GRANT'S

INTEREST RATE OBSERVER®

Vol. 33, No. 02c | Two Wall Street, New York, New York 10005 • www.grantspub.com | JANUARY 23, 2015

Forest City's good news

"So, for us," Bob O'Brien, chief financial officer of Forest City Enterprises (FCE/A on Bloomberg), told colleague David Peligal last summer, "it's really a question of when we do that, as opposed to *if* we do that" (*Grant's*, July 11). "That" arrived on Jan. 13, with news that Forest City, long a "C" corporation, has opted to become a real estate investment trust. The shares popped by 11.3% to reach $24.67 each. What might an investor do now is the question before the house.

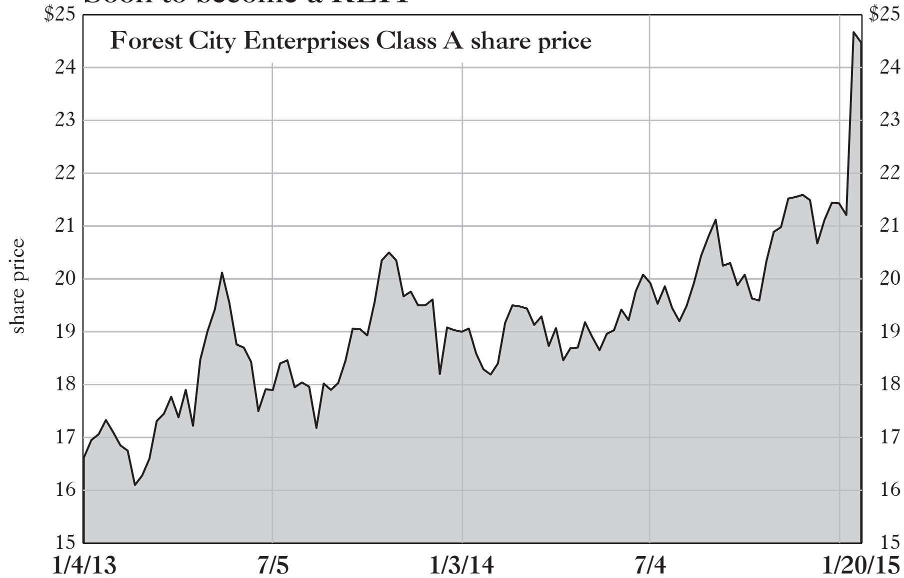
"Nothing, perhaps," is the judgment here. It's a decidedly bottom-up call, as this publication is on record as recently as two weeks ago decrying the mass, interest-rate-induced levitation of the property REITs. Forest City, we continue to think, is a special, underachieving, value-laden case. Its net operating margins are subpar, its property portfolio is eclectic (homogeneity is the preferred flavor on Wall Street) and its balance sheet is leveraged.

"The Jan. 13 announcement was encouraging for many different reasons," Peligal points out. "For one thing, management promised to unveil a strategic plan—the company can use one—and retained some bulge-bracket banks to advise on financial matters. More significant were quoted comments by CFO O'Brien. '[W]e anticipate,' said he, 'executing a number of non-core asset dispositions in 2015 that are expected to generate total net proceeds significantly in excess of our historical averages, which will be used to further deleverage our balance sheet. In addition, we are closely examining, and expect to change, our organizational structure to better align with our strategies and improve operating margins.'

"Most heartening is this last item," Peligal goes on. "Founded in 1920 by the Ratner, Miller, and Shafran families, Forest City has never been known to run the tightest ship. As a for instance, one could mention the unnecessary duplication of IT expense across different parts of the company. The result being that the company's net operating income margins are lower than those of its peers. Take the apartment segment, for example, which runs around a 52% NOI margin. According to Green Street Advisors, the average operating margin for apartment REITs is 62.9%. Now some of this margin discrepancy is justified because Forest City is involved in subsidized senior housing. But when you look at Forest City's diversified portfolio, whether it's apartments, office or retail, the operating margin tends to begin with a 'five' as opposed to the 'six' more commonly seen in the REIT world. Then, too, remarks a Forest City investor we know: 'It's probably no surprise that there are duplicative, mid-level personnel whose last names end with the words Ratner and Miller.'

"As the company starts aggressively to cut expenses," Peligal winds up, "those savings will flow to the bottom line. If investors see that the company is legitimately making progress—selling non-core assets, cutting general and administrative expenses, etc.—

Soon to become a REIT



source: The Bloomberg

the reasons for what is still a 14% discount of the Forest City share price to the estimated net asset value of the business will become harder to justify. Yes, Forest City shares might always trade at some discount to NAV, simply because the dual-class ownership structure is expected to remain after REIT conversion. But when one considers that as of Forest City's most recent quarter, big city or 'core' markets contributed 86% of net operating income, and the fundamentals of those assets in these thriving markets continue to look strong. Why shouldn't the valuation discount close, given that some of these larger multibillion dollar market cap REITs are trading at premiums to NAV?"

Thus, we judge, for the FCE/A holder, no action would seem the best action.

•