

Gold Rush in San Francisco; Target Price \$80/sh; Maintain Buy

- We have chosen to run the numbers by hand and have come up with the following conclusion: selling a 44% interest in two assets for \$508mm (\$1.155B at 100%), a value over 2.7x the cost to acquire the assets, creates value and increases NAV.
- Kilroy acquired the two assets, 303 Second and 100 First Street, in 2010 for \$354/SF. The just announced joint venture values these two assets at \$963/SF and a quoted 'low 4%' cash cap rate.
- We think the transaction underscores the willingness of offshore global capital to pay very full prices for assets in barrier-to-entry markets and make major investments in Gateway City office REITs. We expect additional similar investments to occur selectively throughout our coverage.

- After adjusting our estimates for this transaction, we are increasing our target price to \$80/sh. The new target price equates to 2017E FFO/FAD/sh multiples of 22.5x/35.4x, a 4.8% implied NOI cap rate and a TEV of \$637/SF, versus our estimate of adjusted replacement cost of \$538/SF.
- We estimate that Kilroy Realty currently trades at very reasonable real estate valuation metrics: 1) 5.3%/4.5%/3.8% for Implied NOI, Cash Flow, and CF less G&A Cap Rates. TEV/SF of \$584/SF is also reasonable relative to our estimates of \$620/\$538/SF for gross/adjusted replacement cost. Finally, KRC trades at a 16%/6% discount to our 4.5%-5.0% NAV range.
- This accentuates the pivotal question with REIT valuations -- does a discount to NAV and other attractive real estate valuations offset historically high FFO/FAD multiples?
- Please find our 2Q16 Office market fundamentals update here: [Houston Free Fall. San Francisco and Boston Solid, Los Angeles Hype Not in Numbers. 2Q16 Office Fundamentals Update](#). While concerned about the Silicon Valley, the rest of the KRC markets are relatively solid.
- While clearly Net Asset Value accretive, the transaction will result in cash staying on the balance sheet until spent on development, and near term earnings dilution.
- We are adjusting 2016 FFO/FAD/sh estimates to \$3.38/\$2.19 from \$3.40/\$2.21 and our 2017 FFO/FAD/sh to \$3.55/\$2.26 from \$3.57/\$2.27. We estimate the normalized 2015-2017 FFO/FAD growth to be 5.0%/7.7%.

Changes	Previous	Current
Rating	—	Buy
Target Price	\$75.00	\$80.00
FY16E FFO	\$3.40	\$3.38
FY17E FFO	\$3.57	\$3.55
FY16E FAD	—	2.19
FY17E FAD	—	2.26

Price (08/31/16):	\$72.63
52-Week Range:	\$74 – \$47
Market Cap.(mm):	6,891.6
Shr.O/S-Diluted (mm):	94.9
Enterprise Val. (mm):	\$9,888.4
Avg Daily Vol (3 Mo):	562,758
LT Debt/Total Cap.:	27.9%
Dividend(\$ / %)	\$1.50 / 2.1%
S&P Index	2,170.94

FFO	2015A	2016E	2017E
Q1	\$1.01	\$0.82A	\$0.86
Q2	0.82	0.86A	0.89
Q3	0.77	0.86	0.90
Q4	0.80	0.84	0.90
FY Dec	\$3.39A	\$3.38	\$3.55
P/FFO	21.4x	21.5x	20.5x

FAD	2015A	2016E	2017E
Q1	0.64	0.51A	0.54
Q2	0.45	0.61A	0.57
Q3	0.46	0.54	0.57
Q4	0.40	0.53	0.58
FY Dec	1.94A	2.19	2.26
P/FAD	37.4x	33.2x	32.1x

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Target Price Methodology/Risks

- Our target price of \$80/sh, equates to 22.5x/35.4x on our updated 2017 FFO/FAD/sh estimates of \$3.55/\$2.26 and an implied NOI cap rate of 4.8%.
- Risks to achieving our target price include development and lease-up risk, tech bubble fears, interest rate and general economic risk.

