GRANT'S
INTEREST RATE OBSERVER®

Vol. 31, No. 18c | Two Wall Street, New York, New York 10005 • www.grantspub.com | SEPTEMBER 20, 2013

Forest and trees

Earlier this month, Jason Kidd bought $500,000 worth of the team of which he's the head coach, the Brooklyn Nets of the National Basketball Association. Jay-Z, the noted art collector, was the seller. How different things might have been had the 10-time NBA All Star invested in the company that owns a portion of the team rather than in the team itself. Forest City Enterprises (FCE/A on Bloomberg) is that company, and *Grant's* is bullish on it.

Your editor has been trying to imagine Kidd initiating the stock-market transaction that never was. "Say," we can almost hear him saying to his broker over the phone, "buy me 27,778 shares in FCE/A—not the 'B' shares, mind you, but the 'A' shares—at $18 or better."

The broker would have been curious to hear his client's reasoning, the former point guard being no reputed Warren Buffett. "Well," Kidd might have replied, "let's stipulate that, in public equities, complexity sometimes masks value. Forest City is a complex real-estate company. It's cheap partly because of a checkered narrative and a convoluted corporate structure."

It's beginning to dawn on the broker that Kidd just might be Warren Buffett.

"FCE owns office buildings, shopping malls, apartments," Kidd goes on. "At $18 a share, you get a high-quality real-estate portfolio at a discount to its evident private-equity value. And a property-development pipeline and the Nets and the Barclays Center all come for free. (Jay-Z must think I'm a chump to drop a half million for an illiquid 0.16% of the team.) Forest City isn't a REIT, but it could be one day. There are pros and cons to a REIT conversion, but such an event would likely deliver an upside jolt to the share price. Call that possibility catalyst No. 1. There are others."

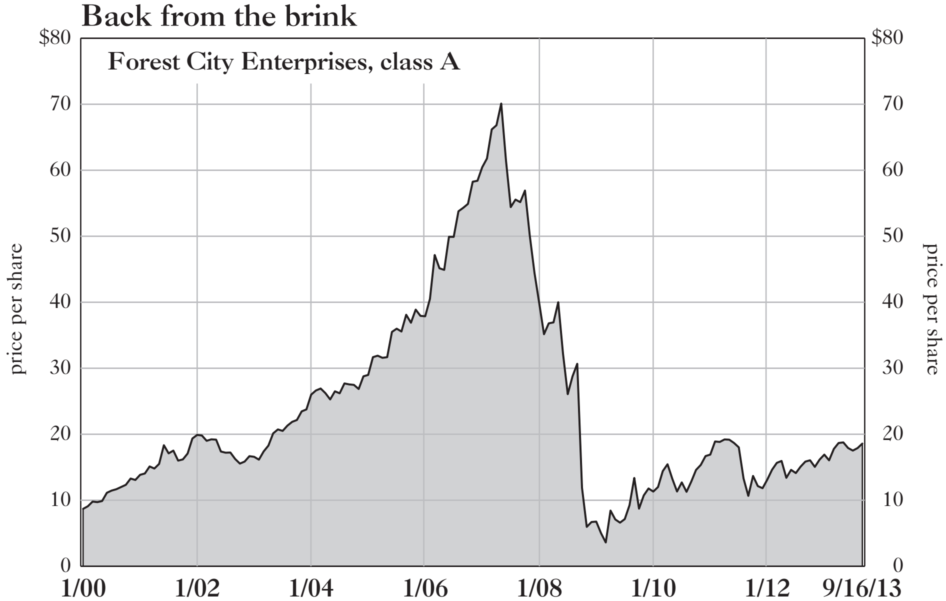
Like the Nets themselves, Forest City has had its ups and downs. Founded in Cleveland in 1920, the company went public in 1960. By 2007—we are whizzing by a cycle or two—Forest City was in its element. Its balance sheet was leveraged 13:1. The shares fetched $70 each.

