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Acres of hope

Asset-rich and management-poor, Forestar Group (FOR on the New York Stock Exchange) has delivered remarkably consistent results. From the close of 2007 till just the other day, its stock has generated a compound annual return of minus 7¼%. Never mind that the company holds 111,000 acres of the thing that nobody's making any more of, or that the share price is quoted at a steep discount to Forestar's guesstimated net asset value; investors have collectively decided that enough is enough. Following is the case for bullish reconsideration.

The market will take some persuading. You might have supposed that short-sellers were running the company, so predictably has the decision-making redounded to the benefit of the bears. Too many employees, too much overhead, too great an exposure to the capital-intensive side of the oil- and gas-extraction business—the front office has piled error on error. Happily, a change at the top is under way.

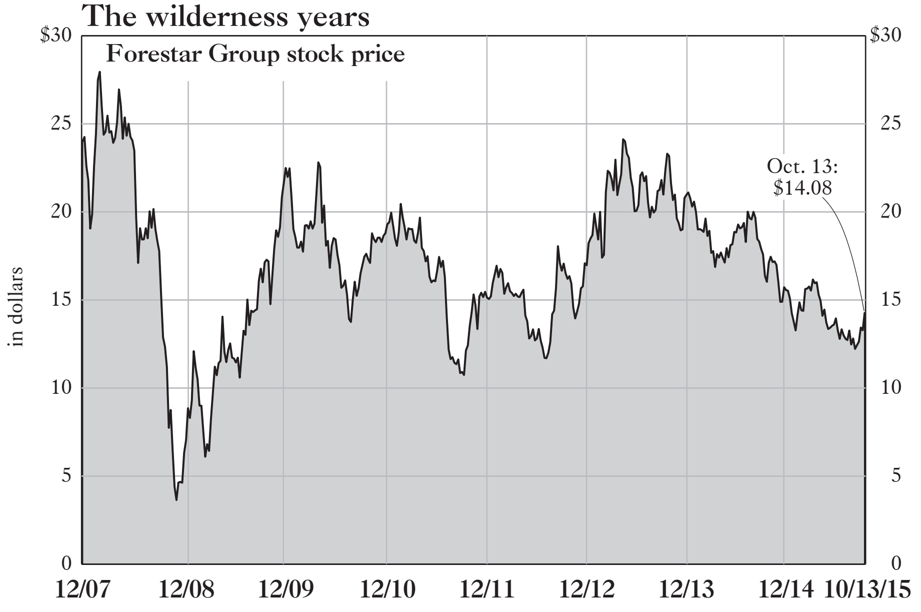
What does Forestar produce, besides—in its now concluding wilderness years—disappointment? It develops real estate, owns and operates oil and gas leaseholds and sells groundwater. True to the "forest" in "Forestar," the company—founded in 1955 as Lumbermen's Investment Corp.—markets wood products from company-owned timber stands. It owns land in 14 markets in 11 different states. It owns 935,000 net acres of oil and gas mineral interests. It holds royalty interests in underground springs on 1.4 million acres. Acquiring, entitling and developing the land on which to build apartment buildings, houses and hotels is the main stock-in-trade.

Your editor is here to testify that land qua land doesn't necessarily punch one's ticket to investment success. Forgiving readers will draw a blank at the mention of Tejon Ranch (TRC on the New York Stock Exchange), holder of 270,000 sun-drenched California acres on which prosper almonds, pistachios, walnuts, wine grapes and the odd unit of income-producing real estate (*Grant's*, Nov. 30, 2012). Though the Tejon share price, too, has prospered at intervals over the past two decades, it happens to sit today exactly where it did in the summer of 1997. As much as management strives to develop its land, by just that much, or more, do phalanxes of California preservationists work to block development. There must be easier ways to make a living than by butting heads with them.

Then, again, the shining example of Consolidated-Tomoka Land Co. (CTO on the Big Board) shows what skilled management, prompted by engaged investors, can accomplish (at least outside the Golden State's land-use jurisdiction). A $300-million market-cap business that employs just 15 people and pays general and administrative expense of only $7 million a year, Consolidated-Tomoka is a kind of right-sized Forestar. The company owns 10,500 acres in Daytona Beach, Fla. and 490,000 acres of subsurface mineral rights tied to oil production in plum sites near Fort Myers. The Consolidated-Tomoka share price has zoomed since a 2011 management change that installed John Albright as the company's chief executive officer.

"Consolidated has found the keys to success in better disclosure and more intelligent capital allocation," colleague

The wilderness years



source: The Bloomberg

David Peligal reports. "It doesn't bear the expense of drilling for oil. And it does what's required to monetize the value of its land. Thus in August 2014, the company sold 76 acres to Trader Joe's for $7.8 million, or $103,000 per acre—a big deal. Trader Joe's opened up a 630,000-square-foot regional distribution center, in which it invested over $80 million and hired 450 employees. That validated that particular Daytona Beach land location and the investment story therein. In addition, Consolidated management has no objection to income-producing property. Nothing wrong with a little cash coming in the door, it reasons. Recurring revenue takes some of the pressure off the Consolidated salesmen to engineer big transactions just to cover the overhead."

