ValueInvestor INSIGHT

October 31, 2023

The Leading Authority on Value Investing

On the Field

Real estate is a diverse sector with a number of well-known and potentially scary pressure points. Which makes it a good time to ask investing experts in the field if they're seeing any pockets of opportunity amid the seeming turmoil.

INVESTOR INSIGHT

Third Avenue Management
(*l* to *r*) Ryan Dobratz, Quentin Velleley, Jason Wolf

Editor's Note: *While pandemic-related factors have thankfully receded from many equity investment cases, such is less the case in real estate, where big-picture issues like work from home and supply-chain restructuring are still prominently playing out. For insight into navigating the in-flux sector we turned to Third Avenue Management, an early pioneer in dedicated real estate investing with the launch of its global Third Avenue Real Estate Value Fund in 1998, which added an international strategy, the Third Avenue International Real Estate Value Fund, in 2020. We spoke recently – from our home over Zoom – with global portfolio managers Ryan Dobratz and Jason Wolf and with international PM Quentin Velleley.*

Start out by describing your field of play in real estate and what you think separates Third Avenue's approach to it?

Ryan Dobratz: The three basic areas we invest in are commercial, residential – through the value chain including timber, homebuilding and home-improvement retail – and real estate services and management. We as a firm have always taken a balance-sheet-first approach, both in terms of a focus on net asset value in valuation and in trying to ensure our companies are extremely well-financed to live through inevitable macroeconomic or cyclical weakness. We think that approach applies to all businesses but is certainly relevant when investing in real estate.

Highlighting further what we care about, the average net debt to assets for our global portfolio companies today is 16%, probably half of what you'd find in an index of publicly traded real estate stocks. We want close alignment with management – insider ownership across the portfolio is about 20%. We also want to pay discounted prices. The average discount to what we consider conservative estimates of net asset value for our companies today exceeds 30%. That number since we started tracking it in 2008 has averaged less than 10%.

Jason Wolf: The narrative around real estate today is as negative as we've seen it, due in large part to the increase in interest rates from what we considered abnormally low levels. But there are different dynamics in different subsectors of the industry. When a capital-markets dislocation like we've had resets valuations broadly, that can create specific opportunities in specific areas. That's exactly what we as active investors are trying to take advantage of.

Let's talk about some areas you're finding of particular opportunity, starting with international industrial real estate.

RD: Underlying the general theme is the ongoing penetration of e-commerce, the need to improve supply-chain resilience exposed by Covid, and the adaptation of manufacturing capacity – through near-shoring and re-shoring – to evolving geopolitical realities. That has driven a significant increase in many parts of the world in demand for modern manufacturing, distribution and warehousing facilities at a time when consumer spending remains strong and capital-markets dislocation has tempered speculative development. Current rental rates on industrial real estate in many markets are twice what they were pre-pandemic.

Quentin Velleley: In the international fund we have about 15% of the portfolio in developers and owners of industrial real estate exposed to near-shoring trends, mostly in Mexico, but to a lesser extent in Central and Eastern Europe.

Our largest holding is Mexico's Corporación Inmobiliaria Vesta [Mexico City: VESTA], which specializes in developing logistics warehouses and industrial parks across the country. Mexico is particularly well positioned to benefit from the trends Ryan mentioned due to its proximity to the United States, its positive trade relationship with the U.S. after the signing of the new North American trade agreement in 2020, and its widening advantage globally in labor costs. The cost of labor in Mexico is now roughly 25% of what it is in China.

That's driving significant demand both for existing and new industrial facilities. Vesta currently owns and manages 37 million square feet of gross leasable space and its development pipeline is now at just over 17 million square feet and focused in northern Mexico. Much of that demand is from international companies expanding in the country, but there are domestic growth drivers as well. Prominent among those is the continued expansion of Mexican e-commerce. Only 10-11% of retail sales happen online, relative to twice that or more in developed markets. In China that number is now around 40%.

Talk about corporate governance here.

QV: The current CEO is a member of the founding family, which still owns around 5% of the shares, but the shareholder base is well diversified and there's plenty of liquidity in the stock. Compensation plans are returns focused and aligned well with shareholder interests. After recently completing the IPO of an ADR in the U.S. that raised $445 million, they should have in place all the funding they'll need for the development pipeline over the next two to three years.

The company has an excellent record of compounding value. Net asset value including dividends has compounded at about 12% per year over the last five years. If we're right about the sustained acceleration of demand and the company executes as it should, we think NAV growth over the next three to five years could be in the mid-teens.

