Dormant Assets: Predictive Attributes for Outperformance

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We have noted frequently over the past two years the many risks now facing investors, particularly to their expectations about how the future will unfold. Many influences that have provided support for growing corporate profits over the past several decades are unlikely to continue. These include: decreasing corporate tax rates since 1952, three decades of declining interest rates, and an even longer period of consistent growth in government spending above the rate of GDP growth. Aided by these factors, as well as the operating cost reductions implemented during the recent recession, many companies have achieved corporate profits and margins at or near their peak historical levels. Stock prices of many such companies have been buoyed not only by these results, but also, for those companies included in major indexes, by enormous flows of funds into indexed products such as exchange-traded funds (“ETFs”). We believe that these results are not sustainable—it is probable that many widely-held stocks may experience declines in profit growth in addition to profit margin contraction over the coming quarters. Despite these risks, there are significant and perhaps greater risks in avoiding equities as an asset class. Accordingly, we believe that careful consideration is needed in assessing companies for investment, in order to identify securities trading at discounts to their intrinsic value and that offer the potential for adequate long-term returns greater than those of the market.

In this vein, we continue our series on predictive attributes by highlighting companies with dormant assets. These refer to assets within a company that do not yet produce a level of profit appropriate to that asset or that have not yet been monetized, and the value of which, therefore, may not be recognized by most investors. In some cases, the value may be widely acknowledged, but may require too long an investment horizon to be of interest to most investors. Dormant assets can fall into many categories, including patents or intellectual property rights, undeveloped land assets, and vacant real estate assets. Below, we highlight some companies, which are held in several of our strategies, with dormant assets in the areas of spectrum capacity and land or real estate development.

Dish Network Corp. (“DISH”) is a prime example of a company with an attractive core business and valuation, yet substantial, unrecognized dormant assets. Through its subsidiary, Dish Network LLC, DISH provides satellite television services to over 14 million subscribers (as of September 30, 2012) and is overseen by its majority shareholder and Chairman Charles Ergen. DISH is currently traded at approximately 14x consensus estimated earnings for 2012, which may appear to be an appropriate multiple for a company with flattening revenue growth and increasing competition. However, this valuation fails to consider the substantial investments in the yet-to-be-utilized wireless spectrum licenses owned by DISH.

Demand for wireless data transmission has increased markedly over the past five years, with the introduction of advanced smart phones and tablet computers. However, there is a finite amount of electromagnetic spectrum (frequency bands at which data is transmitted) available, and even less spectrum that has been developed for commercial users. It is widely recognized that the current wireless infrastructure in the United States will be unable to accommodate continued growth in consumer demand. Charles Ergen recognized this trend and has been acquiring spectrum licenses at distressed prices dating back to 2008. The market value of these licenses, based on acquisition cost and similar transactions, exceeds $3 billion on an undeveloped basis. If one were to adjust the enterprise value of DISH for the value of its dormant spectrum capacity, DISH is would be valued at merely 4.5x its expected 2013 EBITDA of $3.2 to $3.3 billion. Furthermore, DISH has ample liquidity to continue

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development of its spectrum holdings, even taking into account its near-term debt maturities, having nearly $6.4 billion of cash, cash equivalents, and marketable securities.

The dormant spectrum licenses owned by DISH are acknowledged by industry analysts and investment professionals; however, most investors are not willing to wait for these assets to be monetized. Due to their short-term inclination, those investors with a longer outlook are able to purchase the "core" DISH business at a fair or perhaps favorable multiple, providing an ample margin of safety in the event that the spectrum is not efficiently developed. This is a prime example of one of our favorite investment scenarios whereby we are able to participate in a situation that has the potential to provide exceptional returns without paying for the optionality.

Icahn Enterprises, L.P. is an owner-operated holding company with a variety of operating businesses, including Carl Icahn's hedge fund. The company currently has an approximately $4 billion market capitalization and trades below stated book value. Moreover, the reported book value can hardly reflect the true liquidation value of the assets, considering, for instance, that Mr. Icahn purchased the Fontainebleau Resort in Las Vegas in 2009, during the depths of the credit crisis, for $156 million despite the fact that the building already had $2 billion sunk into construction. Even a modest monetization of this property has the potential to materially impact the net asset value of the company.

The Howard Hughes Corporation ("Howard Hughes") is a real estate development company that was created through the reorganization of General Growth Properties Inc. Unlike conventional real estate investment trusts, Howard Hughes (which is not a REIT) does not pay a dividend, as cash flows are reinvested in development projects. The company currently trades at a slight premium to its stated book value, although we believe that the actual liquidation value is considerably higher. Consider the South Street Seaport property in lower Manhattan, for which Howard Hughes possesses a long-term ground lease. This property has a gross leasable area of approximately 300,000 square feet and generated $5.65 million of net operating income in 2011. Howard Hughes is in the process of converting this space into a modern retail property as well as a waterfront apartment complex; despite these statistics the Seaport property is shown on the balance sheet at a value of only $5.9 million, the price that a good-sized apartment in that area might fetch.

As with many of our investments, the dormant assets embedded in these companies are not particularly difficult to identify. In fact, company managements highlight them regularly in financial reports and on conference calls. Unlike most short-term oriented investors, we are delighted to embrace such opportunities, since we believe that we will earn a satisfactory return – we are, simply, indifferent as to whether that satisfactory annualized return is realized over a period of years as opposed to a period of months. These are particularly compelling scenarios in which we believe that dormant real estate values effectively act as a value floor for shares, thus creating "free" exposure to companies' other assets.

Dormant assets are but one of several predictive attributes embedded in many of our holdings. We believe that thorough qualitative analyses, through which such attributes are identified, combined with rigorous quantitative research, allow one to identify and capitalize upon such investment opportunities. This affords the opportunity to invest with a substantial margin of safety and allow our holdings, many of which are owner-operated (another predictive attribute), to compound value over time.

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