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You take Manhattan

Evan Lorenz writes:

Here in balmy New York, spring has sprung, vaccinations proceed apace and green shoots of commerce bravely poke through the unbusy sidewalks. Whether Mr. Market has jumped the gun in his uber-optimistic appraisal of a pair of New York-centric equities, however, is the question before the house.

Signature Bank Corp. (SBNY on the Nasdaq), a former pick not to click and a big lender against real estate in the five boroughs, and SL Green Realty Corp. (SLG on the Big Board), the preeminent owner and developer of Manhattan offices, are the subjects under the *Grant's* lens. In preview, we're bearish on both.

In and out of New York, the economic recovery traces a jagged path forward. According to the Census Bureau's late-February Small Business Pulse Survey, 52.6% of small firms are operating at or above their pre-Covid capacity. Of course, the Department of Commerce can only poll companies that haven't shuttered.

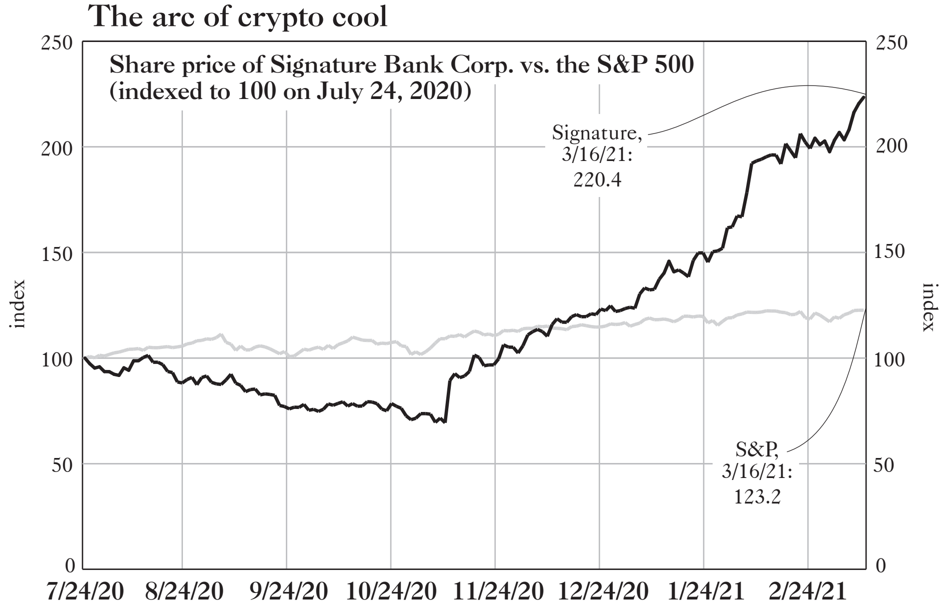
On the other end of the spectrum, businesses and cultural institutions continue to struggle. In February, no less a city monument than the Metropolitan Museum of Art announced that it may have to sell some of its collection to fund operating losses. "[O]ur first priority will be to preserve the mission of the institution," said Max Hollein, the Met's director, "which also requires preserving the staff as best as we can."

Signature Bank, as you may recall, is a business-focused lender—consumer debt makes up just 2% of the loan portfolio. As of Dec. 31, 2020, Signature's $73.9 billion balance sheet was invested in loans and leases ($48.3 billion), cash and equivalents ($12.3 billion) and securities ($11.2 billion). Real estate-related credits secured by New York City properties dominated the loan book (60% of the total), of which loans to apartment owners (31%) was the top subcategory. With common equity representing 9.9% of assets (the so-called Tier 1 ratio), Signature appears well-capitalized.

Small business and small buildings are the bank's stock in trade. Rent-stabilized buildings collateralize half of the multifamily portfolio, and lending to retail operators is skewed to local pizzerias, dry cleaners and bodegas, as opposed to the kind of vacant luxury storefronts that line Fifth Avenue.

