Boston Properties (BXP)

August 30, 2012
DJIA: **13,001** | RMZ: **910** | 10-Yr Treasury Note: **1.62%**
Price: **$111.40** | Recommendation: **BUY**

Green Street Advisors

Swooping into SoMa

Overview: Boston Properties (BXP) is *the* blue-chip office REIT and owns a nearly $30 billion portfolio of high-quality properties in a handful of top U.S. markets, including Midtown Manhattan, Boston, the Washington D.C. metro, and the San Francisco Bay Area. The Bay Area office market remains the strongest in the U.S., with the best secular growth story and the healthiest 5-year outlook for fundamentals. Boston Properties' Bay Area portfolio represents ~10% of total assets and is dominated by Embarcadero Center, a trophy office complex in San Francisco's Financial District.

Boston Properties recently announced an expansion in San Francisco, planting its flag in the red-hot, tech-fueled South of Market ("SoMa") district. Boston Properties is acquiring a well-located $340 million redevelopment project that is 85% pre-leased to a pair of mature technology firms and projected to stabilize in roughly two years. The news is consistent with recent company commentary that a sizable acquisition or two were likely in the near-term. Expected economics do not put the deal in "home run" territory, but suggest a relatively safe first step into arguably the country's hottest submarket, an area that Boston Properties has steadily warmed to over time.

Acquisition Details: The centerpiece of this off-market acquisition is 680 Folsom Street, a 1960's-vintage office asset currently being redeveloped into a premier ~475,000 sq. ft. Class A building. Additionally, Boston Properties will pick up 50 Hawthorne Street, an adjacent 50,000 sq. ft. asset also being redeveloped. A third piece of the equation is a nearby land parcel that currently houses a pint-sized vacant building, and offers an attractive (albeit modest) retail development opportunity. TMG Partners, a well-respected Bay Area sharp-shooter and part of the selling party, will complete the development.

The project will be anchored by a pair of established technology firms, Macys.com and Riverbed Technology, a publicly-traded networking hardware specialist. Their leases commence in 2014 and extend for 15 and 10 years, respectively. The REIT anticipates a successful lease-up of the remaining 15% availability, resulting in a mid-'14 expected stabilization of the project.

Boston Properties will fund the acquisition with a combination of ~$60 million in cash and $80 million in preferred stock, and assume a $170 million construction loan. The company represents that an additional $30 million of equity will be required to complete the project, bringing its all-in basis to $340 million (~1% asset expansion), or roughly $650/sq. ft. This translates into a ~low 6% stabilized yield on the investment.

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The Submarket Fit: Boston Properties generally focuses on trophy-quality assets in traditional CBDs and other well-established business districts. SoMa historically did not meet this criteria, given its concentration of lower-quality, brick & timber product and plethora of start-up tech firms. The recent tech boom has attracted a new generation of more credit-worthy tenants to the submarket, however. With it has come shrinking vacancies (now ~5%), spiraling rents (+60% over two years), and a rush of new capital. Opportunistic investors such as Kilroy (KRC) have made a rapid push into SoMa and are now assembling development projects to meet the strong local tenant demand. Boston Properties represents that this first SoMa play will clear its quality hurdle on two fronts: the asset will be new, state-of-the-art product and the tenancy will be credit-worthy and long-term.

Deal Economics: Boston Properties has an impressive and well-respected track record as a developer, but in this case has opted to acquire a project where much of the value-creation has already been realized by the original developers. The company represents that it was attracted to the "hybrid" flavor of this investment: the deal offers core-like ingredients (asset quality, location, tenancy) with some value-add seasonings (additional lease-up opportunity in a thriving market and retail pad potential).

Boston Properties perceives that the all-in basis and potential stabilized returns compare favorably to the core office economics offered in San Francisco today. Indeed, top San Francisco office assets are now trading south of a 5% cap rate, with values touching $800/sq. ft. Assuming this cap rate environment persists, the REIT's investment appears to offer a respectable, though not eye-popping, value-creation margin. This seems sensible for the company's initial splash into a new submarket, particularly one with considerable historic volatility that is largely dependent on the boom-and-bust tech sector.

Risk Profile: San Francisco remains the undisputed king of the U.S. office land, yet a few secular headwinds do loom. First, up to 70% of SoMa demand emanates from the tech sector. Market participants report that Bay Area tech demand generally remains strong, though has cooled a touch from its recent breakneck pace. A few rocky IPOs, most notably Facebook, may have taken some of this wind out of the sails. At the same time, a San Francisco development pipeline is quickly materializing. The supply volume (an estimated 5% growth over the next several years) appears manageable for now, though bears watching. The good news for Boston Properties is that this project's secure tenancy and premier asset quality should offer a safe haven in the event that tech demand were to turn south in a hurry, or that the local office development spigot was opened too wide.