Company Description

Kilroy Realty Corporation (KRC) owns, operates, and develops Class A suburban office and industrial real estate, primarily in Southern California. Founded in 1947, KRC has operated since 1997 as a publicly traded, self-administered and self-managed real estate investment trust. At June 30, 2016, Kilroy owned 13.7mm square feet of commercial office space. Key markets are San Diego, Los Angeles, Orange County, San Francisco, and the greater Seattle area.

Kilroy Realty Corporation

Quarterly Earnings Model

(in thousands, except per share data)

8/31/2016

Assumptions:	2015 A	1Q16 A	2Q16 A	3Q16 E	4Q16 E	2016 E	1Q17 E	2Q17 E	3Q17 E	4Q17 E	2017 E
Acquisitions during period (1)	\$ 78,000	\$ -	\$ 55,400	\$ -	\$ -	\$ 55,400	\$ -	\$ -	\$ -	\$ -	\$ -
Rate of return on new acquisitions (annually)	5.3%	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%
Dispositions during period (1)	\$ (309,200)	\$ (262,300)	\$ -	\$ (191,400)	\$ (316,800)	\$ (770,500)	\$ -	\$ -	\$ -	\$ -	\$ -
Rate of return on dispositions (annually)	5.2%	5.5%	5.5%	4.6%	4.6%	5.1%	5.0%	5.0%	5.0%	5.0%	5.0%
Dev put in service during the quarter (1)	265,020	381,100	-	-	98,333	479,433	273,333	53,333	-	-	326,667
Rate of return on development (annually)	7.9%	8.0%	7.0%	6.0%	6.5%	6.9%	7.5%	7.5%	7.0%	7.0%	7.3%
Rev growth - existing properties (quarterly)	4.7%	0.2%	7.4%	0.7%	0.7%	9.1%	0.9%	0.9%	0.9%	0.9%	3.4%
Capex as % of NOI	0.0%	0.0%	0.0%	2.0%	1.9%	1.0%	2.0%	2.0%	1.9%	1.9%	2.0%
NOI growth on acquired prop (quarterly)	1.0%	0.3%	0.3%	0.3%	0.3%	1.0%	0.3%	0.3%	0.3%	0.3%	1.0%
Eff. interest rate on avg. debt outst. (annually)	2.4%	2.1%	2.4%	2.4%	2.4%	2.3%	2.5%	2.6%	2.7%	2.8%	2.7%
Additional Equity/Preferred issued (ret) during period	\$ 389,700	\$ 31,064	\$ -	\$ -	\$ -	\$ 31,064	\$ -	\$ -	\$ -	\$ -	\$ -
Addt. Comm. shrs issued (ret) during per.	5,640	868	-	-	-	868	-	-	-	-	-
Stock Price/FFO Ratio	18.2	21.3	20.8	20.8	20.8	20.8	20.8	20.8	20.8	20.8	20.8
Ending common stock price	\$61.89	\$69.88	\$72.51	\$70.60	\$70.40	\$70.40	\$71.70	\$72.90	\$73.60	\$74.00	\$74.00
NOI from existing properties: (2)											
Existing property rental income	\$ 525,355	\$ 133,755	\$ 143,653	\$ 144,723	\$ 145,801	\$ 567,932	\$ 147,040	\$ 148,290	\$ 149,550	\$ 150,821	\$ 595,701
Tenant reimbursements	53,774	11,404	16,138	14,805	14,915	57,263	15,042	15,170	15,299	15,429	60,940
Other prop related rev.	2,146	287	342	345	347	1,321	350	353	356	359	1,418
Less operating exps., r.e. taxes & other costs	(158,697)	(37,826)	(43,834)	(44,864)	(45,198)	(171,722)	(45,582)	(45,970)	(46,361)	(46,755)	(184,667)
NOI from existing properties (2)	422,578	107,620	116,299	115,009	115,865	454,793	116,850	117,843	118,845	119,855	473,392
