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Special situation redux

In its fair and balanced coverage of U.S. monetary policy, this publication censures the Fed for its downward suppression of interest rates. Yet, equally, we extoll the prudent exploitation of that public-policy blunder for private gain. Enter—or, rather, reenter—iStar Financial, the real-estate finance company that we liked when its share price was 33% lower than it is today (*Grant's*, Dec. 14). In preview, we like it still.

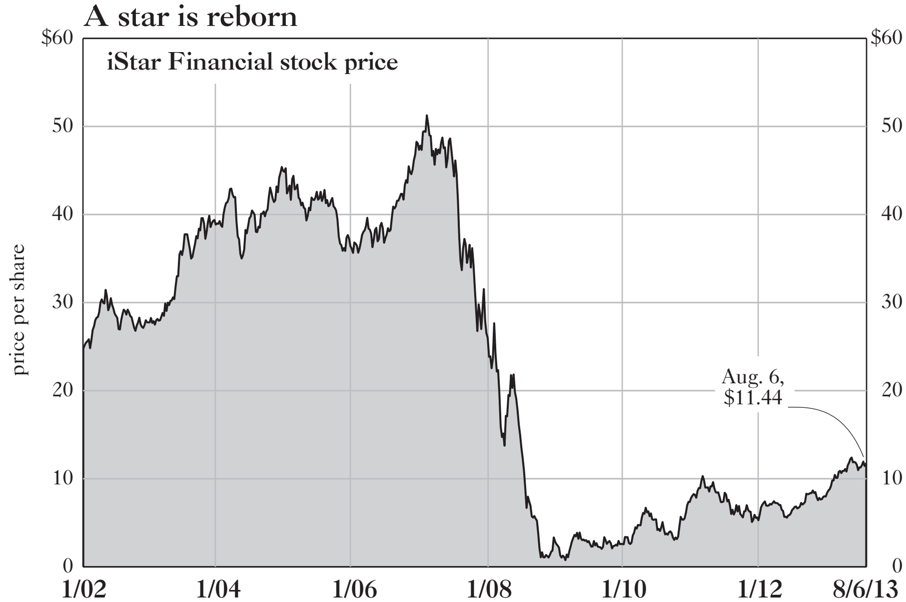
iStar (SFI on the New York Stock Exchange), organized as a real estate investment trust, opened for business in 1993, went public in 1998 and nearly went to heaven in 2008. The share price was $45 when management (still in place) got it into its head to buy the commercial and construction loan portfolio of the Fremont, Calif., General Bank. That was in 2007. Next thing you knew, it was 2008 and the price of a share of iStar wasn't $45 anymore but $1. Yet the company lived. Deliverance in the shape of a $1 billion secured term bank loan arrived in 2009.

With respect to the right-hand side of its balance sheet, iStar today is sitting pretty. Funded as it is in the capital markets, the company will forever remain vulnerable to dysfunction on Wall Street. But this year's advantageous financings have removed near-term funding risk from the list of goblins and dragons that iStar confronted only a few years back. Illustrative transactions in 2013 include the re-pricing of a senior secured bank loan (featuring a 100 basis-point reduction in coupon interest) and the issuance, at par, of $265 million of 3⁷/₈% senior unsecured three-year notes and $300 million of 4⁷/₈% senior unsecured five-year notes. The company's average weighted cost of borrowing stands at 6% today, down from 6.2% in the first quarter and 6¹/₂% in the fourth quarter of 2012. At June 30, the balance sheet was leveraged 2:1; on July 11, Moody's revised its iStar debt rating to positive from stable (with a "corporate family" rating of B2). Management has no pressing need to return to the markets until 2017.

In the 2012 annual report, Jay Sugarman, iStar's chairman and CEO, boasted that, having fixed the liabilities portion of the balance sheet, management would turn its attention to "deriving maximum value from its existing $6 billion portfolio, its multiple business platforms and its 20 years of experience across a large portion of the real estate marketplace."

In that portfolio, land is the standout value, observes colleague David Peligal, our analyst on the iStar case. Dozens of parcels acquired in default in the bad old days are carried on the balance sheet at the eminently reasonable value of $962 million. "That carrying value," Peligal goes on, "represents about 40% of the original cost of the land, i.e., what the original buyer paid for such property before defaulting. Certainly, many overpaid for land during the housing boom, but lots of markets have rebounded dramatically, and homebuilders are out looking for land again. Then, too,

