Bits and Pieces: Predictive Attributes for Outperformance

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This month we continue our series on Predictive Attributes by discussing companies that fall under the rubric of "Bits & Pieces." Bits & Pieces, which we actually research on a formal basis and for which we publish a monthly review, refers to the ownership by a publicly-traded company of stakes in other public companies or marketable securities. As the three examples below illustrate, it is occasionally possible to identify cases where, if one subtracts the market value of the investment stakes (even when they are publicly-traded and therefore readily verifiable), the market appears to attribute little or no value to the remaining operating businesses. Such circumstances are akin to acquiring the core business or assets of a company for free.

There are a number of reasons why a seemingly glaring violation of the so-called efficient markets hypothesis like this can exist, and it might seem perplexing when so many investors are energetically seeking some small advantage or relative discount. The primary reason can probably be laid at the door of the desire—or need—for definitive, short- or near-term performance results. It is not surprising that many Bits & Pieces companies (and all of the examples below) are also owner-operator businesses. In general, owner-operators share a proclivity to seek out and invest in undervalued, even troubled or distressed, assets. While they have a history of undertaking shareholder-friendly transactions such as spin-offs or asset sales to ultimately monetize the value of their assets, they often do so over an extended time horizon, since in practice asset development or business turnarounds take some period of years, not quarters. In a sense, those investors who avoid Bits & Pieces companies are correct in their assessment that these parent companies, such as Leucadia National or Brookfield Asset Management, might not monetize or transact in their publicly traded subsidiaries—ergo, no specific valuation catalyst—for a very long time.

However, the practical effect of their correctly reasoned collective assessment is an absence of buying interest in those shares and the deep discounts that are observable in the examples below. This contributor to mis-valuation is little other than the operation of the equity yield curve, created by those who place a high premium on near-term returns, and which we always seek to make use of. There is, newly, an added element of discount creation here in the ETF Divide—Bits & Pieces companies, due to more limited liquidity and their multi-industry profiles, are far less likely to be included in the major exchange-traded funds, or ETFs, that attract most new investment dollars nowadays. Accordingly, Bits & Pieces are a structural segment of the stock market that often supplies more than its fair share of objectively undervalued securities.

Dundee Corporation ("Dundee")

Dundee is a Canadian holding company operating in real estate and natural resources. In February 2011, Dundee sold its controlling stake in DundeeWealth, a very sizable asset management business it had created, to the Bank of Nova Scotia ("Scotiabank", or "BNS") in exchange for common and preferred BNS shares. Dundee's nearly 18.5 million shares of BNS have a market value of about C$1 billion. In December 2012, Dundee announced plans to carve out a 50% stake in Dundee Realty; owner-operator Ned Goodman, who with his family controls over 86% of Dundee's voting power, apparently believes that the value of the realty business is not currently appreciated by investors. In fact, the market value of Dundee following the carve-out announcement is still below the market value of some of the stakes it owns in publicly-listed companies.

Company	Dundee ownership	Market Value 12/31/2012 (C$ in millions)
Bank of Nova Scotia	Approx. 18.6 M shares	1,077
Dundee REIT	6%	218
Dundee International REIT	21%	157
Dundee Precious Metals	23%	245
	Total	*$1,697*
Dundee Corp. (ticker: DC/A:CN, DDEJF)		**$1,562**

Source: Company reports, Bloomberg

The publicly-traded investments above represent only a small portion of the Dundee's value. In fact, these are only the largest of the company's publicly-traded investments—a cursory review of the company's filings reveals tens of stakes with market values of a few million dollars each. Consolidated assets include: Dundee Realty (though as noted above, 50% of this asset will soon be carved out. Dundee will retain a 20% position in the company); Dundee Energy Limited, Dundee Agricultural, and Dundee Capital Markets, to name just a few.

Brookfield Asset Management ("Brookfield")

Brookfield is a global asset manager with approximately $150 billion in assets under management, focusing on real estate, hydro power, timberlands, infrastructure, and private equity—largely, hard assets of large scale and with long-term inflation-beneficiary qualities. Brookfield holds significant stakes in several publicly-traded entities. The table below totals Brookfield's publicly-traded holdings, including some of their more notable ones, the combined market value of which totaled $17.4 billion at the end of 2012, compared to a market capitalization of $22.6 billion for the company overall. If one strips out the investments in General Growth Properties, Brookfield Office Properties, Brookfield Residential Properties, Rouse Properties, Howard Hughes Corp., and other publicly-held securities, the market prices the rest of the rest of the company, which is comprised of real assets, operating companies, and private equity investments, at only $5.1 billion. In February 2013, Brookfield announced plans to spin off Brookfield Property Partners ("BPY"), which will comprise the company's commercial property operations. If valued within the range of comparable companies–a 4% dividend yield, 20x funds from operations and 1x book value–a fair value estimate for BPY would be, at $25 per share, a $11.4 market value, which may be added to the $17+ billion of public securities already controlled by Brookfield. This recent example strikes us as a remarkable discount to intrinsic value based upon both NAV and future cash flow.

