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Just you wait

Though 10 lush bull-market months have skipped by since we published our upbeat analysis of Forest City Enterprises, FCE's "A" shares have rallied by only 10% (*Grant's*, Sept. 20, 2013). Interest rates have remained stunted, the Fed has continued to conjure new dollars (even at progressively reduced rates of conjuring) and commercial real estate prices have broadly appreciated. In meting out a gain as grudging as the one he did, Mr. Market might as well have spit in our eye.

Now under way is a reappraisal of Forest City and its 235.5 million diluted shares. Bullish, we remain, to anticipate the investment conclusion. At a price of just under $20, the stock continues to change hands at a meaningful discount from estimated net asset value per share; we judge that figure to be in the neighborhood of $25.

Naturally, there are reasons to doubt that the discount will soon close. Forest City nearly met its maker in 2008-09, a reminder that leveraged real estate companies are always at risk. As for the present moment, the company is neither a real estate investment trust nor an income play. It's a C-corporation, and it pays no dividend. And because it's not a REIT, therefore not a component of the MSCI US REIT Index, no REIT index hugger feels compelled to buy it. Then, too, descendants of the founding families—Forest City dates from 1920—hold the vast majority of the privileged "B" shares. And what is almost as unpleasing to the bulls as the existence of dual classes of stock is that some of these "B" shareholding heirs have lately been unloading.

Other items for the not-bullish side of the argument include the fact that Forest City remains a work in progress. "Management is still trying to 'stabilize'—meaning to infuse with tenants so as to achieve break-even—properties like the Ridge Hill mall in Yonkers, N.Y., which represents about 9% of the assets on the corporate balance sheet and is 73% leased, and the Barclays Center arena, of which Forest City owns 34%," relates colleague David Peligal. "Then, too, investors were surprised a few months ago by the magnitude of the pre-tax, non-cash impairment the company took relating to its 22-acre, mixed-use Atlantic Yards project in Brooklyn. On top of that, management had warned that the completion date for B2 BKLYN, the first residential tower at Atlantic Yards, would be delayed until the fourth quarter of 2015." Peligal predicted this particular wrinkle from information he gleaned from an on-site construction worker last year. Returning to the scene of his investigative coup on Monday, our reporter encountered the very same, now very tight-lipped hard hat. Thrown back on his own resources, Peligal performed a visual inspection on the structure in question. "Now seven stories high and rising, it looks OK for the 2015 deadline," he relates.

At the corner of Dean St. and Flatbush Ave. rises B2 BKLYN

It would require a Forest City holder of superhuman serenity not to envy the valuations that the market accords to the REITs whose property portfolios bear a more than passing resemblance to Forest City's own. SL Green, Vornado, Boston Properties and Empire State Realty Trust trade closer to the 4% cap rate that so-called core New York property commands than they do to Forest City's 6%-plus valuation (cap rate being defined as net operating income, or NOI, divided by gross asset value). Peligal asked Forest City's CFO, Bob O'Brien, why that might be.

Leverage, for one thing, O'Brien replied. Forest City sailed into the crisis of 2008 showing a ratio of debt to EBITDA—i.e., earnings before interest, taxes, depreciation and amortization—of 14. The 2007-08 track of the share price—to $4 from $70—tells you everything you need to know about the success of that balance-sheet strategy. As of the March 31 statement date, debt to EBITDA had been pared to 11:1. Management is pointing for a further reduction to 10:1 in the next 12 to 24 months, says O'Brien. *Grant's* readers may recall that that was the target for year-end 2013, too.

There are three wholesome ways, at least, to reduce leverage. One can pare back debt, boost NOI or do both at once. Forest City has fallen short in the income/EBITDA department. "Our NOI and EBITDA has to grow," O'Brien says. "We expect that as we reach stabilization in Ridge Hill, as we reach stabilization at Barclays Center, as we reach stabilization at some of the other assets that are under construction and now just beginning to open, those will add nicely to our EBITDA number. Remember that the majority of the debt in our development pipeline and our construction pipeline is already in place—and as those assets begin to produce income, that will improve our debt metrics. But that's one of the barriers."