NOI from acq./dsp. property - cumulative (2)	-	-	-	(615)	(3,541)	(4,156)	(5,376)	(5,389)	(5,403)	(5,416)	(21,585)
NOI from dev put in service - cumulative (2)	-	-	-	-	799	799	4,164	7,244	7,763	7,782	26,954
Total NOI (2)	422,578	107,620	116,299	114,394	113,123	451,436	115,638	119,697	121,205	122,221	478,761
Other income and expenses:											
Management, dev & leasing fee income	-	-	-	-	-	-	-	-	-	-	-
Interest income	243	271	311	156	78	815	78	78	78	78	311
Equity in earnings from unconsol investmnts	-	-	-	-	-	-	-	-	-	-	-
Acquisition-related expenses	(497)	(62)	(714)	-	-	(776)	-	-	-	-	-
General and administrative expenses	(48,265)	(13,437)	(13,979)	(12,583)	(13,009)	(53,009)	(13,298)	(13,765)	(13,939)	(14,055)	(55,058)
EBITDA	374,059	94,392	101,917	101,966	100,192	398,467	102,418	106,010	107,344	108,243	424,014
Reconciliation of EBITDA to (FFO):											
Less: Interest expense	(57,682)	(11,829)	(14,384)	(14,756)	(14,645)	(55,615)	(14,924)	(15,259)	(15,741)	(16,214)	(62,138)
Less: Non-cash interest exp. (APB 14)	-	-	-	-	-	-	-	-	-	-	-
Less: Non-real estate depreciation and amortization	(2,902)	(862)	(988)	(988)	(988)	(3,826)	(988)	(988)	(988)	(988)	(3,952)
Less: Min interest - net of FFO adjstmnts	-	-	-	-	-	-	-	-	-	-	-
Less: Div on non-convertible preferred stock	(13,250)	(3,313)	(3,312)	(3,312)	(3,312)	(13,249)	(3,312)	(3,312)	(3,312)	(3,312)	(13,248)
Add: Real Est. dep./amort. of unconsolidated	-	-	-	-	-	-	-	-	-	-	-
Impairment charges & Bad Debt Reserves	(545)	-	-	-	-	-	-	-	-	-	-
Add: Gain (loss) on debt repurchases	-	-	-	-	-	-	-	-	-	-	-
Other nonrecurring (Discontinued Ops)	17,116	-	(295)	-	-	(295)	-	-	-	-	-
Funds from operation (FFO)	316,796	78,388	82,938	\$82,910	\$81,247	325,482	83,194	\$86,451	\$87,303	\$87,728	344,676
Add: Non-cash financing charges	376	280	348	144	144	916	144	144	144	144	576
Add: Non-cash interest exp. (APB 14)	-	-	-	-	-	-	-	-	-	-	-
Add: Deferred compensation/revenue	-	-	-	-	-	-	-	-	-	-	-
Add: Impairment charges	-	-	-	-	-	-	-	-	-	-	-
Add: Non-real estate depreciation	-	-	-	-	-	-	-	-	-	-	-
Less: Gain (loss) on debt repurchases	-	-	-	-	-	-	-	-	-	-	-
Less: Straight-line rents/FAS141	(65,927)	(13,942)	(13,938)	(13,710)	(13,557)	(55,147)	(13,859)	(14,345)	(14,526)	(14,648)	(57,378)
Less: 2nd generation TILC	(69,994)	(15,540)	(10,768)	(14,731)	(14,100)	(55,139)	(14,889)	(15,043)	(15,043)	(15,043)	(60,019)
Less: base building capital costs	-	-	-	(2,296)	(2,197)	(4,493)	(2,320)	(2,344)	(2,344)	(2,344)	(9,354)
Less: Other	-	-	-	-	-	-	-	-	-	-	-
Funds available for distribution (FAD)	181,251	49,186	58,580	52,318	51,536	211,619	52,269	54,862	55,533	55,837	218,502
FFO per common share - fully diluted	\$ 3.39	\$ 0.82	\$ 0.86	\$ 0.86	\$ 0.84	\$ 3.38	\$ 0.86	\$ 0.89	\$ 0.90	\$ 0.90	\$ 3.55