Then came certain financial disturbances about which you might have read. By November 2008, the shares had plunged to $4. Would they follow the federal funds rate to zero? They would not. In May 2009, the company raised $345 million in an equity offering at $6.60 a share. The patient lived.

But it would not live as it had previously lived. No more bloated balance sheet, no more giant backlog of development projects. The penitent started divesting assets and paying down debt. In March 2011, it raised $172.3 million by selling 49% interests in a collection of 15 entertainment and retail properties in New York. Madison International Realty was the buyer. Based on 2010 net operating income, the assets commanded a cap rate of 6.9% (i.e., NOI divided by market value).

It was a start, but one of Forest City's largest and most patient shareholders

Back from the brink



source: The Bloomberg

was tapping its foot. In October 2011, Third Avenue Management boosted its holdings of FCE/A above the 10% it already owned, as the share price dipped below $10. Now breathing directly down the company's neck, the fund manager demanded quicker action in debt, non-core assets, corporate governance and transparency. Then, too, Third Avenue pressed, there ought to be one class of stock, not two.

Ryan Dobratz, co-portfolio manager of the Third Avenue Real Estate Value Fund, tells colleague David Peligal how he sees the situation:

"If you look back to 2007, early 2008, before the financial crisis, Forest City historically traded in line to NAV, if not a slight premium to NAV. That's because they have historically been able to create so much value for shareholders over time by undertaking these complicated mixed-use development projects in urban locations. But when we went into the financial crisis, Forest City was saddled with too much development and too much debt. And since that time, they've been stuck in the penalty box. They've been chipping away and reducing that debt. They've been reducing their exposure to development and, frankly, they're probably in the eighth inning of fixing those issues, but the stock price today is probably only in the fourth or fifth inning in terms of reflecting the progress that they have made thus far."

"Progress," as far as the new Forest City is concerned, still means what it meant in 2009: selling marginal assets, developing new assets and reducing debt. As last count, the company owned properties worth $10.7 billion, down from $12.2 billion at the peak on Jan. 31, 2010. Against these shopping centers, office buildings and apartment houses, as of July 31, stood $6.8 billion of debt, down from a grand total of $8.8 billion at the 2010 peak. By the end of this year, if all goes according to plan, net debt to EBITDA (that's earnings before interest, taxes, depreciation and amortization) will register at 10 times, down from the 2009 maximum of 14 times.

However, for Forest City, "debt" isn't all that it seems. The corporation itself owes just 9% of the enumerated obligations; the rest encumber individual properties and are non-recourse to the parent. The meaning of this structure is that one impaired asset doesn't pull down the others. In the crisis, Forest City had to issue stock at the worst possible moment and price because it came to the end of its bank-credit tether. Investors who declined to participate in the offering, or who chose not to buy stock on comparable terms after the offering, were thereby diluted. The few properties the company lost to foreclosure were of no great value. "I would actually consider those properties that went back to lenders as strategic defaults on Forest City's part," Dobratz says. "In fact, in a couple of cases, Forest City bought back the notes at a discount and continued operating the properties."

Taking what the Federal Reserve has given it, Forest City has streamlined its debt, extending its average life and reducing its cost. Comparing July 31, 2013, with the same date 12 months earlier, details are these: 6.9 years from 6.2 years, and 4.95% from 5.05%.

Of course, balance-sheet restructuring isn't an end in itself, but rather the means to the end of delighting the stockholders. And foremost among the stockholders are the founding families—the Ratners, Millers and Shafrans—who control the company by dint of holding 89.1% of the privileged 'B' shares. That some shares are more equal does not delight the Third Avenue portfolio managers, though they do applaud the fact that most of the Forest City directors are independent and that David LaRue, the CEO, is neither a Ratner nor a Miller nor a Shafran. LaRue took over in June 2011 as the first non-family head.

"Then, again," Peligal observes, "the reality is that the lion's share of the controlling families' net worth is invested in Forest City, and their goal is to make that grow. Yes, the dual class structure is an issue but people only talk about it when the stock is cheap. If Forest City management can raise up the share price, protests may subside. Investors in Molex Inc. and Google have done just fine, unequal share structures notwithstanding."