Signature's M.O. is high touch, high service. A business borrower applying for credit at Bank Behemoth must navigate layers of due diligence. Not so at Signature, Brian Wyremski, vice president of investor relations, tells me. Customers apply to their banker, and their banker can go straight to the top for a fast loan approval, if the need is pressing. The customer's personal banker, says Wyremski, "will call Signature CEO Joe DePaolo. Joe will walk down the hall to [Chairman] Scott Shay or to [Vice Chairman] John Tamberlane or whoever is on that approval committee, and they will get together

The arc of crypto cool



source: The Bloomberg

SL Green Realty Corp at a glance
all figures in $ millions except per share data

	2020	2019	2018	2017	2016
revenue	$1,052.7	$1,239.0	$1,227.4	$1,511.5	$1,864.0
total expenses	958.3	1,054.8	1,049.8	1,346.4	1,858.6
net income	356.1	255.5	232.5	86.4	234.0
shares (millions)	77.2	86.6	91.5	103.4	104.9
earnings per share	4.87	3.10	2.67	0.87	2.34
cash	266.1	166.1	129.5	127.0	270.4
debt	5,878.9	6,523.5	6,249.4	6,954.5	7,482.2
total assets	11,707.6	12,766.3	12,751.4	13,982.9	15,857.8
funds from operations	562.7	605.7	605.7	667.5	880.9

source: company reports

and they will get that loan approved immediately."

Since a bearish appraisal in the July 24, 2020 issue of *Grant's*, Signature Bank has rallied 123.9% versus a 24.5% appreciation in the S&P 500 (both figures include reinvested dividends).

Credit quality was our point of analytical focus. The March 27, 2020 Coronavirus Aid, Relief, and Economic Security Act gave banks the green light to grant forbearance to pandemic-stricken borrowers while still marking credits as performing. As of June 30, 2020, Cares Act deferrals footed to $9.4 billion, or 21% of Signature's total loan book, equivalent to 1.9 times capital.

At first glance, the Feb. 5 earnings release would seem to allay those worries. Thus, as of Dec. 31, Cares Act deferrals had declined to $1.3 billion, or 2.7% of loans. In the fourth quarter, non-accrual loans summed to 0.25% of total lending and were amply covered by loss reserves amounting to 1.04% of the loan book. In the December quarter, Signature charged off $11.4 million's worth of credits as uncollectible, which annualizes to 0.1% of average loans.

What's going on with Signature, Matthew Breese, who rates SBNY a buy for Stephens, Inc., tells me, is really nothing more than management trying to get its customers "to the other side—and they have a little bit more latitude here from the Cares Act."

The crypto boom has likewise smiled on Signature, an early mover in that department. In April 2018, the bank hired away a digital-currencies team from competitor Metropolitan Bank Holding Corp. The new arrivals built an internal blockchain that allows Signature clients to transfer dollars to one another for free, every day and around the clock. Deposits in the digital division soared to $10 billion at year-end 2020, from $2 billion in 2019, and have spurted by an additional $3 billion through early March, according to management.

Credit is another story. In addition to 2.7% of loans that are still on Cares Act deferrals, Signature holds 6.6% of Covid-impacted loans with modified principal or interest payments. In total, these unpunctual borrowers represent 9.3% of the portfolio, or 78% of total capital.

Signature flags the trouble itself. Performing loans score 1 through 6 on the internal 9-point scale; 7 means special mention, 8 substandard and 9 doubtful. Since June 30, loans rated special mention or substandard, as a proportion of overall loans, has increased to 8.5% from 1.4%.

By asking for help, borrowers in effect downgrade their own loans. "When a deferral was granted at the beginning on the pandemic, it was common practice to assess the loan and downgrade the risk rating," Wyremski advises by email. "Should a client ask for an additional round of deferral, the loan would be reassessed, which would usually result in an additional downgrade."

Not that the pandemic is the only thing that plagues the New York business community. Legislation to cap the ability of landlords to recoup the cost of capital upgrades by raising the rent was enacted a year before the lockdown. A building owner with whom I spoke described the long-range consequences of the Housing Stability and Tenant Protection Act of 2019 in these words: "They took away the future from all of those owners."

Apartment rents in Manhattan fell by 14.4% year over year in February while the vacancy rate rose to 5% from a pre-pandemic 2%. In a December interview, Jonathan Miller, the CEO of appraiser Miller Samuel, Inc., said the real vacancy rate may be nearer 18% if you include the units that landlords are holding off the market because their prior tenants may have decamped to surrounding states and lower-tax jurisdictions like Florida. How many of these ex-pats will return, and when, are open questions.

"A lot of landlords I know are not able to pay their property taxes or their bills," says Seth Weissman, the founder and managing partner of Urban Standard Capital, which has raised a $100 million fund to buy distressed condos. "The operating margin is probably 30%–35%, and the after-interest margin is probably 10%. It's just very, very thin." This, of course, wasn't made any easier by the aforementioned collapse in rents.