Another impediment to a higher share price, O'Brien speculates, is the very nature of the Forest City portfolio. It's neither one thing nor another but a kind of realty smorgasbord. The market wants, or seems to want, apartment REITs, office REITs or retail REITs; specialization is the flavor of the cycle. What it seems not to have an immediate use for is a diversified "C" corporation whose theme is—more or less—not having to commute.

Living in one place, driving to work in another, and shopping in still a third is yesteryear's way of living, O'Brien contends. Forest City is in the business of geographical unity—"24-7 communities" is the corporate theme. "So Atlantic Yards, which will be residential, will have retail at the ground floor and be right across the street from large retail centers. There are offices surrounding it. It's right adjacent to public transit. So we want to build what the marketplace is demanding as opposed to saying: 'We're just going to build retail and we'll find that across the country.' We want to focus in locations where mixed-use is an important element of creating that vibrant 24-7 community."

Shortly after we published last fall, Forest City reached a preliminary agreement to sell a majority stake in the Atlantic Yards' development to a government-owned Chinese developer, Greenland Group of Shanghai. Greenland, headed in this country by the Taiwanese-born Ifei Chang, would make a capital contribution of roughly $200 million to acquire 70% of the project, excluding Barclays Center and B2 BKLYN; Forest City would retain the remaining 30%. Project costs would likewise be split 70-30. "We hope the city permit procedure will pick up the speed we want, pick up the speed the businesses want, pick up the speed investors want, pick up the speed the citizens really need," Bloomberg quoted Chang as saying in an April profile featuring numerous testimonials to Chang's irrepressible energy. "We should all move very fast. We should catch the moment." The transaction closed on July 1.

Peligal next asked O'Brien about that pre-tax, non-cash impairment charge at Atlantic Yards; it amounted to about $1 per share. "I think underappreciated by most is the fact that we have committed to complete hundreds of millions of dollars of essentially public infrastructure that is necessary to allow the housing to get built," the CFO replied. "This site was, for lack of a better description, a bit of a hole in the ground, particularly where the Long Island Rail Road tracks come in. In order to accommodate the arena, we had to move those tracks and provide a 'temporary' rail yard, which is where the trains are stored during the day. As we move to phase two, we are committing to not just buy the air rights from the Long Island Rail Road but also create a 'permanent' rail yard, which is a major improvement for the LIRR and a very expensive undertaking. Finally, we will have to create a platform over that permanent yard—creating the foundations and decking over those tracks—all of which adds significantly to the ultimate cost of the transaction. So that infrastructure, which ultimately benefits the LIRR and the commuters, and ultimately the city of New York, is being borne primarily by us. As a result of the time delays between the time we started and the time we could go forward, as a result of the increases in the costs of the infrastructure compared to our original estimates as well as other factors, we had to write off $242 million of our investment."

As you may recall, Atlantic Yards will ultimately consist of 6,400 residential apartments. Rental units will predominate, including 2,250 units earmarked for low- or middle-income occupants. The set-aside for so-called affordable housing may be seen as a cost, a kind of tribute, for doing business in New York. Anyway, Forest City, or perhaps the dynamic Ifei Chang, seems to have passed political muster. In a June 27 press release, New York Gov. Andrew Cuomo announced "a comprehensive plan to accelerate the development of Atlantic Yards, including a fast-tracked timeline for delivery of affordable housing. The new plan will shorten the completion time frame to build 2,250 affordable apartments by 10 years, from 2035 to 2025."

Before hanging up the phone, Peligal asked O'Brien about future conversion to REIT status. "We've been pretty open about the fact that as Forest City begins to generate regular taxable income, unless something changes in the marketplace, we should convert to a REIT before that happens. Rather than paying corporate taxes to Uncle Sam, converting to a REIT will obviously allow us to avoid corporate tax and pass the income through to shareholders to our collective benefit. And we'll do so at the appropriate time. The reason we have not yet converted is because we still remain tax efficient. We're not paying any federal corporate tax because we ended last year with $150 million of net operating loss carryforwards. . . . So, for us, it's really more a question of when do we do that, as opposed to *if* we do that."

A higher Forest City share price is contingent on a number of things, including the many over which management has no control. However, as for the closing of the discount between market value and NAV, we judge that that is a matter of "when," not "if."

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