In the cause of lower leverage and sharper focus, Forest City has been peeling off properties in the hinterlands: Pittsburgh, South Dade, Fla., and even Cleveland, its corporate birthplace and still its headquarters. What remains are "core" holdings in the likes of New York, Los Angeles and Washington, D.C. These three cities, in fact, chipped in almost 50% of net operating income in the six months to July 31. For comparison, assets designated non-core contributed 15.2% of net operating income. Hence the theme of the evolving Forest City portfolio: "A" assets in "core" markets.

Retail properties and office buildings each deliver a little more than 34% of the company's net operating income; apartments account for another 24.5%. An outside public investor can have no exact idea of what these structures are worth, but the company does provide clues. For instance, last week, with completion and partial closing of a previously announced joint venture with the Australian asset manager QIC, came word that the eight regional malls in which QIC has chosen to invest were valued at a cap rate of 5¾% on projected 2013 income. The transaction will yield $350 million to Forest City after costs and fees; proceeds are chiefly earmarked for debt reduction.

"As for the apartment portfolio," Peligal relates, "in December, Forest City monetized the value of 8 Spruce St. in lower Manhattan, a Frank Gehry-designed, 76-story, 899-unit tower overlooking the Brooklyn Bridge. TIAA-CREF acquired a 49% stake in the property at a cost that imputed to it a value of $1.05 billion. Based on a projected income stream, the billion-dollar price implies a sub-4% cap rate. The point is that monetizing assets at cap rates of 5¾% or 4% is a great way to underscore the difference between the evident value of your portfolio, on the one hand, with the value that Mr. Market has chosen to stick on it, on the other."

The 2007-09 downturn was good, at least, for the accumulation of net operating-loss carryforwards that Forest City may now use to offset gains and income; $200 million worth of such credits are still on the books. "So we really have not been a federal taxpayer," Bob O'Brien, Forest City's chief financial officer, tells Peligal. "We've paid a modest amount of state taxes. As we sell more non-core assets, we will utilize those NOLs. It's something we continue to monitor. We certainly don't see ourselves becoming a consistent taxable-income generator until sometime post 2014 or 2015."

As Kidd mentioned in the conversation we imagined him having with his imaginary broker, Forest City is a C-corporation that pays no dividends. It might, however, choose to become a REIT after it exhausts its NOLs.

At least, this is the *Grant's* working hypothesis, and Peligal raised the point with O'Brien. "Does Forest City's non-REIT status hurt the share price?" our man asked.

"A comment we often get," the CFO replied, "is that we're not a REIT and because of that we're not in the REIT index. I guess, as people have said, 'when you're in the REIT index, they have to choose to ignore you, as opposed to choose to follow you.' [W]e get the question often, 'Are you going to become a REIT, and, if so, when?' We certainly believe it is simply a function of taxes." So as the NOLs dwindle, REIT status may loom, pleasing those in search of current income while displeasing any who prefer the company to continue to create value not by paying out money but by reinvesting it.