Not a few of Signature's business borrowers must be making heavy weather of it. According to the Harvard-run database TrackTheRecovery.com, 42% of small businesses in New York City have closed their doors.

Some 49% of the respondents to a national survey of small-business owners in the week ended March 2 (Alignable, Inc. did the polling) said that they couldn't make March rent, an increase from 38% in February and 33% in January. Small enterprises in New York State seem particularly hard-hit, with 55% responding that they can't, or won't, stump up funds to their landlord this month.

Hats off to Signature's crypto department for its deposit-gathering prowess, but that business line is so far profitless. Money transfers on the Signature blockchain are free of charge, and the newly recruited crypto clients have (at least so far) borrowed no money. Signature's hyper-growth may stem, in part, from that no-fee model; Silvergate Capital Corp., another bank specializing in digital currencies, charges crypto depositors what amounts to a small negative interest rate.

Nationally, loan growth is the tortoise (up 2.3% since the end of 2019) to the hare of deposit growth (up 22.7% over the same span). In fact, loan balances have declined by 5% to $10.3 trillion, from a high of $10.9 trillion in May 2020, while competition for earning assets and the Fed's EZ monetary policy are pressuring net interest margins. Signature's NIM slipped to 2.23% from 2.55% between the third and fourth quarters.

Owing to its newly-minted crypto coolness, Signature bank trades at 20.1 times estimated 2021 earnings and 2.2 times book value, versus 13.8 times earnings and 1.1 times book for the KBW Bank Index. Of the 21 analysts who follow the stock, 19 say buy and none says sell. Short interest sums to 3.3% of the float.

Over the past 12 months, insiders have purchased a net 59,996 shares, though that bare fact may overstate the C-suite's bullishness. When, on Dec. 10, 2020, Signature employees purchased stock, they chose the preferred rather than the common ($2.3 million's worth of the $25 par issue, which yielded 5%). For the rest of the year, insiders sold 32,844 common shares for net proceeds of $2.9 million, or an average of $88.16 per share versus the current price of $241.57.

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While white-collar workers stay away from the office, Mr. Market is champing at the bit to leave home. Year-to-date, office REITs have rallied by 13.4%, outpacing the 9.5% rise in the MSCI U.S. REIT Index. Investors are especially keen on a return of the hustle and bustle in Manhattan, where currently less than one out of every six workers is returning to his desk—or so one may conjecture by the 20.7% boost in SL Green's share price this year.

Green is a Manhattan pure play, with all but 2.4% of net operating income generated in the borough that we New Yorkers know as "the city." Well-situated, high-end, class-A office buildings, including the newly completed One Vanderbilt across the street from Grand Central Station, fill the Green portfolio. At year end, SLG had interests in 69 buildings comprising 29.5 million square feet. Company-wide occupancy finished the year at 91.2%, down from 94.3% at the close of 2019.

Office leases are typically struck for 7–10 years, so white-collar absenteeism has yet to make its mark on SL Green's P&L. In the fourth quarter, per share funds from operations fell 10.9% year over year, with losses on debt instruments accounting for slightly more than half of the decline. For full-year 2020, Green collected 94.8% of total rents; retail tenants came across with 80.8% of what they owed, office tenants with 97.9%.

Management responded to the pandemic and lockdown by selling properties—and by buying back stock with the proceeds of those sales. Last year, SLG generated $497.1 million more in the sale of real estate than it invested in capital expenditures and acquisitions. It spent $638.6 million repurchasing common shares, preferreds and interests in operating partnerships.

CEO Marc Holliday laid out the bull case for Green and the New York office sector on the Jan. 28 earnings call: "The financial and tech sectors in New York City, which account for over half of the office-space demand, are doing extremely well, and they added 5,000 office using jobs in December alone. The city is forecasting a significant amount of new office jobs in 2021, such that we would return to pre-pandemic office employment levels by the fourth quarter of this year, recouping all of the 165,000 office jobs lost at the outset of the pandemic."

However, there were problems in Green's home market even before the virus struck. "New York office fundamentals were basically limping into the Covid-19 recession," Daniel Ismail, who leads Green Street's office research team, tells me. "This is a bit of a departure from the last recession, the GFC, where New York office fundamentals and rent growth were really good."