Normalized FFO/sh - fully diluted	\$ 3.22	\$ 0.82	\$ 0.87	\$ 0.86	\$ 0.84	\$ 3.39	\$ 0.86	\$ 0.89	\$ 0.90	\$ 0.90	\$ 3.55
FAD per common share	\$ 1.94	\$ 0.51	\$ 0.61	\$ 0.54	\$ 0.53	\$ 2.19	\$ 0.54	\$ 0.57	\$ 0.57	\$ 0.58	\$ 2.26
Dividends per share	\$ 1.40	\$ 0.35	\$ 0.38	\$ 0.38	\$ 2.23	\$ 3.33	\$ 0.38	\$ 0.40	\$ 0.40	\$ 0.40	\$ 1.58
Weighted average common shares and OP units:											
Wtd. Avg Shrs and Units Outstanding - Basic	92,796	95,319	95,966	95,966	95,966	95,804	95,966	95,966	95,966	95,966	95,966
Conv. warrants, optns, prf stock, debentures	545	510	615	677	740	636	802	862	922	982	892
Convertible Notes	-	-	-	-	-	-	-	-	-	-	-
Wtd. Avg. Shrs & Units Outstanding - Diluted	93,340	95,829	96,581	96,643	96,706	96,440	96,768	96,828	96,888	96,948	95,120
Balance Sheet Information:											
Average debt outstanding	2,449,212	2,276,007	2,384,909	2,446,660	2,428,209	2,383,946	2,387,850	2,347,490	2,332,037	2,316,354	2,345,933
Ending debt outstanding	2,239,696	2,312,318	2,457,500	2,435,820	2,420,598	2,420,598	2,355,101	2,339,879	2,324,196	2,308,512	2,308,512
Additional debt issued (retired) during period	(392,630)	38,610	40,643	(21,680)	(15,222)	42,351	(65,497)	(15,222)	(15,683)	(15,683)	(112,086)
FAD-Dividend	49,127	14,757	21,680	15,222	13,838	65,497	15,222	15,683	15,683	16,606	63,195
Ending preferred stock outstanding	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000
Ending Common & OP units - for dividend	92,259	92,229	92,255	92,255	92,255	92,255	92,255	92,255	92,255	92,255	92,255
Ending Common & OP units, fully diluted	94,024	94,860	94,886	94,949	95,012	95,012	95,072	95,132	95,192	95,252	95,252
Equity Market Capitalization - including pref	6,019,145	6,828,817	7,080,184	6,903,397	6,888,821	6,888,821	7,016,676	7,135,150	7,206,149	7,248,644	7,248,644
Equity Market Capitalization - excluding pref	5,819,145	6,628,817	6,880,184	6,703,397	6,688,821	6,688,821	6,816,676	6,935,150	7,006,149	7,048,644	7,048,644
Total Market Capitalization	8,258,841	9,141,135	9,537,684	9,339,217	9,309,419	9,309,419	9,371,777	9,475,029	9,530,345	9,557,156	9,557,156
Debt/Total Market Cap	27.1%	25.3%	25.8%	26.1%	26.0%	26.0%	25.1%	24.7%	24.4%	24.2%	24.2%
Debt+Preferred/Total Market Cap	29.5%	27.5%	27.9%	28.2%	28.1%	28.1%	27.3%	26.8%	26.5%	26.2%	26.2%
Ratios:											
Interest coverage	6.5	8.0	7.1	6.9	6.8	7.2	6.9	6.9	6.8	6.7	6.8
Fixed charges coverage	5.3	6.2	5.8	5.6	5.6	5.8	5.6	5.7	5.6	5.5	5.6
Dividend Yield	2.3%	2.0%	2.1%	2.1%	12.6%	4.7%	2.1%	2.2%	2.2%	2.2%	2.1%
FFO Growth	19.3%	(18.8%)	4.9%	11.7%	5.0%	(0.6%)	4.9%	3.5%	4.7%	7.1%	5.0%
FFO payout ratio - fully diluted	41.2%	42.7%	43.6%	43.6%	264.9%	98.4%	43.6%	44.9%	44.4%	44.4%	44.4%
FAD payout ratio - fully diluted	71.8%	68.6%	61.5%	69.4%	419.8%	151.8%	69.4%	70.2%	70.2%	69.0%	69.7%
	19.1%					-0.4%					5.0%