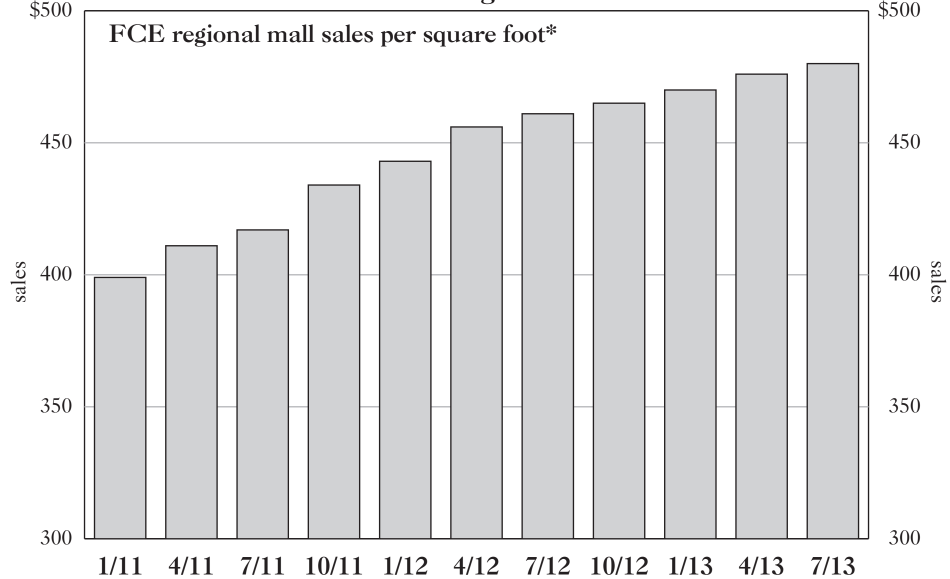
In partnership with the Arizona State Retirement System, Forest City is pursuing a reinvestment strategy in and around the Barclays Center in downtown Brooklyn. B2 BKLYN is the joint venturers' contemplated residential tower hard by the Nets' playground. Construction, featuring prefabricated building components, began late last year. Of the projected 32 stories, all that's visible is a steel frame rising 20 feet or so, Peligal reports. It seems it's easier to design a prefab apartment tower than it is to actually build the parts off site (in this case, at the Brooklyn Navy Yard), and on site to hoist them to the sky on a giant Bay Crane. Anyway, a construction worker advised Peligal, the project is months behind schedule.

Maybe the most impressive feature of the B2 BKLYN development is the presence, at this formative phase of work, of the Arizona fund. "Historically," Peligal notes, "to get institutional capital involved at the very early stages of development—the very speculative stages—is near impossible. The Arizona partnership is thus a feather in Forest City's cap."

Word on the street is that, as gentrification proceeds, crime goes down and rents go up. "Outside of Barclays Center," Peligal reports, "you'll see Best Buy, DSW, Target, Pathmark, Old Navy, Marshalls, Burlington Coat Factory and Applebee's. There are some vacant smaller shops. I spoke to a guy named Sury who is the proprietor of Mondini Fashion on Dean Street. He said that these landlords are waiting for big corporate customers to come in and pay big-dollar rents. He ventures the educated guess that a new, Jennifer Lopez-branded cell phone store, Viva Móvil, is paying $15,000 a month for 2,000 square feet. The previous tenant probably paid $2,500 a month, he said. While Forest City does not pocket this particular stream of income, Barclays Center indirectly benefits by anything that improves the neighborhood. Twenty years ago, who'd have dreamt that the then-menacing downtown Brooklyn would enjoy a renaissance of urban cool? Well, maybe Forest City did."

A gleam in the company's eye is a much bigger Brooklyn apartment complex. Atlantic Yards is a projected 6,400-unit habitation on which $700 million (including $200 million of debt) has already been lavished, and which may wind up costing $3.5 billion more. To get to the finish line, Forest City is looking for moneyed partners. "We were asked on the earnings call, is it worth more or less than our cost?" O'Brien tells Peligal. "We're not going to speculate on that. We have just begun to approach the marketplace to see if there are investors out there who would like to partner with us on the development of Atlantic Yards. What is that land worth? We think the opportunity that Atlantic Yards represents is unique and worth a substantial amount. The marketplace will ultimately tell us whether it is worth more or less or equal to the cost we have invested thus far."

Amazon.com notwithstanding



*rolling 12-month basis for periods presented
source: company filings

And what, you may ask, does the marketplace have to say about Forest City's 17 regional malls? In the 12 months ended July 31, those properties delivered sales of $480 per square foot, a showing almost as good as the one lately reported by the Australia-based Westfield Group, operator of one of the world's largest collection of shopping centers. Concerning the future of bricks-and-mortar retailing, a story in Tuesday's *New York Times* quoted the retailing titan, Millard S. Drexler (he of J. Crew), as "emphatically" advising the founders of Warby Parker, a three-year-old vendor of hipster eyewear, that they needed a physical presence to complement their Web site.