A star is reborn



source: The Bloomberg

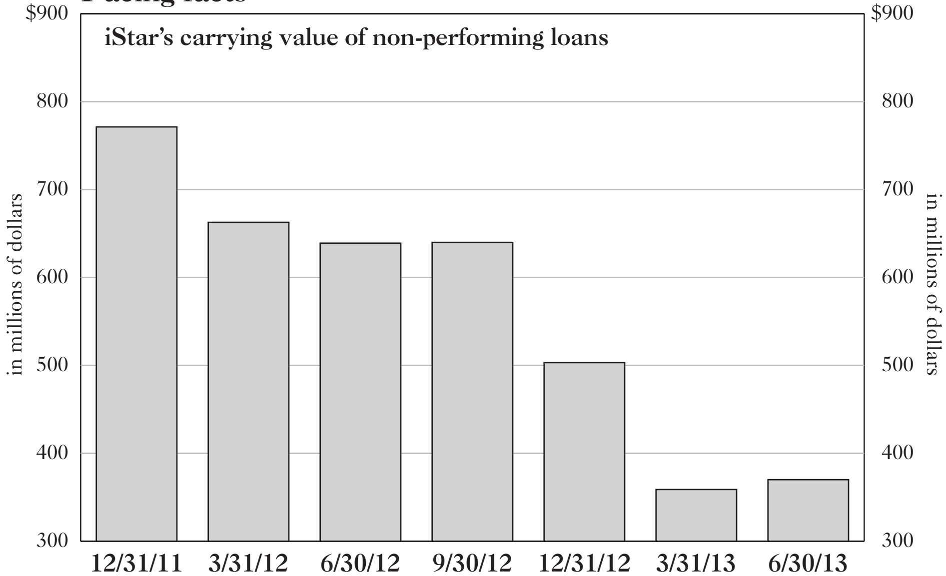
land is not the worst asset when the Fed is printing money."

Besides its holdings of mother earth, iStar has operations in real estate finance, net leasing and operating properties. "As for the first, lending against commercial property," Peligal continues, "iStar isn't trying to pick off deals from regional banks on whatever plain-vanilla construction or development loan that everyone else is looking at. They're trying to finance people with complex and perhaps hairy transactions who are prepared to pay a higher interest rate in exchange for greater flexibility. An example of the type is a financing announced on July 8, in which iStar committed to provide up to $146 million of preferred equity to Landmark Apartment Trust of America, a non-traded, public multifamily REIT that owns and operates 27,000 apartment units in the Southeast. Blackstone Real Estate Special Situations Advisors provided an additional dollop of preferred equity. LATA is a fast-growing company that needs a boatload of capital. They probably asked around, saying, more or less, 'We don't know how much we need, or when we need it.' If you walk into a bank and ask for that, you're going to get a strange look. But it's exactly the kind of deal that's in iStar's wheelhouse. While the headline number on the preferred equity is a rate of 8.75%, iStar estimates that the all-in return will rise to the mid-teens."

The real estate finance portfolio, which totaled $1.55 billion at June 30, still bears the scars of the bust—$1.18 billion of that sum is performing and $370 million isn't. The performing loans, consisting of $683.9 million of first mortgages or senior loans and $492.1 million of mezzanine loans or subordinated debt, generated a weighted average effective yield for the quarter of 7%. As for the NPLs, Sugarman, on the July 25 earnings call, said that "several . . . are getting closer to resolutions that will free up both unproductive capital and significant management resources."

"Two of the bigger NPL cases to monitor," Peligal elaborates, "are the Mandarin Oriental Hotel site in Chicago, which has been in litigation since February 2009, and Manoir Resort Villas in Florida, a Don Peebles-sponsored project that has been in litigation since 2008. Why are these relevant? If you transform today's non-cash generative assets into earning assets at attractive yields or simply convert them into cash, which can then be invested in new deals, suddenly you start to see glimpses of what iStar's business can look like."

Facing facts



source: company filings

As to the second business segment mentioned above, net leasing, iStar writes long-term leases on 20 million square feet in 275 buildings, the great majority of which it owns. The portfolio is carried at $1.65 billion, which is the original cost of its constituent parts. As of June 30, iStar's buildings were 93.8% occupied, according to management, with a weighted-average remaining lease term of 12 years. En masse, occupied and vacant, the properties delivered an unleveraged weighted-average effective yield of 7.2% on gross carrying value. We judge that the book seems conservatively marked.

iStar is also in the condominium development business; it's the third business line and is called "operating properties." At the end of the second quarter, 805 condo units were on the books for $303 million, about $376,000 per unit. During those three months, the company sold 118 units. Proceeds of the sale came to $92.4 million, on which iStar recorded $36.3 million of income, offset by $4.6 million of expenses. For the 118 units sold during the quarter, that works out to $783,000 per unit—impressive yes, though not necessarily representative. Not every asset in the portfolio measures up to the quality of Ocean House in Miami, 1 Rector Park in New York, the Martin in Las Vegas or 10 Rittenhouse Square in Philadelphia.

Westwood Entertainment District in Glendale, Ariz., hard by the arena where the NHL's Phoenix Coyotes skate, stands out as an example of iStar's commercial operating portfolio. It, like so many other good things on the corporate balance sheet, came to the company by way of foreclosure, in this case in 2011. "With the hockey team now set to stay in Glendale's publicly financed arena," Peligal relates, "chances appear strong for more of what the brokers like to call 'positive leasing momentum.'"

