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Game of monopoly

Evan Lorenz writes:

Jeff Bezos may have his eyes on the stars, but his employees have their feet on the ground, and not a few of those earthlings will wind up working at the second headquarters of Amazon.com, Inc. in suburban Washington, D.C. Now unfolding is a bullish analysis of JBG Smith Properties (JBGS on the New York Stock Exchange), an office real estate investment trust that happens to occupy much of that soon-to-be-coveted ground.

Even a card-carrying *Grant's* skeptic may wonder if the age of the office isn't over and done with. "Pre-Covid, the U.S. Census would tell you that people came to the office on average about 4.5 days a week," Daniel Ismail, who leads Green Street's office research team and rates JBG a hold, tells me, but now something like 15% of the white-collar workforce has registered its preference for returning to the office zero days a week.

What damage would such absenteeism inflict on the owners of office REITs? Ismail estimates a compound 1.6% decline in revenues per square foot over the next five years, and the market seems to agree. Office REITs trade at an average 20.6% discount to net asset value versus a 16.4% premium for the overall REIT sector, according to Green Street data.

Plans for PenPlace, the intended second Amazon headquarters in Arlington, Va., are something to behold: A tree-sprouting double helix swirls to a peak 22 stories tall. The building will contain 2.8 million square feet of office space and 115,000 square feet of retail in addition to a 250-seat amphitheater. It will sit on 2.5 acres of green space on which dogs will frolic, water will splash and public art will be ogled. LEED platinum status, the top rating conferred by the U.S. Green Building Council, is expected to crown it.

Green, Amazon may be; politically popular, it isn't. Governments worldwide are weighing a minimum tax on the big tech earners. Congress is mulling bills that could force Amazon to stop selling private-label goods or to spin off business units or even to break itself into pieces, à la the Standard Oil Co. of John D. Rockefeller. The new chair of the Federal Trade Commission, Lina Khan, a longstanding critic of Amazon, has just received a petition from the Everything Store inviting her to recuse herself preemptively from the commission's multiple Amazon antitrust probes.

You'd suppose that the nation's capital would be recession-proof, but the 2005 Base Realignment and Closure Commission and the 2011 Budget Control Act left swaths of empty District of Columbia offices in their wake. As a result, it's one of the only major markets in the United States that didn't see much rent growth coming out of the financial crisis.

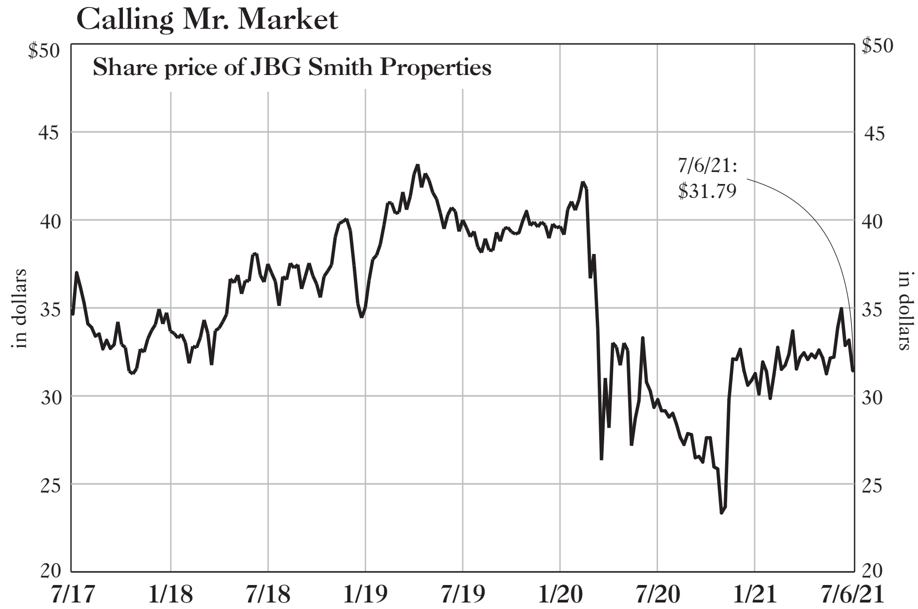
At year-end 2019, 16.6% of D.C. office space was vacant, yet tenants were willing to pay up for A-plus/trophy-style buildings, according to Matthew Birnbaum, a senior research analyst at CBRE Group, Inc. In consequence, "developers were building speculatively and bringing vacant space to the market upon delivery, especially in D.C. proper." Now vacancies stand at 18.8%.

Sale of the Washington Real Estate Investment Trust portfolio to Brookfield Asset Management, Inc. on June 15 underscored the poor operating fundamentals. The transaction, which encompassed 12 D.C.-area office buildings with a total of 2.4 million square feet of space, came at a price tag of $766 million or a cheap 8% capitalization rate. The Street had penciled in proceeds closer to $1 billion or roughly a mid-6% cap rate. Since the disposition, the share price of Washington REIT has decreased by 12.1% and that of JBG by 8.6%.

