



STRICTLY PLATONIC

“In the region of the knowable the last thing to be seen, and that with considerable effort, is the idea of good.”

– Plato, *The Republic*

We admit, while poring over financial statements and meeting with management teams, our thoughts can sometimes wander. During a recent coffee-fueled, freshman-year flashback, Plato’s Republic sprang to mind. In it, the philosopher describes a group of lifelong prisoners chained inside a cave and facing a blank wall. Behind them, puppets representing real objects – cutouts of plants, animals, etc. – are passed in front of a fire and project shadows onto the wall. Having never truly seen

“Business operators don’t invest in assets hoping those assets might someday go up in value. They invest in assets because they produce value”

the objects represented by these shadows, the prisoners take the mere outlines to be real things. In the cave, the shadows are their reality and the prisoners praise as clever whoever best guesses the shadow that appears next.

We’re not certain – we’ve forgotten a lot between Philosophy 101 and Empirical Asset Pricing – but it seems obvious to us that Plato meant this allegory to describe the stock market. It’s a sad reality (in fact it’s the law!) that from the outside, no public equity investor can understand a company the way its CEO or CFO does. Instead, shackled to their Herman Millers, analysts see only second or third-hand representations of real businesses: the SEC filings, the sell-side rumblings, the latest book-

to-bills. And much like Plato’s prisoners, they place their wagers on these shadows.

In practice, the wise investor has no better information than does any other investor. They are all outsiders after all. His advantage instead resides in his perspective, a keener understanding of what he’s really betting on. And, although reductivists might disagree, the wise investor is not betting on the price of a stock. In fact, he’s not betting on anything; he’s buying a return on his capital. He also understands that stock price is merely the denominator in calculating that return. Meanwhile, the more important element in his calculation – the numerator – is manufactured out in the real world by actual employees, doing actual work, making actual things and generating what the investor really cares about: actual dollars.

It comes as no surprise to us that the wise investor’s perspective resembles that of flesh and blood operators of real businesses. Business operators don’t invest in assets hoping those assets might someday go up in value. They invest in assets because they produce value. And, oddly enough, business operators define a good investment just as any stock market investor would: according to its return. A good investment earns a return and obviously, the higher the return, the better the investment. Instead of stock price, though, the business operator’s denominator is invested capital. In turn, the higher (lower) a business’ return on capital, the better (worse) the business is.

Things would be awfully simple if companies traded at parity with the value of their invested capital. But of course, companies with historically high returns on capital generally trade at a premium, while companies with historically low returns on capital tend to trade at a discount. As a result, investors' returns can differ from the returns of the underlying businesses they own. They give up returns in good businesses by paying a premium and earn extra returns by buying inferior businesses at a discount. In short, an ostensibly efficient market has rendered good and bad companies equivalent.

Don't index your money quite yet, though. The truth is that even against the masses of hyper-informed, the wise investor's advantaged perspective remains... well ...advantaged. Yes, most high ROIC businesses command a premium and most low ROIC businesses trade at discounts. But deviations do occur. And, in practice, the wise investor is more likely to profit from them. This is because most market participants are merely going through the motions, running misspecified mental models. They end up chasing tangential indicators they know are somehow correlated with stock prices. EPS, adjusted EBITDA, FFO, backlog – these things are certainly related to a business' prospects, but lacking appropriate context can also be incomplete, backward-looking or bewilderingly short-sighted. The market's confounding position on real estate, for example, is right now showing us that whether a business is floundering or firing on all cylinders, some people simply can't imagine a scenario until it's directly upon them.

As we write this, legions of investors continue clipping 3% to 5% dividend yields in the REIT space. For perspective, most REITs are now trading at 20x – 25x next year's free cash flow, putting some of their payout ratios at 100% (or higher) – a tidbit that would give the wise investor pause. Many people are focused on another set of facts, however. Fueled by the Fed's near zero interest rate policy, "cap rates" on class-A multifamily properties in some cities

have fallen to the low 4s. Never mind that the cap rate is essentially a buyer's return on capital and, as we understand the world, low returns are bad for buyers; low cap rates imply higher prices and the market sees this as a bullish sign. Indeed, it's a sign on the surface corroborated by a few prominent mortgage-meltdown profiteers currently hailing the virtues of direct real estate investment. Layer on the cheap money REITs are scoring with every new debt or equity offering they bring to the table and you've got some acquisition-fueled growth as icing on the cake.

