# Outrunning the Storm?

Given its ongoing relationship with Sears Holdings, it's not surprising that many investors run the other way from Seritage Growth Properties. Hotchkis & Wiley's Judd Peters explains why that might prove to be short-sighted.

The black hole that is Sears Holdings has pulled many related parties into its deathly gravitational pull, including employees, suppliers and a fair number of value investors who have bet on its recovery. So it's not surprising that the bears are roaring about Seritage Growth Properties, the real estate investment trust spun off by Sears in mid-2015. The company owns some 250 retail properties and 60% of its square footage is rented to Sears, which might reasonably be considered an ominous sign. Today, one-third of Seritage's outstanding shares are sold short.

Hotchkis & Wiley portfolio manager Judd Peters argues that the shorts have it wrong. The speed of Sears' demise may prove inconvenient, he says, but Seritage is more than capable of outrunning the storm and will ultimately be much stronger – and more valuable – for it.

While Sears rents 60% of the space, it only accounts for 47% of Seritage's current rental income because it pays belowmarket rents of \$4-5 per square foot. Around 20% of the square footage has been redeveloped and rents out at \$13-19 per square foot, to a diversified mix of tenants such as Nordstrom Rack, DSW Designer Shoe Warehouse, 24 Hour Fitness and Cinemark Theaters. The remaining 20% is vacant and at various stages of repurposing. Including plans for even more ambitious mixed-use projects, Peters expects rents across the portfolio, after full redevelopment, to average \$23-24 per square foot.

In addition to seeing the closure of Sears stores as a long-run positive for Seritage, his argument rests on beliefs that the vast majority of its properties are well-located and upgradeable, and that the company has the wherewithal to ride out any bumps in the process. It needs capital for redevelopment, but in many cases is forming joint ventures in which it provides the property while partners put up the invest-

ment capital. Should Sears-store closures occur faster than expected, he says Seritage has sufficient third-party rental income and sources of cash – from the sale of unneeded land or reducing its dividend – to avoid having to raise dilutive equity.

## INVESTMENT SNAPSHOT

## **Seritage Growth Properties**

(NYSE: SRG)

**Business**: Independent REIT set up in 2015 to own, manage and eventually redevelop some 250 Sears-related retail properties.

## Share Information (@6/29/18):

| Price          | 42.43          |
|----------------|----------------|
| 52-Week Range  | 34.07 - 50.00  |
| Dividend Yield | 2.8%           |
| Market Cap     | \$2.37 billion |

Financials (TTM):

Revenue \$233.2 million
Operating Profit Margin (-5.5%)
Net Profit Margin (-31.6%)

## **Valuation Metrics**

(@6/29/18):

 SRG
 S&P 500

 P/E (TTM)
 n/a
 24.0

 Forward P/E (Est.)
 n/a
 17.2

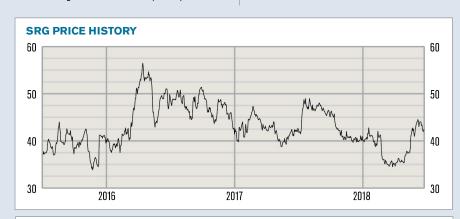
## **Largest Institutional Owners**

(@3/31/18):

| <u>Company</u>   | <u>% Owner</u> |
|------------------|----------------|
| EdgePoint Inv    | 13.7%          |
| Vanguard Group   | 10.8%          |
| Hotchkis & Wilev | 9.8%           |

Short Interest (as of 6/15/18):

Shares Short/Float 33.2%



## THE BOTTOM LINE

There may be bumps along the way, but as the company fully divorces itself from Sears Holdings, its property portfolio will become vastly more profitable and diversified, says Judd Peters. As a result, he believes within five years that the shares can reach \$100.

Sources: Company reports, other publicly available information

If he's right, what's the upside for Seritage shares, now trading at \$42.40? Going property by property through the portfolio, he estimates that within five years, fully weaned of Sears, the company can earn \$800-900 million in net operating income, up from \$150 million today. On his

roughly \$5.7 billion adjusted estimate of enterprise value – \$3.7 billion in current EV, plus roughly \$3 billion in net present value of required redevelopment capital, minus \$1 billion in excess land value – that normalized NOI results in a roughly 15% cap rate on the shares. If they traded

at a conservative 8% cap rate, adjusting the share count to assume full dilution, he estimates intrinsic value at \$100 per share.

He's in good company in seeing unrecognized value: According to a March SEC filing, Warren Buffett owns two million Seritage shares for his own account.



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| Equity   | Income  |
|--|---|
| <ul> <li>Large Cap Diversified Value</li> <li>Large Cap Fundamental Value</li> <li>Mid-Cap Value</li> <li>Small Cap Value (<i>Limited</i>)</li> <li>Small Cap Diversified Value</li> <li>Global Value</li> <li>International</li> <li>Value Opportunities</li> </ul> | <ul><li>High Yield</li><li>Capital Income</li></ul> |

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As of 9/30/18, Seritage Growth Properties represents 4.8%, 4.7%, 2.7%, 1.7% and 0.4% of the Small Cap Value, Value Opportunities, Global Value, Capital Income and Small Cap Diversified Value Funds' net assets, respectively. Nordstrom Rack, DSW Designer Shoe Warehouse, 24 Hour Fitness and Cinemark Theaters were not held in the Hotchkis and Wiley portfolios. Fund holdings are subject to change and should not be considered a recommendation to buy or sell any security.

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