In the decade before Covid-19, Ismail continued, office supply expanded by around 1% per year. While that may not sound like much, tenants were in the process of downsizing ("densifying," in real estate lingo), and supply expanded at a mere 0.2% annual clip between 1990 and 2010. So, in 2019, asking rents for prime office space climbed by about 1%–2%, or slightly less than the measured rate of inflation.

Today, office availability in Manhattan (the combination of vacant space listed by landlords and sublease space listed by tenants) stands at 16.7%, according to Victor Rodriguez, the director of market analytics at CoStar Group, Inc. "Availability is up 38% year over year, and that's currently an all-time high," he tells me. While Macy's, Inc. and WeWork Cos., Inc. are perhaps predictably trying to offload space—a combined 409,000 square feet in their case—so is the hale and hearty JPMorgan Chase & Co., which is aiming to downsize its Manhattan presence by 800,000 square feet.

Given the vogue in working from home as well as the observed migration out of New York, few tenants are willing to commit to new long-term leases.

Signature Bank at a glance

all figures in $ millions except per share data

	2020	2019	2018	2017	2016
interest income	$1,931.6	$1,911.7	$1,708.9	$1,470.2	$1,317.2
interest expense	412.6	600.1	409.9	232.6	169.9
provision for credit losses	248.1	22.6	162.5	263.3	155.8
net income	528.4	586.5	506.4	383.6	392.1
shares (millions)	55.5	55.4	54.4	54.0	53.4
earnings per share	9.96	10.82	9.25	7.03	7.29
total assets	73,888.3	50,591.8	47,341.5	43,099.0	39,033.2
loans	48,324.8	38,859.6	36,193.1	32,416.6	28,829.7
deposits	63,315.3	40,383.2	36,378.8	33,439.8	31,861.3
equity	5,826.9	4,745.2	4,383.9	4,013.0	3,597.8

source: company reports

The resulting dearth of transactions obscures the extent to which rents have really dropped. On its Feb. 18 earnings call, peer Empire State Realty Trust, Inc., which takes the name of its iconic flagship office tower, guessed the decline was 10%–15% below pre-Covid levels. Ismail and Rodriguez tell me the figure could be closer to 20%.

"The drawdown in New York is not dissimilar for the last two recessions," Ismail says. "What is different is we are not calling for a 'V'-shaped recovery. This is more 'L'-shaped. Because of many of these secular changes, it is a tough picture. Office is a commodity product, and you are selling a commodity product that Covid-19 has proved is not an immediate necessity."

Operationally and geographically leveraged to Manhattan, SL Green is likewise leveraged in the financial way. As of Dec. 31, 2020, debt footed to 11.9 times trailing Ebitda, highest in the office sector, which, on average, shows a leverage ratio of 7 times. SL Green has a development pipeline equivalent to 25% of its operating real estate, also the highest among office peers, where the average is 7%. Then, too, Green faces mark-to-market risk if rental rates don't pick up. The Manhattan stalwart will see 9.3% of its floor space come up for renewal this year, followed by 7.6% in 2021 and 8.2% in 2023.

So far, so good, however, with regard to credit metrics: In the fourth quarter, operating income covered interest expense by 3.8 times, while the developer's triple-B-minus-rated, senior unsecured 4½s of Dec. 1, 2022 change hands at $105.14 to yield 0.93%, a premium of just 78 basis points to the two-year notes of the split-rated U.S. Treasury.

SL Green trades at 17 times estimated 2021 adjusted funds from operations and offers a 4.9% dividend yield, a discount to the 21.7 times AFFO multiple and 3.8% yield posted by other public-office REITs. Of the 17 analyst who cover SLG, three say buy, 13 hold and one says sell.

With a short interest equal to 15% of its float, bears are sniffing as insiders are selling: Over the past 12 months, the execs have sold 220,762 shares for proceeds of $13.5 million, or an average of $61.04 per share versus the current price of $74.01; no insider has purchased a share.

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To a person, the authorities with whom I've spoken are bullish on Manhattan over the long run. And who wouldn't be, given all that New York, New York has surmounted in the past 300 years? But even our city-loving authorities invoke a caveat with regard to progressive local politics.

Thus, the 2019 state budget authorized congestion fees for vehicles entering busy neighborhoods in Manhattan—it may cost more just to enter Midtown beginning in 2022. And starting in 2024, building owners will be assessed based on their estimated greenhouse emissions. Both the state and city are eyeing higher income taxes and, potentially, a wealth tax and a levy on condos whose owners make their primary residence outside the city limits.

"At some point," a fed-up source observes, "there is a tipping point."

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