Company	Shares owned by Brookfield	Market Value 12/31/2012 ($M)
General Growth Properties	357,662,764	$7,100
Brookfield Office Properties	249,362,561	4,242
Brookfield Renewable Energy	68% ownership	2,261
Brookfield Residential Properties	73,555,457	1,320
Rouse Properties	26,580,603	448
Howard Hughes Corp	2,424,618	177
Other publicly held securities	(41% to 52% ownership)	1,882
	Total	*$17,429*
Brookfield (ticker: BAM)		**$22,594**

Source: Company reports, Bloomberg

Icahn Enterprises LP ("Icahn Enterprises" or "IEP")

Icahn Enterprises is the investment holding company of famed investor Carl Icahn. Mr. Icahn has gradually concentrated his investments into IEP, in many cases transferring assets from his hedge fund into the holding company (effectively swapping assets for LP units in the holding company). Through public and private company investments, IEP owns stakes in businesses in the following industries: investment management, automotive, metals, real estate, home fashion, railcar, hotels and gaming, consumer staples, energy, and pharmaceuticals. The table below shows some of IEP's largest publicly-listed holdings; note that IEP unit holders gain exposure to additional public investments through IEP's stake in Mr. Icahn's hedge fund. When subtracting just these public holdings from IEP's market capitalization at year-end, the so-called IEP stub was trading at a negative value at the end of 2012. Shares in IEP have rallied nearly 64% since the beginning of this year, but even at its current market capitalization ($7.5 billion as of February 28, 2013) the combined market value of IEP's shares in the companies in the table below still approximates 63% of the market capitalization of IEP (this excludes IEP's substantial holdings in recent spin-off CVR Refining, which itself appears to be significantly undervalued).

Stated another way, at year-end a purchase of IEP shares allowed for ownership in all its publicly traded holdings while effectively offering ownership of the private businesses for a very low price. The private assets also contain enormous positive optionality. One of these, for instance, is the Fontainebleau, the unfinished, hotel/casino project in Las Vegas, which IEP purchased in 2010, during the depths of the financial crisis, for a mere $150 million. The project's developers had invested $2 billion in construction prior to IEP's involvement. Accordingly, IEP paid less than 10 cents on the dollar for assets with an original replacement cost equal to about one-quarter of IEP's current stock market capitalization.

Company	Shares owned by IEP		Market Value 12/31/2012 ($M)
CVR Energy*	71,198,718		$3,474
Federal Mogul	76,697,804		615
American Railcar Industries	11,871,268		377
Tropicana Entertainment	17,862,706		239
		Total	*$4,705*
Icahn Enterprises (ticker: IEP)			**$4,687**

*Note that this table reflects market prices as of December 31, 2012, and therefore predates the recent spin-off of CVR Refining, in which Mr. Icahn is also an investor.
Source: Company reports, Bloomberg

It is also noteworthy that the holdings listed in the table above are held on the balance sheet using the equity method of accounting, which approximates book value. Due to this accounting treatment, the book value of the public investment portfolio is significantly understated. The combined year-end market value of these four positions was $4.7 billion. On the Q3 2012 IEP balance sheet, these positions were held at a combined value of $4 billion—this represents a discount of $700 million, or nearly 15% to the market price.

Additionally, on February 11, 2013, Icahn Enterprises announced an increase in the annual distribution to LP units to $4, which may be received as additional LP units or cash. Using the closing price of $59.95 on the day prior to the announcement, this represents a 6.67% dividend yield–even at the higher IEP trading price in late February, the yield still exceeds 5%.

Broadly speaking, the predictive attributes that are embedded in many of our holdings are identifiable by investors willing to do the necessary research. However, they are not standard metrics that are readily available on any Bloomberg screen. They are based on publicly-available information, such as proxy statements and other SEC filings, evaluated in the context of an understanding of the company in question. What is striking about the companies described above (and other Bits and Pieces investment opportunities) is the discrepancy between the value of the publicly-traded holdings, as measured by their easily verifiable market value, and the market capitalization of the companies themselves. It is merely that an extended investment horizon may be required for the intrinsic value of these businesses to be reflected in their stock prices.

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