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Well-marked book

iStar Financial (SFI on the New York Stock Exchange) lives and breathes. This seemingly minor claim to fame is no small accolade for a real estate finance business that borrowed to buy at the top of the market in 2007. But, like Marley's ghost, iStar really does exist, and *Grant's* is bullish on it.

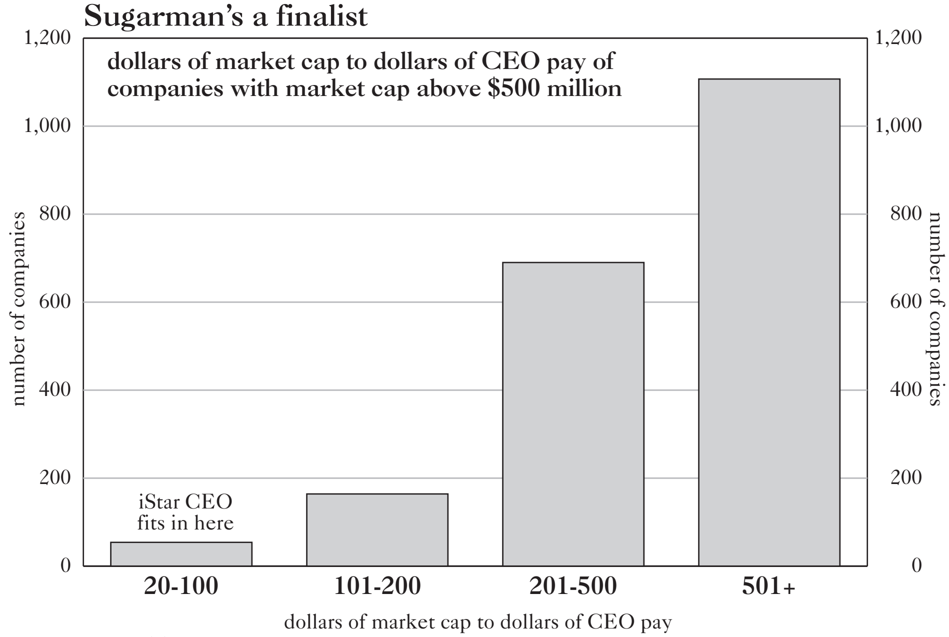
Let us only say that there are warts. The income statement is a fright, the directors vote no dividend and management won't come to the phone (at least, not to talk to us). The $6 billion balance sheet, though less encumbered than it used to be, is still leveraged, and nonperforming loans are still a drag on earnings. The CEO, Jay Sugarman, 50, earned $25.9 million in 2011, a figure that puts him in the running for a new title that the staff of *Grant's* has teased from the Bloomberg data base. This is the title: "recipient of the highest total compensation as a percentage of the market cap of the company that the CEO leads."

iStar, which is organized as a real estate investment trust, opened for business in 1993, went public in 1998 and—skipping ahead a full decade—purchased the commercial and construction loan portfolio of the Fremont, Calif., General Bank in July 2007 at the opening gun of the great debt contraction. Over the next 16 months, the SFI share price, too, did some contracting, to $1 from $45. Then, on March 16, 2009, iStar negotiated a $1 billion secured term loan from its bankers. The clouds parted, the sun shone and Sugarman exhaled.

"Its funding base secured," relates colleague David Peligal, "iStar showed its mettle by buying back boatloads of stock at huge discounts to book and hundreds of millions of dollars of debt at meaningful discounts to par. Before the crisis broke, there were 131 million iStar shares outstanding. Today, there are 83.6 million, at $7.88 each. After shooting itself in the foot with the Fremont purchase, iStar smartly managed its liabilities during the crisis. There aren't too many financials, especially credit-focused ones, that had both the will and the way to shrink their share counts." Except for management's coolness under fire—to be sure, fire it had partly trained on itself—the iStar book value per share would certainly be lower than the $10.23 one can simplistically calculate today: $1.4 billion of book equity minus $545 million for the preferreds divided by 83.6 million of outstanding common shares.

Lending is iStar's main operating business. Real estate developers are its principal customers, and they borrow from $20 million to $150 million for periods of three to 10 years. Whole loans, loan participations and debt securities stock the iStar portfolio.