JBG Smith came into existence on July 17, 2017 via a spinoff cum merger. Vornado Realty Trust's D.C. assets were the acquired properties. They comprise 10.1 million square feet of commercial space and 3,175 apartment units (businesses collectively known as Charles E. Smith, L.P.). JBG Companies, a private real estate developer focused on the capital, merged with that portfolio in a transaction that gave 73% of the resulting equity to Vornado shareholders and 27% to JBG's.

While JBG may not be a household name, it was among the capital's biggest developers. From 1999 until the merger, it raised $3.7 billion in equity across nine funds and invested in more than 235 properties, including 80 development projects, generating a 23.4% gross internal rate of return.

JBG's M.O. is "place making," by which management means developing a community rather than just throwing up a building. Retail and restaurant buildings, walkable streets, public art and green space are among the corporate trademarks.



source: The Bloomberg

As of March 31, JBG Smith owned 11.4 million square feet of commercial space (mainly office) across 42 towers and 5,999 apartments in 21 buildings situated in Washington, D.C., northern Virginia and Maryland. In the first quarter, commercial space produced 79% of net operating income (NOI), multifamily units 21%. Uncle Sam, JBG's biggest tenant, chipped in 20.3% of first-quarter rent, followed by Amazon at 8.2%. Occupancy in the commercial portfolio fell to 86.9% as of March 31, from 88.7% a year earlier; in the apartment portfolio, occupancy increased to 85.9% from 84.5%.

On Nov. 13, 2018, Amazon designated National Landing (a rebranding of Crystal City, Pentagon City and Potomac Yard in northern Virginia) as well as Long Island City, NY, as its new headquarters sites. On the same day, the Virginia Polytechnic Institute and State University unveiled plans for a 1 million square-foot graduate campus in National Landing that will enroll 750 masters students and hundreds of doctoral students and postdocs.

As an inducement to snag Amazon, the state and local governments agreed to fund an infrastructure overhaul in National Landing, including the construction of a pedestrian bridge to Reagan National Airport, the lowering of an elevated highway to a ground-level boulevard as well as providing for subway entrances, bus services and Amtrak and Virginia Railway Express services. Investments by Amazon, Virginia Tech and the state and local governments are expected to top $5 billion. Protests greeted the proffered inducements to build in New York, and Amazon turned on its heel.

Tax incentives, linked to the hiring of employees earning more than $150,000 a year, were likewise part of the National Landing deal: For the first 25,000 workers, Amazon stands to receive benefits worth $550 million; for the next 12,850, an additional $200 million. At the top end of the range, the new hires would boost the existing office population of the National Landing submarket by 76%. And inasmuch as Amazon canceled the Long Island City HQ, more than the anticipated 37,850 workers may sign on. "I think it is a safe assumption that Amazon will do what they say they will do and will probably do more," JBG's chief executive, Matthew Kelly, tells me.

JBG expects to develop multifamily space (73% of the pipeline) and offices (27%) at National Landing. To pay for construction, management plans to sell $1.5 billion's worth of noncore assets, primarily office buildings outside of the key submarket. When all is said and done, more than half the portfolio will consist of apartment buildings—not a bad thing, as the average apartment REIT trades at a 1.1% premium to net asset value today.

The low price that Washington REIT received for its office portfolio highlights a risk to this strategy, but there are mitigants. For one, every source I contacted says that JBG's vendable assets are better than the ones that Washington REIT sold. For another, Washington's management, having decided to pivot entirely to multifamily assets, chose not to sell deliberately, building by building, but quickly and all at once.

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As for what success in National Landing might look like, we turn to South Lake Union, the Seattle submarket where Amazon built its headquarters in 2010. There are many similarities between the markets: Both are close to a downtown central-business district served by mass transit, and each had been starved of investment dollars prior to Amazon's move. By 2018, Amazon had brought more than 40,000 workers into the Seattle suburb, about the same number it expects at National Landing. Follow-on hiring by other tech companies expanded the tech ecosystem.

"From 2010 to 2020, the size of the South Lake Union office market more than doubled through development," Justin Meng, a managing partner at V3 Capital Management, a real estate-focused fund that holds a position in JBG, tells me. "The buildings filled up, and rents went up 70%."

"I'm personally not optimistic about the general trajectory of office rents across the major U.S. markets," Charles Fitzgerald, Meng's partner, says. "But I do think rents in National Landing have the potential to double over the next 10 years."

It's difficult to overstate JBG Smith's dominance of National Landing. It has at its disposal 77% of the existing office space and 79% of the unencumbered land in the submarket; such holdings tally to more than half of JBG's real estate. That level of control has benefits. Owing to the over-supplied D.C. market, National Landing is one of the few submarkets where a commercial construction contractor can look for reliable work for the next several years, a fact that may give JBG leverage in contract negotiations. In this light, it's perhaps notable that JBG obtained a price 7.5% lower than the pre-pandemic quote for an apartment building on 1900 Crystal Drive in late March.

