Kilroy Realty Corporation (KRC)

Name: Vikram Sinnathamby	College/School: Arts and Sciences	Year: 3rd

Important Company Financial Data

Last Trade	36.4	52 Wk range	18.08-36.51
Market Cap	1.57 B	Shares Outstanding	43.1M
Short Ratio	8.30%	Dividend	1.4
P/E Ratio	68.81	Yield	3.80%
Assets	2,084,281	Liabilities	1,200,443
		Equity	854,948

Thesis / Key Points

I believe KRC is a good short because it will be difficult for them, as an office real estate investment trust, to find and renew debt financing, and their concentration in California means demand for their office space will be low in the near future.

- Banks are reluctant to finance office properties
  - Demand for office space lags behind changes in the economy
  - Occupancy rates will take a while to go up, even if recovery has already started
  - Banks want lower loan-to-value ratios (<65% rather than 80-90% during the bubble)
  - Difficult to refinance properties purchased for inflated values during the bubble
- KRC relying on stock offerings to finance acquisitions, operations, pay off debt
  - Postponed expiration $550M credit line one year, to April 2011, while renegotiating new credit facility
  - Expect smaller credit line in the future, with higher interest rate spreads.
  - In April, offered $300M in stock to finance $237M building, using the rest to fund operations and pay back debt
  - More shares outstanding means less dividends per investor, lowers value of stock
- Low demand for office space in California
  - Unemployment (12.6%) and underemployment (24%) are higher than American average, have slightly worsened since the beginning of 2010
  - KRC's current occupancy rate is 82.8%, compared to usual 93.1%
  - Huge CA government budget deficit must be addressed with higher taxes, which will be a disincentive for business expansion
  - CA not the most business-friendly state – high taxes, strict environmental regulations, high cost-of-living
  - Increase in productivity per worker, even as unemployment remains high – businesses are doing more with less people and less space
- Substantial insider selling
  - Management sold 29% of their shares in the last 6 months

Misperception

"A rising tide lifts all boats."

- Success of other REITs in 2010 has helped lift KRC
- Falsely linked with factors affecting other REITs, such as increased apartment rentals and consumer expenditures
- Impending commercial real estate crash is viewed as overhyped, and the economic recovery is here to stay, as shown by the stock market
- The government will step in if there's a crisis
  - Peter Palandjian, CEO of Intercontinental Real Estate – The government probably cannot take care of this "looming trillion-dollar problem"
- Cramer Bump – mentioned on April 8th as his favorite REIT
  - Sees KRC as the REIT with the most room to grow, due to their low occupancy rate
  - Increased apartment rentals show that CA is recovering
  - Southern California, where KRC is based, will lead California in economic recovery

Kilroy Realty Corporation (KRC)

VAR

- Dr. Ed Burton, Professor of Economics at UVA, and member of the Board of Directors for SL Green (SLG), a Manhattan-based office REIT
  - The worst is over, prices slowly increasing
  - Still hard for REITs to find financing
  - Office REITs hit particularly hard
- Peter Palandjian, CEO of Intercontinental Real Estate Corporation
  - Some financing available for apartment and shopping center REITs
  - Banks very reluctant to loan to office REITs
  - Reluctant to finance properties in hard-hit states such as CA, FL
  - Some banks would rather extend loans and hope they get paid off than foreclose and accept the loss
  - US Gov. probably cannot afford to deal with the impending $1.2T commercial real-estate problem
  - Eventually, the CMBS market will figure itself out, and the crisis will be resolved
  - Great to be a firm with free cash right now, because properties are on sale at good prices

How It Plays Out

- Stock price drops once KRC declares its quarterly dividend, which will be lower than expected due to an increase in the shares outstanding
- Drops further as KRC announces the terms of its new credit line, with lower borrowing capacity and higher interest rates
- More equity financing will be needed to compensate for less debt financing, further diluting share value
- The company could also sell off assets, but for much less than the bubble prices at which they were last financed
- If they cannot sell the assets at a high enough price, they would become insolvent

Risks / What Signs Would Indicate We Are Wrong?

- Economic recovery in California
- Banks start lending at higher loan-to-value ratios
- CMBS market quickly picks up
- CA Property values increase
- CA Unemployment decreases
- KRC's next dividend increases

Signposts / Follow-Up

- KRC's next 10-Q released in early May
- Follow changes in CA GDP, budget, tax rate, and unemployment rate
- Look for future KRC stock offerings
- Look at the conditions of their new credit line

Company Description

KRC is an office real estate investment trust, specializing in Class A office buildings in Southern California, specifically in San Diego and Orange County. As part of the conditions of being a real estate investment trust, they must distribute 90% of their taxable income to shareholders through dividends.

Kilroy Realty Corporation (KRC)

Ideas for the Club

1. Talking to stock analysts should be part of VAR. An important part of MII presentations is understanding the market's misperceptions, and analysts play a role in the impressions the market has of a stock.
2. Maintain a stock watch-list on the MII website, and update it regularly. Many MII members want to do a presentation, but have a lot of trouble finding an idea to begin with. An actively updated watch-list would give them somewhere to start.