How do you assess the political risks of operating in Mexico?

QV: We have owned this for many years and the political risk over that period has actually been more from the U.S. during the Trump years. Given his anti-business rhetoric in the past, we were concerned when President López Obrador was elected in 2018, but so far outside of the energy sector he's proven to be quite pragmatic. We generally think there's too much at stake for the administration to do anything but support manufacturing growth in the country.

One thing that gives us comfort is the quality of the company's tenant base of blue-chip multinational firms and the fact that they typically pay rent in U.S. dollars. This isn't a political issue, but the strength of Vesta's balance sheet also reduces risk. Net debt to assets is currently only 14%. All in all, we consider this one of the lower-risk names in emerging markets real estate.

The company's shares have done quite well over the past year. How are you looking at upside from today's price of around 56 Mexican pesos?

QV: The stock at today's price trades at a 10% or so discount to our conservative estimate of net asset value and at an implied cap rate of nearly 8%, vs. 5% for U.S. industrial real estate investment trusts. That does not seem too demanding for a company that we believe can compound free cash flow and NAV over the next three to five years at around 15%. We think there's a good chance the shares rerate to trade more in line with U.S. peers, but even if they don't, if we're right about the NAV growth we should do quite well owning the shares.

You've also been finding what you consider attractive values in the residential real

INVESTMENT SNAPSHOT

Corporación Inmobiliaria Vesta
(Mexico City: VESTA)

Business: Develops, owns and manages more than 210 industrial buildings and distribution centers located in areas of Mexico expected to benefit from trade with the U.S.

Share Information
(@10/30/23, Exchange Rate: $1 = 18.06 pesos):

Price	**MXN 56.23**
52-Week Range	MXN 41.57 – MXN 65.21
Dividend Yield	2.8%
Market Cap	MXN 46.21 billion

Financials (TTM):

Revenue	MXN 205.9 million
Operating Profit Margin	79.7%
Net Profit Margin	136.7%

Valuation Metrics
(@10/30/23):

	VESTA	S&P 500
P/E (TTM)	8.9	18.9
Forward P/E (Est.)	18.4	18.5

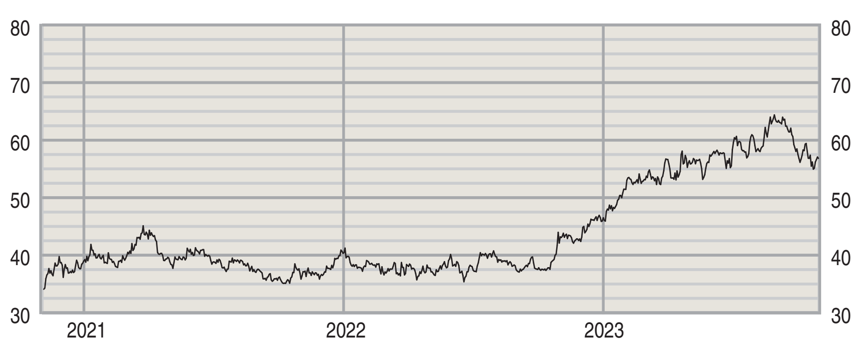
Largest Institutional Owners
(@6/30/23 or latest filing):

Company	% Owned
Afore Coppel SA	6.8%
BlackRock	6.1%
Capital Research & Mgmt	5.1%
Massachusetts Fin Serv	4.2%
SURA Inv Mgmt	4.1%

Short Interest (as of 10/15/23):

Shares Short/Float	n/a

VESTA PRICE HISTORY



THE BOTTOM LINE

The company has a strong record of compounding value and is well positioned to benefit from global supply-chain investments in Mexico, says Quentin Velleley. He believes the shares should re-rate, but absent that as a shareholder he still expects to at least match the estimated mid-teens annual percentage growth in the company's net asset value.

Sources: Company reports, other publicly available information

estate sector in the U.S. Describe the general opportunity there.

RD: The broader case reflects the chronic undersupply of new housing in the U.S. since the financial crisis turning what had been a housing glut into a material deficit of housing supply against normalized housing demand. That's happening at the same time the 35-49 age cohort – the prime homebuying demographic – is set to grow by some seven million people over the next ten years.

We see additional crosscurrents in the market. Remote working has become more entrenched, putting a premium on additional living space in the home. With the rise in interest rates, later-stage baby boomers and existing homeowners in general with inexpensive mortgages are slower to move, taking supply off the market. We're sitting in the U.S. with only 1.1 million existing homes for sale, vs. an average 2.5 million or so over the past 30 years.