JBG Smith at a glance
all figures in USD millions except per share data

	TTM*	2020	2019	2018	2017
revenue	$609.9	$602.7	$647.8	$644.2	$543.0
net operating income	254.7	256.8	311.1	320.0	289.3
funds from operations	-121.5	115.9	150.6	158.6	–
shares	131.5	134.0	130.7	119.2	105.4
FFO per share	0.92	0.87	1.15	1.33	–
cash	208.7	225.6	126.4	260.6	316.7
debt	1,990.0	1,991.7	1,623.1	2,135.5	2,188.0
total assets	6,019.3	6,079.5	5,986.3	5,997.3	6,071.8

* Twelve months ended March 31, 2021.

source: company reports

"Nobody has developed more in Arlington County than we have in the history of the county," Kelly says. "We are very well-positioned to execute on this. If you look back at our track record and what we've done since the spin, we have one project that we delivered on budget and on time. Every other project we've delivered better than budget and ahead of schedule. We do have a tendency to under-promise and over-deliver."

This high level of ownership allows JBG to do things that other developers can't. Case in point: 5G connectivity. The latest wireless standard is up to 100 times faster than 4G, but the higher bandwidth spectrum doesn't propagate well. It requires dense networks of towers, which, in turn, requires negotiations with dozens of landlords and the installation of backhaul fiber-optic capacity.

As JBG essentially controls National Landing, it can put towers and fiber where it chooses. Last September, it spent $25.3 million to buy 5G spectrum in the two counties that National Landing bestrides. In addition, JBG is building an edge data center nearby to maximize the speed of mobile apps that use its 5G airwaves.

"It's also opened the door where we can go to a technology company and say, 'test and showcase your technology here,'" Evan Regan-Levine, an executive vice president at JBG, tells me.

"They are good," Steve Sakwa, who heads Evercore ISI's real estate research and rates the stock a hold, comments on the JBG front office. "They keep their eye on the long term. They're not really focused on the quarterly vagaries of their business. They're really trying to create a brand new area. I think they're doing all the right things."

Not that many seem to notice. The grand total of securities analysts who follow this $4.6 billion market-cap enterprise is three, each of whom rates it "hold." The typical analyst complement for a company of JBG's size is nine.

There are many reasons for this lack of attention. For one, JGB went public via a merger and spinoff rather than under the wing of an underwriting syndicate. Management's intention to shift into multifamily real estate also complicates matters: Office-focused analysts know that one day they will have to unfollow the company; at the moment, JBG does not have enough multifamily exposure to justify coverage for apartment-focused analysts. Then there's the unusual JBG approach to investor relations. In lieu of earnings calls, it issues detailed quarterly letters and publishes long-form answers to frequently asked questions. The CFO, Moina Banerjee, tells me that there's an IR upgrade in the works: "We want to make sure the story is out there."

While the worldwide crackdown on big tech is an obvious risk to JBG Smith, it also presents an opportunity. Microsoft Corp., a recipient of antitrust scrutiny two decades ago, last week announced plans for a 20% boost in the size of its legal and corporate affairs divisions. And if the Ending Platform Monopolies legislation does become law, and if that law were enforced, and if big Amazon therefore were reconstituted as many not-so-big Amazons, the new corporate entities would presumably need more legal and administrative staff and the space in which to house them.

JBG commands a $4.6 billion market cap and owes $2.2 billion in net debt for an enterprise value of $6.7 billion, but it's no simple job to calculate its valuation. The large development pipeline complicates matters.

The first step is to value JBG's extensive land holdings. Using a conservative $67 per buildable square foot, this sums to $1.1 billion.

In the first quarter, net operating income annualized to $322.2 million. Adjusting for Covid-related impacts (e.g., rent deferrals and lower parking fees) and adding in the prospective income from newly delivered projects that are in the process of being leased up as well as projects under development, we get NOI in the neighborhood of $450 million. Of course, it will cost money to finish construction, so we gross up net debt by an additional $500 million. To finish this analysis, it appears that JBG's commercial and multifamily portfolio is valued at a 7.3% implied cap rate, above the average 5.9% cap rate for office REITs and the 4% cap rate for apartment REITs. In other words, the shares trade at a discount to their peers and impute no value to the possible future growth in National Landing. The dividend yield is 2.8%.

JBG's balance sheet is visibly burdened with the cost to develop new properties, but the income statement records no earnings from these developments yet. Net debt foots to 6.8 times Covid-impacted Ebitda and 5.8 times virus-adjusted Ebitda. As a percentage of enterprise value, net debt amounts to 32% of the firm's value. The average office REIT sports a leverage ratio of 8 times Ebitda and carries debt equivalent to 44.2% of EV.

In the past 12 months, insiders have purchased a net 46,500 shares at a net cost of $1.2 million. CBRE's Birnbaum wrote to say he's bullish on National Landing: "There are few submarkets that will undergo the positive change National Landing will experience over the next few years." More importantly, Birnbaum continues, prospective tenants are scoping out the region despite the work-from-home overhang:

"Over the past couple of months, touring activity has begun to return to pre-pandemic levels, signaling an increase in leases signed in National Landing in the next year."

Whether or not Amazon is shown to be a monopolist, its landlord at National Landing could almost pass for one now.

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