"Owning valuable assets, such as CTO's land, is a great advantage for a company," David Winters, managing member of Wintergreen Advisers, which owns 25.7% of Consolidated-Tomoka's outstanding shares, reminds his shareholders, "but without the right people running the company, there is little chance of that asset value accruing to the shareholders."

Little to none, to judge by Forestar. The company leases 535,000 of its aforementioned 935,000 net acres of oil and gas interests in return for bonus payments and royalty interests. It works the remaining acres on its own nickel. These are interests that Forestar acquired in its 2012 purchase of Credo Petroleum Corp. for $146.4 million in cash, a transaction that doubled Forestar's oil-and-gas production and proven reserves.

"Management underestimated just how costly do-it-yourself oil production can be," Peligal observes. "It's capital-intensive—one might call it a business that was invented to separate capital from its owners. To finance part of this undertaking, Forestar put through a dilutive financing. Tangible equity units, issued through Goldman Sachs, consisted of an amortizing note and a prepaid stock purchase contract. One consequence is that, depending on the stock price in December 2016, the fully diluted share count might be as high as 42 million shares, rather than the 34 million basic shares outstanding as of the end of the second quarter. What the company's old management team and board of directors forgot are the advantages of leasing oil and gas deposits to people who know what they're in for. You don't want to be the guy drilling wells—that's not your business. You simply want to be the asset guy, the one who lends his land for revenue."

Grant's estimate of Forestar Group's net asset value

	Forestar value per share
Owned entitled/developed/in-entitlement real estate	$17.50
Ventures assets	$1.75
Income producing properties/development sites	$4.40
Unconsolidated ventures	$1.60
Water assets	$0.75
Mineral rights	$2.25
Credo assets	$3.25
Municipal utility-district reimbursements	$0.50
Net debt	($8)
Capital gain on entitled and developed	($2)
	$22.00

sources: Company financials, proprietary research, etc.

You can't blame management for failing to divine the coming of the 2014–15 energy-price spill. You can blame it for failing to focus. Is Forestar an energy-exploration and -development company, or is it a real-estate development company? Could it be both, with a pinch of timber and a soupçon of groundwater? No, a strategic review concluded in May, Forestar is a real-estate company, first and foremost: "[W]e are focused on building a best-in-class real-estate business and growing net asset value by acquiring, entitling and developing residential and mixed-use communities. . . ." So the oil and gas segment was demoted to "non-core" status and a $57 million noncash charge was levied to reflect the cost of asset impairment and of drilling dry holes in Oklahoma, Nebraska and Kansas. Third-quarter financial results will likely incorporate further writedowns; management hinted as much on Sept. 30 when it entered into an amendment to relax a certain covenant with its bank lenders. Then, too, the company has suspended exploration and drilling operations in the aforementioned states, slashed energy-related capital expenditures and culled energy-associated staff. Maybe a clairvoyant, correctly espying some recovery in energy prices, would judge that management is taking these steps at the worst possible moment. We know of no clairvoyants to ask. For better or worse (for better, we judge), Forestar is today a real-estate development business.

Management didn't just wake up to these facts of life; value- and activist-oriented shareholders rather impressed the message on a reluctant audience as the stock price dwindled to what is today $14 from $24 in May 2013. The combination of land, mineral rights, water rights, desirable markets—all of which Forestar possesses—attracts one kind of investor. A management's expressed indifference to the interests of the public shareholders attracts another kind. Both sources of attraction have led to a promising shake-up at the top.

There are new faces at Forestar today, including a pair of directors who passed muster with two dissatisfied Forestar shareholders, Cove Street Capital and SpringOwl Associates. Perhaps just as important, there are fewer old faces in the executive suite and on the board. Among the cast of former, or imminently former, characters is CEO Jim DeCosmo—he stepped down on Sept. 28—and longtime director and non-executive chairman, Kenneth M. Jastrow II. Another director, good-governance scourge James A. Johnson, the former head of Fannie Mae, will not seek reelection to the board in 2016. The old chief financial officer is out, too, and there's no more poison pill (the board was persuaded to remove it in March).

The new CEO, Phillip J. Weber, comes from within Forestar; he'd headed the real-estate investment committee and, before that, the water division. Before joining Forestar, Weber led the multifamily-housing division of Fannie Mae, Jim Johnson's alma mater. While these credentials seem hardly calculated to assuage the anxieties of a battered shareholder constituency, the new broom is reputed to be a solid citizen (though not one with a large immediate interest in the Forestar share price; he owns little more than 40,000 of them). Perhaps the new CEO could begin by publishing an estimate of net asset value per share, something the old regime refused to do. Insofar as there's an analytical consensus on NAV per share, it settles in the low $20s. Taking an educated guess—see the accompanying table—Peligal arrives at $22 a share.