Here at Cooke & Bieler, we see these same shadows. But we also have a funny preoccupation with returns beyond next year and that makes us more than a little wary of the way most REIT management teams are financing their growth. More specifically, we think investors are ignoring serious asset-liability mismatches lurking on the average REIT's balance sheet. Rather than terming out their debt and locking in historically low rates, many REITs have instead gorged themselves on shorter, non-amortizing maturities to shave off a little near-term interest expense. In the process, they've knowingly exposed themselves to significant refinancing risk. In other words, these companies are taking on heaps of debt and buying new properties to fund their growth. However, when their non-amortizing loans roll over at potentially much higher rates in a few years, one of two things is likely to occur: these properties will go right back on the auction block or share counts will balloon. Either way, cash flows to shareholders decline.

“REIT investors are accepting 4% returns and deploying capital to economics that managements admit are unsustainable”

Why, then, do they keep financing acquisitions

so aggressively when interest rate risk is so asymmetric? We've heard more than one management team indicate that if they assumed a significantly higher rate environment over the next decade, they'd never do any deals. Reminiscent of deposed Citigroup CEO Chuck Prince's famous last words, as long as the music's playing, they've got to get up and dance. Forgive us for sitting this one out.

To be clear, we are not bearish on the fundamentals of real estate. We are saying that because REITs are expensive and because most of them have increasingly dangerous funding profiles, it is probable that any favorable fundamental performance in commercial real estate will not accrue to their shareholders. We'd also like to highlight that, while public REIT investors are accepting 4% returns and deploying capital to economics that managements admit are unsustainable, we think they're unwisely giving residential real estate the cold shoulder. No doubt this has as much to do with being burned by the fire as it does with understanding the shadows: many investors lost their shirts in the meltdown owning homebuilders and lenders they thought were cheap. As a result, their conclusion now seems to be that home building is a bad business, or worse, that they should wait until the shadows form a more propitious pattern.

Then again, since investors don't really understand what just happened, it's probably not surprising they are confused about what is happening now and what is likely to happen next. During the credit boom, many homebuilders profited not from "bricks and sticks" but from price appreciation in the land they owned. Similarly (and more expensively for taxpayers) lenders became dependent on home price appreciation for the repayment of their loans. The whole ecosystem was doing what good investors and business owners never do – betting on an asset to increase in price. And as is always the case in such an environment, the most indebted fared best. While the shadows may have shown stocks

with low price to books and record earnings, the reality was a lot of highly levered businesses with huge amounts of over-investment and the handmaiden of that over-investment: falling returns.

Today, the shadows show falling home prices, housing starts at levels not seen since the 1960s, and existing home sales depressed by tighter lending standards and high unemployment. But the reality is that some homebuilders actually understood that their business was to create value by building houses, not to make money by speculating on land. Those wise enough to enter the downturn with a lot of cash and very little land are now enjoying decreased competition, increasing returns and rising market share. Reported profits must follow if housing starts stage any meaningful recovery. And with the economy generating almost a million new households a year yet building fewer than 400,000 new houses, that seems a certainty.

In his allegory, Plato describes the fate of a prisoner who is released from the cave and grows accustomed to the outside world, only to be returned to the cave. The other prisoners disbelieve his fantastic tales, ridiculing his newfound perspective – an allusion to Plato's teacher, Socrates, being put to death. Lucky for us, hemlock is hard to come by these days.

The material presented above represents the portfolio manager's assessment of the market and should not be relied upon by the reader as investment advice.



COOKE & BIELER

1700 Market Street, Suite 3222

Philadelphia, PA 19103

Phone: (215) 567-1101

Fax: (215) 567-1681

Web: www.cooke-bieler.com