"There is no doubt there is a major shift ongoing in the retail space," Dobratz adds. "There will, however, always be a place for the regional mall, in our view, as a destination and a place where shoppers go to touch items and retailers showcase items. What we are actually finding is that successful online retailers are opening stores in malls so that they have an 'omni-channel model' and dominant malls (say sales of $400 per square foot or more) are getting stronger by taking market share from tertiary properties (less than $400 per square foot). For instance, one could look at the sales productivity of Forest City centers, which is highlighted in the supplement, where sales have increased by approximately 4% over the

Forest City Enterprises
net asset value components, July 31, 2013

	development pipeline —pro rata cost— 100%	0%
FCE/A stock price as of 9/17/13	$18.78	$18.78
Diluted shares	224.00mil.	224.00mil.
Market cap	4,206.70	4,206.70
Subtract:	–1,924.60*	–595.20*
Implied equity value of completed rental properties	2,282.10	3,611.50
Add: rental properties nonrecourse debt	+6,364.20	+6,364.20
Implied gross value of completed rental properties	8,646.30	9,975.70
Annualized stabilized NOI for completed rental properties	668.10	668.10
Implied cap rate**	7.73%	6.70%

* represents sum of development pipeline, other tangible assets, recourse debt and other liabilities
** divide NOI by gross value
source: company filings

past year despite the continued double-digit increases in e-commerce. This is why a number of the larger players in the space are shedding B and C malls (i.e., General Growth, Westfield, etc.)."

Ridge Hill mall in Yonkers, N.Y., a northern New York City suburb, is one of these Forest City properties, and its story well illustrates what retailing landlords confront in this digitized and less-than-vibrant economy. An outdoor space, Ridge Hill is anchored by, among others, Lord & Taylor, H&M and Dick's Sporting Goods. It can't be said that the mall is situated in virgin retailing territory; from Ridge Hill, you can drive to the Cross County Shopping Center in 10 minutes, to the Westchester Mall in White Plains in 15 or 20 minutes.

Opened in 2011, Ridge Hill is only 71% leased. "Whereas the Cross County Shopping Center, 60 years young after a recent makeover, is noisy and crowded," Peligal relates. "Ridge Hill is quiet and serene. Not the best news for the developer, but for the shopper who doesn't want to deal with lots of people, it's lovely. Management is shooting to have 75% of the space leased by the end of the year and to reach break-even—'stabilization,' as it's known in the trade—by 2015 or 2016. Ridge Hill is one of Forest City's problem children, but, from what I saw, it's definitely not incorrigible. "

How to value Forest City? Easy, it would seem: Divide net operating income by an informed estimate of the value of the completed rental properties. Voila: The implied cap rate.

But, on closer inspection, it's not quite so easy. The wrinkle is the development pipeline. Should it be carried at cost, which is $1.33 billion? Or at nothing, to reflect the market's current aversion to real estate pie in the sky? Either way—to skip to the bottom line—the company is in a valuation league of its own. Assigning the development pipeline its value at cost yields a cap rate of 7.7%. Giving it no value produces a cap rate of 6.7%. The nearby table fleshes out the calculations.

Dobratz, because Forest City is his biggest position (and twice the size of the next largest holding), is allowed to round the aforementioned 7.7% up to 8%. "An 8% cap rate," he tells Peligal, "does not justify what they have today. In fact, if you look at the comps, most of which are REITs, their closest comps trade closer to 6% caps today. If you put that kind of cap rate on Forest City, you're talking a value per share that's closer to $30. We think the REITs are generally overvalued today, so we don't necessarily sign off on these cap rates for the long term. But we think that a conservative estimate for NAV is definitely somewhere in between today's stock price and that $30 per-share value which the comps would suggest."

Jason Kidd, please copy.

•