

# GRANTS'S

INTEREST RATE OBSERVER®

Vol. 27, No. 23b

Two Wall Street, New York, New York 10005 • www.grantspub.com

NOVEMBER 27, 2009

## Cheap as dirt

“We certainly, at a gut level, feel like this is the best opportunity we are ever going to see. That doesn’t mean it is easy, because to buy at the right price is never easy, even at these times of distress.” The speaker is Marvin Shapiro, principal of Avanti Investment Advisors, and the subject is land—the kind without gold deposits.

“Distress” seems just the right word for the dirt beneath America’s sagging stock of residential real estate. “Opportunity” seems a less apposite choice. Tuesday’s *Wall Street Journal* reports that 10.7 million households, almost one in four, owed more on their houses and on the land underneath them than that real estate was worth at the end of the third quarter. The numbers are more likely to elicit an involuntary shudder than a pen poised over an open checkbook. Nevertheless, a bullish overview of the American land market—residential, commercial and industrial, from California’s Tejon Ranch to Florida’s St. Joe Co. to points in between—is now under way.

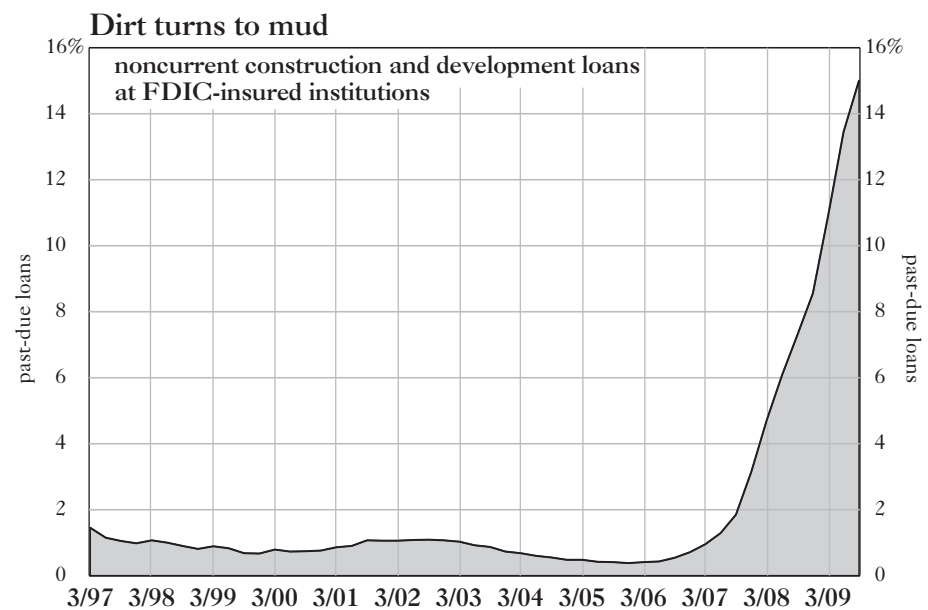
“There’s always been a fundamental capital inefficiency to it,” says Shapiro, a lender at the old Chemical Bank before joining Avanti 19 years ago. “There is always a shortage of money, particularly when you are looking at land that isn’t going to be absorbed soon—that is, past the current development window.” Anybody for a long-term commitment to an illiquid, negative-carry asset that may or may not be ready to climb out of its post-bubble crater? The shortage of takers is understandable. “Not many people want to sit for an unknown period of

time with the ultimate raw material—which is land—and that’s what we’ve made a business out of. . . .”

Since 1992, seven Avanti-managed partnerships have generated a realized average annual net return of 10.3%, the firm relates (once still-active partnerships are completed, it projects an ultimate return of 12.7%). What you need to succeed is “patient capital” and “an aversion to debt,” says Shapiro. Growth, too, “because without growth, land won’t get absorbed and built on. You need to be in good locations. And probably more than anything, it requires buying at the right price.”