Recommendation: Boston Properties has a valuation premium befitting the office sector's premier company: the stock trades at a 4.6% implied cap rate and the highest unlevered asset value premium in the sector (9% vs. -2% average). Accordingly, the company has a clear green light to grow its asset base, and is shrewdly doing so in the strongest office market in the country. The REIT will likely not hit it out of the park with this investment, but the deal does appear to offer a solid first step into a red-hot submarket at an attractive basis.

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Investors appeared to be unimpressed by the announcement, as BXP shares slightly underperformed on Thursday. This is consistent with year-to-date results, which have seen the REIT's stock continue to lag its office peers. The company's many favorable attributes and strong '13 cash NOI growth outlook appear to be underappreciated at today's share values and the stock remains attractively priced.

At the current price, we continue to rate the shares of BXP as a BUY.

Michael Knott, CFA
Jed Reagan

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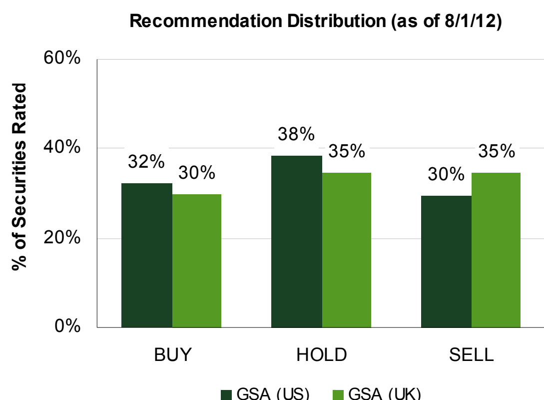

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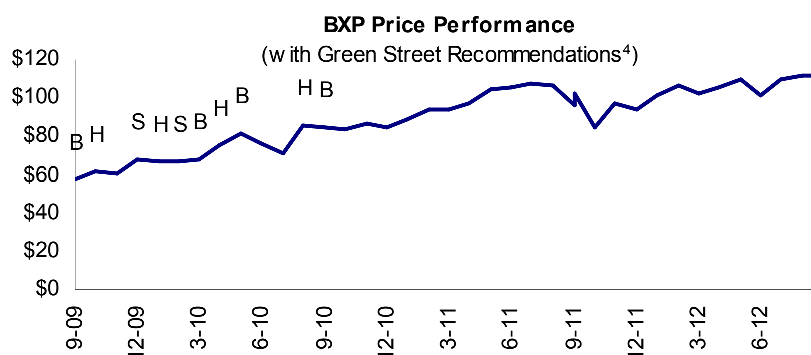
Total Return of Green Street's Recommendations[1,2]

Year	Buy	Hold	Sell	Universe[3]
2012 YTD	21.0%	17.1%	14.0%	17.5%
2011	18.9%	7.6%	-4.7%	7.6%
2010	43.3%	32.8%	26.6%	33.8%
2009	59.0%	47.7%	6.0%	37.9%
2008	-28.1%	-30.9%	-52.6%	-37.3%
2007	-6.9%	-22.4%	-27.8%	-19.7%
2006	45.8%	29.6%	19.5%	31.6%
2005	26.3%	18.5%	-1.8%	15.9%
2004	42.8%	28.7%	16.4%	29.4%
2003	43.3%	37.4%	21.8%	34.8%
2002	17.3%	2.8%	2.6%	5.4%
2001	34.9%	19.1%	13.0%	21.1%
2000	53.4%	28.9%	5.9%	29.6%
1999	12.3%	-9.0%	-20.5%	-6.9%
1998	-1.6%	-15.1%	-15.5%	-12.1%
1997	36.7%	14.8%	7.2%	18.3%
1996	47.6%	30.7%	18.9%	32.1%
1995	22.9%	13.9%	0.5%	13.5%
1994	20.8%	-0.8%	-8.7%	3.1%
1993	27.3%	4.7%	8.1%	12.1%
Cumulative Total Return	**8359.4%**	**679.1%**	**-13.5%**	**767.6%**
Annualized	**25.6%**	**11.1%**	**-0.7%**	**11.7%**

The chart below shows BXP's price performance over the last three years, along with Green Street's recommendations during that time.



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