Sugarman's a finalist



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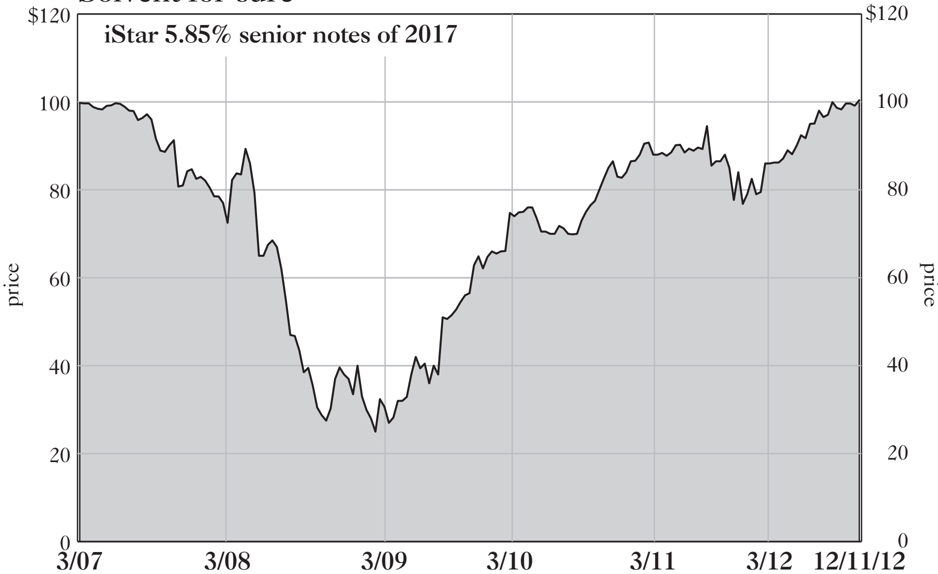
Solvent for sure



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Sometimes the borrowers bite off more than they can service or repay, which opens the door to a second business line. iStar acquires properties, or shells of half-completed properties, through foreclosure, deed in lieu of foreclosure, or in satisfaction of nonperforming loans. These buildings, and this land, are mainly what make us bullish.

A third line of business is the net-lease assets division—leasing a finished property to a single creditworthy corporate tenant. There are miscellaneous investments besides, including a 24.2% stake in LNR Property, a mortgage special servicer.

Chief sources of revenue for iStar are interest income and lease income, but neither is adequate to deliver a net profit. Losses before earnings from equity-method investments and other items totaled $288.4 million in the first nine months of 2012, better than the $1.34 billion recognized in 2009, but a loss nonetheless. "Apple," Peligal remarks, "the company is not."

"It is not a 'beat-and-raise' story," Peligal continues, "nor a 'my-estimates-are-higher-than-the-Street's' story. It's not even a 'I-think-they're-going-to-make-a-lot-of-money-on-a-GAAP-income-basis' kind of story. They're going to lose money over the next few quarters, and it wouldn't be surprising if book value fell a little bit during that time."

iStar is rather the story of asset values still hidden but—perhaps with an assist from Chairman Ben Bernanke—ultimately to be realized on a $900 million land portfolio that is going to be sold to home builders over the next 12 to 36 months, and on a $400 million condominium portfolio that is in the process of being sold, unit by deluxe unit, to wealthy home buyers. The value proposition we judge to be compelling, but instant gratification plays no part in it.

Land—the company's high-quality acres destined for master-planned communities or for waterfront development—was a topic on the third-quarter conference call. "The managed land portfolio," Sugarman told dialers-in, ". . .can be broken down a few different ways, but one simple way is to group them according to when they will begin production. Our current portfolio has 10% of assets by book value already in production, and we anticipate having approximately 60% by book value to be in production by the end of 2014. The remainder are expected to begin production between 2015

10 Rittenhouse Square, Philadelphia—an iStar trophy

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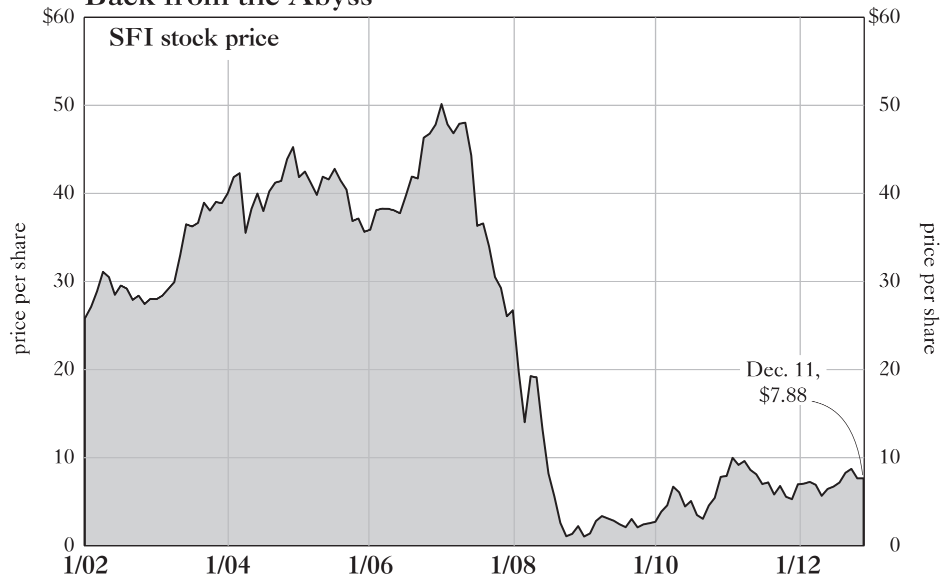
and 2017. This portfolio should be a strong contributor to future earnings, though not until a majority of the projects are in full selling mode and will remain both cash flow and earnings negative until then."