To determine the right price for a tract of residential land, all you have

to do is figure out what houses will be selling for in a decade or two. “Historically,” Shapiro goes on, “it used to be easy to know what the price [would] be because you used last year’s price and added some modest inflation. That equation ended in 2001—2001 was the last year that housing prices and household income maintained a reasonable relationship, and since then they have really diverged. And that was the time we saw prices going up two or three times the rate that household income was increasing. That was another signal it was time to sell. The question is: What is today’s price, and what should we be underwriting today? Our view is that you go back to that 2001 number, and assuming that was a rational



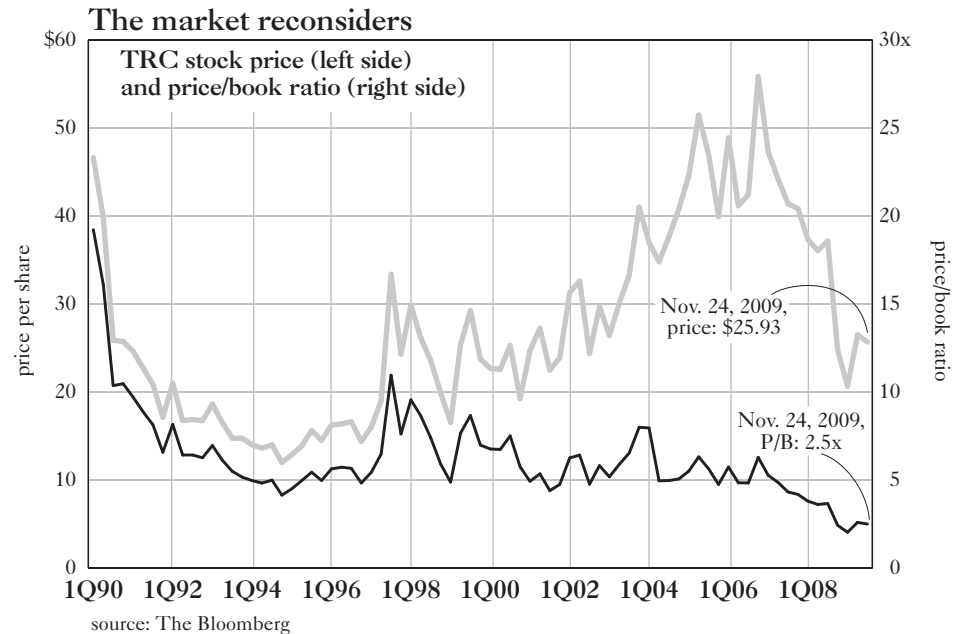
source: Federal Deposit Insurance Corp.

number, we take that number and we say, 'Inflate that by the rate at which income has grown since then, and that will give you today's rational housing price.' Now, in most locations we are in—Florida, California, Arizona, Nevada, Atlanta and a couple of others—I think housing prices have gone below the rational levels. I think underwriting today's housing prices at those locations is too conservative." As for national averages, Avanti projects that it will be 10 years before house prices return to the bubbly peaks.

Charles Schwartz, a co-founder of Avanti, has been watching the cycles turn for over 40 years. What's different about this bear market, he says, is that it isn't regional and it isn't national. "It's global. In all the downturns I've been in—and there have been some very severe ones—capital came in from other geographic areas to take advantage of the spoils. At this point [in this cycle], there is no capital. There's just a trickle of foreign capital, private capital and a trickle of local capital. . . . [T]his one has the least amount of capital."

There is, on the other hand, land to buy. Banks—yesteryear's too-eager lenders—have all too much of it. When you listen to Schwartz saying that out of 2,500 opportunities, the Avanti partnerships may wind up buying just 10 deals, you wonder what the trouble is. Then you consider how few are the stricken, land-heavy community banks that can afford to absorb the losses that sales at market-clearing, knockdown prices would necessarily entail. On Tuesday, the Federal Deposit Insurance Corp. disclosed that of \$492.2 billion of construction and development loans on the balance sheets of FDIC-insured institutions, \$74 billion, or 15%, were noncurrent, i.e., 90 days or more past due or not accruing income. Dud loans rose by \$3 billion in the quarter, which is, however, a slowing in the rate of decay.

