a good business at a fair price. That is compelling to us. The team here would like to stay together and build a business that creates value for shareholders and creates opportunity, career development and challenges for us. But we really are committed to doing the right thing for shareholders. Right now we've got a window where we hope we get our shot."

•