The company's condominium exposure consists of $264 million in performing loans, $65 million in nonperforming loans and—the stuff with the upside potential, we judge—$389 million in "other real estate owned." The iStar OREO portfolio features such sanctuaries for the one-tenth of 1% of American earners as 10 Rittenhouse Square in Philadelphia (an unfinished, 6,900-square-foot space will cost you $7 million, not that you should even blink) and Ocean House in South Beach in Miami, Fla. Both projects are said to be more than 70% sold. "Two years ago," relates Peligal, "there was a lot of doubt about iStar's condo portfolio. Today, there is not."

The process by which a lender by trade becomes an owner and developer begins with someone's miscalculation. "Let's say," says Peligal, "iStar lent to a condominium developer, the developer couldn't pay and iStar repossessed the collateral. The project is stalled, so iStar must complete it. The lobby needs work, the fixtures are uninstalled, whatever. Money goes out of iStar's door to salvage—and to improve and enhance—the value of the project. The expenses go on and on—for security guards, maintenance, utilities. As long as these outlays continue, the condo will remain an eyesore on iStar's income statement. But it's not a terrible assumption to make that the dollars they're investing today are going to allow them to sell the building for a 30% gain compared to where it is marked on the balance sheet."

But this assumption is one that an investor will have to make him- or herself. Goldman Sachs may mark its assets to market, but iStar does something else. It estimates what an asset might be worth in the future, but discounts that value by what the asset might fetch today. Fair value accounting—the kind that iStar, a finance company, employs—defers the recognition of any accretion in value of repossessed collateral until the moment of sale or leasing. "The bottom line," notes Peligal, "is that it takes a very long time for these assets to generate what looks like GAAP earnings. But we could potentially see $100 million to $150 million in gains thrown off from the stable of repossessed condos in the next 18 months."

Back from the Abyss



source: The Bloomberg

Ori Uziel, a big iStar owner and—*and*—a paid-up subscriber to *Grant's*, tells Peligal that what the iStar doubters miss is the quality of the iStar assets. "Most people don't know the tracts of land we're talking about," Uziel says. "If you do know what tracts of land we're talking about, you should be encouraged, but it's a long-tailed process. . . . For an investor to invest here, you have to realize that book value is worth more than what is stated in the 10-Q. This is because the credit tenant lease assets are worth more than book, the condos are worth more than book, their stake in LNR is worth more than book, etc. There is probably not much loss content on the loans, although some people point to mezzanine loans in Europe as potentially a problem. But it's not very much. What you're left with is a big bet on residential land and the potential to restart the lending business. Almost all the land is single-family residential and it's marked at about, according to my calculations, 40 to 45 cents on the dollar vs. peak prices. Some of it is less than that, some of it is more than that. They just sold a piece of property in Hollywood, Calif., to Kilroy Realty for basically the peak market price. iStar actually had it on its books for that price and it was the piece of land I was most worried about. This is because it was sold for $15 million in 2003 and then $66 million in 2006. iStar had it on its books for $64.5 million, and they just sold it for $65 million. Those are the numbers. The market is marking down a well-marked book."

With the Oct. 15 closing on a new $1.82 billion credit facility, iStar secured a lower cost of capital and a more forgiving debt-maturity schedule. Next year, $1 billion of debt falls due, then essentially nothing until 2017. Moody's bestowed its approval on the autumn financing by raising its iStar debt rating to B2 from B3. On the third-quarter call, Sugarman said that some additional reduction in corporate leverage—now running at the top of the company's expressed 2.0:1 to 2.5:1 preferred range—"is probably prudent."

Incidentally, in fairness to Sugarman, the stockholders themselves voted to bestow the $23.4 million of multiyear stock awards that formed the principal source of his $25.9 million jackpot in 2011. But in fairness to us, his sympathetic analysts, there's nothing to do but guess about the reason, or reasons, behind

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his sale of 188,175 shares of iStar at the end of November. We are going to guess that the use of proceeds was to fund his professional soccer team, the Philadelphia Union, which, at 10-18-6, failed to make the Major League Soccer playoffs this year. Even contending teams cost money. Sometimes non-contending teams cost more.

"One of the interesting things about iStar is how hard it is to get information from the company," Peligal winds up. "Maybe there's a reason. Maybe silence better serves the interest of a buyer of discounted shares (its own) or the developer of discounted land. Banks typically sell their foreclosed land. Not iStar, which has to spend money to develop its land. If that's the strategy, you wouldn't want your IR team putting out press releases telling the world how valuable the portfolio will be in 2015. Could this land be worth 50% more than where it's listed on the books now? It's possible. Could it be worth 100% more? Also possible. If you think about the numbers, there's potentially $5 a share to $10 a share of upside for the land portfolio, and probably only a few bucks of downside."

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