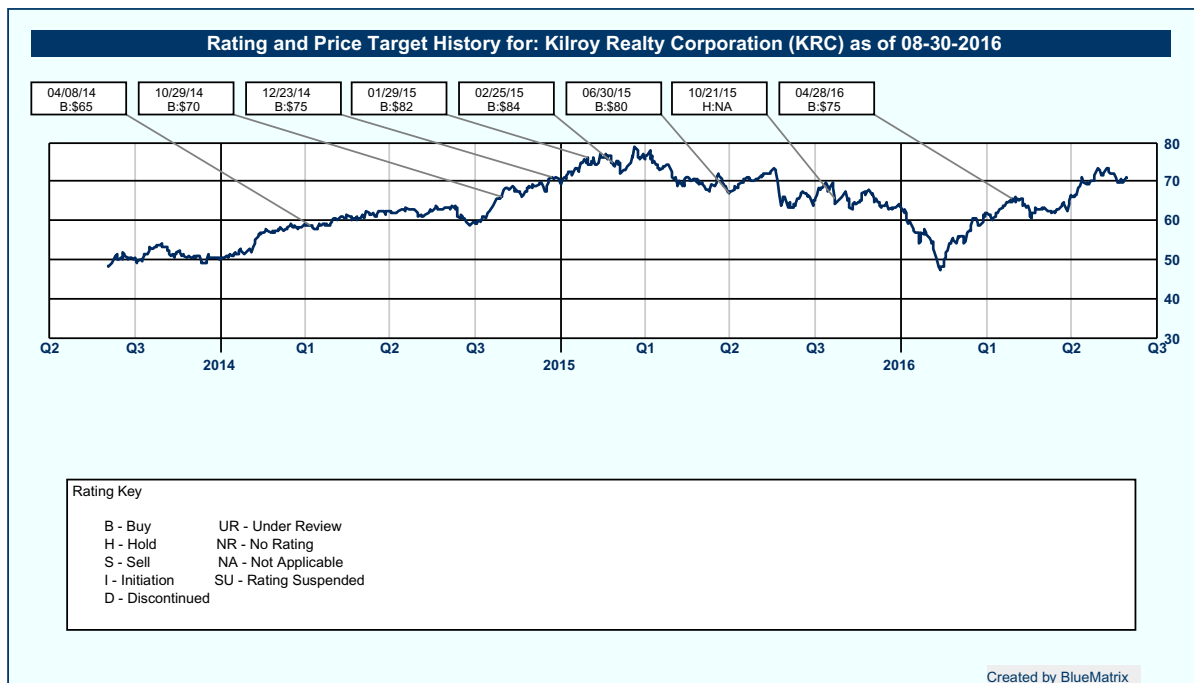
(1) Assumes midperiod acquisition or developed revenue convention.

(2) Net operating income (NOI) is defined as rental revenue plus tenant reimbursements less property-level operating expenses and real estate taxes.

Sources: Company data and Siftel estimates.

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