Which brings us back to the heart of the matter. "Let's take a look at iStar's land assets," Peligal proceeds. "Magnolia Green is one. Situated 31 miles southwest of Richmond, Va., it's one of the hotter developments in the vicinity of the Virginia state capital. iStar's cost basis on Magnolia Green might be around $30,000 per lot, but the company is selling them for $60,000 per lot. Perhaps 3,000 lots remain. To convey a sense of the tempo of things down south, a grand total of 102 lots were sold in 2012, which brought the not-quite grand total of lots disposed of between 2007 and 2012 to 270. With so much inventory to absorb, it seems safe to say that Magnolia Green will prove a long-term investment."

Anyway, the big arrow in the national land market does seem to be pointed up. Looking at both the development and the pre-development sides of the business, one might consider Grand Vista, VIVE or Marina Palms. Each is an iStar asset. Grand Vista, a projected master-planned village situated in Wittmann, Ariz., near Phoenix, has been on the drawing board for eight years. In 2005, Toll Brothers bought the 5,500-acre former DaimlerChrysler proving grounds there for $312 million, or $56,000 an acre. Even in 2005, real estate people were prepared to concede that the price seemed full. iStar now has that land on its books for $100 million. It's not so farfetched to imagine that the anticipated 15,000-house development could be worth $15,000 to $30,000 per lot over the next four years. At the lower price, iStar's land would be worth $225 million before tax.

Famously, Asbury Park isn't Granada, but iStar is the master developer of a luxury townhouse community on the waterfront of that long-faded (now brightening) New Jersey resort community. "We recently brought our first project, a 28-unit townhouse community called VIVE, to market," CEO Sugarman told dialers-in on the July 25 earnings call on the subject of Asbury Park. "While only representing 28 units out of a likely 2,000-plus total waterfront unit, the sellout of the second phase of units in less than a day has confirmed the strong demand we see developing in the market and should enable us to accelerate our conversations with other homebuilders going forward."

Another exhibit from the iStar land bank is a parcel that the company contributed to a waterfront Miami condominium project called Marina Palms. In exchange for its land, including 750 feet of water frontage, and entitlements to build 468 units and over 100 marina slips, iStar got $21.4 million in cash as well as both a preferred partnership interest and a 47.5% equity interest in the development joint venture. Because of the gratifying speed with which 85% of the units on the first 234-unit tower sold, signs seem to point to a generous ultimate return. "Pre-sales to date of the first tower were between $420 and $450 per square foot," reports Peligal. "Compare that to iStar's basis of $330 per square foot. Remember, the money is ultimately made on the second tower, not the first. You're funding the building of the first tower and selling pre-construction units to keep on funding it. By the time you're done building the first tower, you're basically at net zero. Thus, you make all of your money on the second tower."

Then there's "Bevard Farms," 1,250 acres of contention in Prince George's County, Md., within striking distance of the recession-proof, imperial capital of Washington, D.C. iStar seems to own 85% of this evidently hugely valuable property. We surmise that it's valuable because Lennar Corp. and iStar have gone to court to decide which owns how much. In any case, the land is on iStar's books for $102.9 million. It's conceivable that the lawsuit might accelerate, not retard, the realization of this asset. Maybe—we are admittedly daydreaming—the two parties will decide to settle before the case goes to trial in six to nine months, and Lennar will buy out iStar at a suitably fancy price.

"Pretty clearly," Peligal goes on, "iStar's book value—$8.04 a share on June 30 on a GAAP calculation—is understated. It doesn't seem to jibe with the evident rise in land values and condo values. Whatever the business, whether it's Amazon or Zillow or iStar, an investor must ultimately ask, 'What can this thing earn?' Let's assume that, on a current mark, true book value is higher than GAAP book value and that iStar is trading at just about true book. If that were so, one might ask, 'Where's the margin of safety? Where's the upside?' Well, the upside is implicit in a conviction that the business, adequately financed, can generate 'x' in earnings and that the market will assign a conservative multiple to those earnings. Recall that there's about $1 billion worth of land that is generating no income and another $1 billion of operating properties that are generating no income. That's $2 billion of inert assets. But, eventually, those assets will be sold. Now, if iStar can put the proceeds to work to generate a 10% return (calculated on assets)—and the company is almost breaking even now—earnings could reach $2 a share. Put a nine multiple on that and the share price is in the high teens—eventually. It could be higher if land and other assets were sold at gains."

Postscript: If CEO Sugarman had come to the phone, as *Grant's* politely invited him to, we would have asked why he's been selling stock in the company he leads. He sold 26,748 shares on July 8, 53,498 shares between July 3 and July 5, and 80,246 shares between June 5 and June 7, all through a 10b(5)-1 plan. Maybe—we are trying to put ourselves into his affluent shoes—he would reply that he's been selling not because he's bearish on iStar, far from it, but because he needs the cash to live the life that so many of us would live if we had some stock to sell. Even after these dispositions, let the record show, Sugarman owns 2.7 million shares directly (and more indirectly), in total some 3% of the basic common shares outstanding.

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