There's a chance, at least, that Forestar will be run more like a real company rather than a confederation of fiefdoms. Headcount is one addressable problem. One year ago, there were 150 employees; today there are 110. Perhaps there could be far fewer. At last count, general and administrative expense was running at the rate of $25 million a year. An outsider can't know what the ideal number is. A smaller one seems desirable, especially if management were to give itself over to rationalizing the existing portfolio, rather than embarking on new adventures.

"If Forestar's new executive team and Board can succeed in allocating capital wisely," Peligal observes, "the company's real-estate portfolio has lots of potential. For example, Forestar owns the Radisson Hotel in downtown Austin. An asset like this in a hot market like Austin would probably sell at a 5% cap rate today. When you consider its premier location and recent renovation, it's probably worth well over $100 million. Then, too, Forestar believes that it's well-positioned to expand NAV through development and ownership of high-quality apartment buildings, such as the 257-unit Eleven, situated on East 11th Street in Austin, hard by the site of a projected new University of Texas medical school and teaching hospital. An asset like this would also probably trade at a 5% cap rate today. With an estimated net operating income of $3 million this year, Eleven is probably worth at least $60 million."

"Consistent with our strategic initiative to invest in multifamily opportunities," Forestar remarks in the outlook section of its second-quarter earnings release, "including projects which generate recurring cash flows, two new multifamily projects started construction in second quarter, Music Row in Nashville and Dillon in Charlotte. These two projects are wholly-owned, and are expected to represent an additional 609 multifamily units. We expect to continue to focus on growing our pipeline of multifamily development sites utilizing tax-efficient strategies from timberland sales when possible. Construction has been substantially completed on Midtown Cedar Hill, near Dallas, which is almost 90% leased and is being marketed for sale. In addition, Acklen in Nashville and 360° in Denver both delivered units during second quarter and are leasing at rates above our investment underwriting."

Residential real estate is another point of focus. "Including ventures," the Forestar fact sheet relates, "we have 11 projects representing approximately 24,000 acres in the entitlement process and 76 residential and mixed-use projects comprised of almost 18,000 planned residential lots and approximately 1,900 commercial acres." Most of this entitlement bank is situated in the western outskirts of Atlanta. There are, besides, 700 potentially valuable acres in Los Angeles in one of the last remaining parcels in the southern Santa Susana Mountains. Hidden Creek Estates will yield up to 188 residential units if all goes according to plan—no sure thing given the inevitable environmental tussle.

While America's residential real-estate market is hardly on fire, Forestar sold 519 developed residential lots in the second quarter at an average of $73,400 per lot, up 14% from a year ago (average gross profit per lot was higher by 25%). And while oil-dinged Houston has seen better days, land prices seem to be holding their own even in the city's outskirts. In Richmond, Texas, for instance, a development called Long Meadow Farms, of which Forestar owns 38%, features $450,000 houses; they continue to sell, oil bear market or no. If, as a rule of thumb, the land underneath a house represents 20% of the overall value of the property, each lot would command a price tag of $90,000—as lots would, too, in Forestar's 80%-owned Southern Trails development in Pearland, Texas, within striking distance of the Texas Medical Center in Houston. Even if the average Forestar residential lot fails to measure up to the fancy dirt in Long Meadow Farms and Southern Trails, there's good long-term value in the company's portfolio.

There's debt, too, $336.1 million's worth at the end of the second quarter. Borrowings comprised $250 million of 8.50% senior secured notes due 2022, trading at 104; $104.8 million of 3.75% convertible senior notes due 2020, trading at 88; $13 million of closely held tangible-equity unit notes; and $67 million of other debt. At year-end 2014, $70 million in earnings before interest, taxes, depreciation and amortization covered $30 million of interest expense. "I recognize," Peligal says, "that the company is leveraged, and probably over-leveraged. As for the excess of indebtedness, put that down to the now-departed management that couldn't decide whether it wanted to build upper-middle-class gated communities or drill for oil. If you think that the newly refocused Forestar can liquefy in a hurry and that the new management team really might just start whacking at things, the leverage concern might be overstated.

"It's clear that Forestar is an asset story and a turnaround story," Peligal sums up, "but it's not an earnings story. In fact, I would argue that earnings really don't matter in this particular situation. The investment thesis here is: (a) what is the discount to NAV; and (b) what can you do to narrow that discount? I hear that new CEO Weber is currently meeting with investors and is in the process of putting together a detailed NAV. Forestar will most likely have a plan on the best way to maximize shareholder value before year-end. But Weber is in a tricky spot, so think about it from his point of view. Given the disappointing share performance over the years, top Forestar shareholders have little appetite for any strategy but that for selling and shrinking the company to realize NAV. That's a high hurdle rate for any operating plan where the proposed present value is greater than what these shareholders want. And since Forestar's board of directors voted to recommend declassifying the Board in November 2014 so that all directors are elected annually, why take the career risk? If he is known as the CEO—and board member—who presided over a process that led to the realization of NAV over one to two years, that's not a bad thing for him personally."

On Sept. 29, JCP Investment Management, a three-shareholder activist group, disclosed its purchase of a 6.4% stake in Forestar. Analysts can praise, and management can promise. A 13-D filing is the sincerest expression of confidence.

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