You may or may not deploy the kind of institutional money that Avanti invests. If not—and if developable dirt holds an attraction for you at this macroeconomic juncture—there are opportunities in the public market. We are thinking mainly of Tejon Ranch (TRC on the Big Board), owner of the largest private land mass left in California, 270,000 acres situated 60 miles north of Los Angeles and 30 miles



south of Bakersfield, and bounded to the west by Interstate 5. Tejon raises wine grapes, almonds, pistachios, wheat, alfalfa and vegetables. Also, crude oil, resort properties, microwave repeater towers (among other industrial edifices) and residential real estate. As might be imagined, the company also raises lawsuits. Despite a May 2008 conservation agreement that management entered into with five big environmental groups, another collection of environmentally minded plaintiffs filed a pair of suits this month to stop the long-planned development of Tejon Mountain Village, a projected 26,417-acre community in the Tehachapi Mountains. Suffice it to say that California environmental politics are not one of the bullish features of the Tejon story.

Though Tejon produces no gold, the company has a personality that calls to mind the mute and sterile monetary asset. Specifically, its shares pay no dividends, and its management holds no conference calls. EVA Dimensions, the only sell-side firm that admits to following Tejon, rates the stock "hold."

We ourselves are more constructive: "Bullish for the long run, though no promises for the short run," is our call. Tejon was featured in these pages on Oct. 8, 1999, when we reckoned net asset value to be \$1.39 billion—\$1.35 billion for the land and \$38 million for other corporate assets. Against this NAV, Tejon was quoted at an enterprise

value (i.e., stock market capitalization plus debt minus cash and equivalents) of \$400 million. So the company was for sale at 28.8% of NAV. By November 2007—a point near the top if not the pinnacle itself—enterprise value was quoted at \$859 million. Today, it's back to \$447 million, "just 12% higher than a decade ago," Gertner observes, "despite steady developmental progress, including the approval and start of Tejon Industrial Complex East and some critical zoning and development approvals, including that of Tejon Mountain Village last month by Kern County."

Our best guess of 2009 net asset value is \$2.18 billion—\$2.02 billion for the land and \$163.4 million for other net assets on the balance sheet. Current enterprise value foots to \$447 million, or 20.5% of NAV. In November 2007, before the world stopped to reconsider so many things, Tejon changed hands at about 47% of NAV. Slipping into Avanti's shoes, we would want to know when the land will be absorbed into development. Within 10 to 15 years? Yes, speculates Allen Lyda, Tejon's chief financial officer, in conversation with Gertner. "Right now," he says, "more than the lawsuit or anything else, it is the economy. That to us right now is the biggest hurdle."

The management view is that geography will ultimately play into the stockholders' hands. "From a historical perspective, Los Angeles has been underbuilt," Lyda tells Gertner, "and if you believe population growth

trends over the next 10 years, that will continue. Over the last decade, L.A. has been growing north into the Santa Clarita Valley, where Valencia and Newhall are located. The growth north started due to available land for development. L.A. has gone almost as far east as it can go, and southern growth is stopped by Camp Pendleton. . . . Growth to the west is stalled by a Ventura County law that requires a public vote for all new large developments. The growth north is now moving toward Tejon. The Santa Clarita Valley, a new employment area within the L.A. basin, is only 25 minutes from our proposed Centennial development.”

How cheap is cheap? Perhaps the closest public comp to Tejon is St. Joe (JOE on the Big Board), a real estate development business that

counts 41,000 acres of land entitled for residential development among its 580,000 acres in north Florida. So entitled, St. Joe may build 43,000 residential units and over 13 million square feet of commercial space (if and when the need arises, of course). On the rest, St. Joe grows trees and makes paper. “In 1997, the company began its transformation into a real estate operating entity,” Gertner relates. “A new airport—Panama City International—is under construction on St. Joe-donated land. Completion is set for next May. The pace of development on the St. Joe land puts that company years ahead of Tejon in realizable real estate value, though this maturity comes at a price. Dividing the value of the companies by their respective entitled lands is one way to look at the respective valuations. For

St. Joe, the ratio of enterprise value to entitled acres works out to \$57,700. For Tejon, which has not, in fact, achieved final entitlement on all of the 30,000 acres we are counting, the number works out to \$14,900.”

The last word goes to Avanti’s Shapiro: “If you paid the right price and the land doesn’t mature or absorb in the seven or eight years that you figured, and it takes 15 or 16 years instead, clearly your returns are going to get diluted. But no one is going to lose money if you paid the price in a reasonable location.” Or, as they say on Wall Street, good things happen to cheap stocks.



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