To us the industry environment lines up particularly well for a large-scale homebuilder like Lennar [LEN.B]. Instead of suffering with the rise in mortgage rates, it's taken advantage of its scale to reduce average selling prices or offer other incentives on its new homes, which in a constrained-supply market has resulted in sharp increases in sales volumes this year. It's building out its single-family rental business, serving future homebuyers who have been priced out of the market by more-expensive mortgages. And it's doing all this more profitably than ever: gross margins at 24% and net margins at 17% are both up roughly 300 basis points from before the pandemic.

JW: We still don't think it's well appreciated how much the business quality of the biggest public homebuilders like Lennar and D.R. Horton [DHI], which we also own, have improved. In a business with economies of scale, the public builders have significantly expanded their market share. Coming out of the 2008/2009 financial crisis they held just under 25% of the U.S. new-home market, a number that now approaches 50%. Lennar and D.R. Horton are the top two, with a fairly evenly split total of 25% of the market today.

The balance sheets of the companies in the industry are also dramatically improved. They have generally shifted to more land-light strategies, optioning rather than speculatively owning land to mitigate future impairment risk. That's taken capital intensity out of the business and also allowed a significant paydown in debt with the resulting higher cash flow. Lennar now has net cash and has started to repurchase shares aggressively, buying back 3-4% of its stock per year over the past few years.

One strategic initiative for Lennar we also think makes sense is its focus on even-flow production, planning to build about 70,000 homes per year to facilitate planning, lock up scarce labor, and smooth out somewhat the operating profit stream. We think all this argues for the stock earning a higher multiple from the market over time, closer to that of competitor NVR [NVR].

How are you looking at valuation from today's B-share price of around $96.30?

RD: We look at this on a sum-of-the-parts basis. For the core homebuilding business

INVESTMENT SNAPSHOT

Lennar
(NYSE: LEN.B)

Business: U.S. single-family homebuilder operating in 25 states, selling homes primarily under the Lennar brand name to first-time, move-up and active-adult homebuyers.

Share Information (@10/30/23):

Price	**96.32**
52-Week Range	62.91 – 121.08
Dividend Yield	1.4%
Market Cap	$29.44 billion

Financials (TTM):

Revenue	$33.44 billion
Operating Profit Margin	17.6%
Net Profit Margin	11.7%

Valuation Metrics
(@10/30/23):

	LEN.B	S&P 500
P/E (TTM)	7.7	18.9
Forward P/E (Est.)	7.3	18.5

Largest Institutional Owners
(@6/30/23 or latest filing):

Company	% Owned
Vanguard Group	10.5%
BlackRock	7.8%
Wellington Mgmt	4.8%
Capital Research & Mgmt	4.5%
Aristotle Capital	4.1%

Short Interest (as of 10/15/23):

Shares Short/Float	1.9%

LEN.B PRICE HISTORY

THE BOTTOM LINE

The company continues to improve its business quality and market position, says Ryan Dobratz, and should be a leading beneficiary of the positive long-term supply/demand dynamics he sees in place for the U.S. housing market. Valuing its core homebuilding and "other" businesses separately, he estimates the fair value of its shares to be around $145.

Sources: Company reports, other publicly available information we assume annual deliveries remain in line with recent levels and normalize gross margins at 21% and operating margins at 14% to arrive at what this business can earn on a steady-state basis. To that we apply what we believe is a reasonable 8x multiple of operating profit to estimate a value for it of $130 per share.

Lennar has also been successful in building out its separate Quarterra division, which includes a multi-family development business, the single-family rental business, a 40% stake in a coastal California development company called Five Point Holdings [FPH] and other property assets. Without any heroic assumptions we value these other assets at about $15 per share, bringing our total fair-value estimate to about $145.

We own the B shares because they trade at a discount to the A shares, despite having equal economics and super-majority voting rights. The discount is a historical artifact stemming from the fact that the B shares were mostly owned by the founding Miller family and didn't trade much. Over time the company has issued B shares related to acquisitions, increasing the float. We don't think there's any reason for them to still trade at a discount.

Just over two years ago [*VII*, July 30, 2021] you made the case for U.K.-based self-storage company Big Yellow [London: BYG], whose stock hasn't fared particularly well in the interim. Is your thesis for it still intact?

QV: The shares haven't been helped by a number of issues, including the war in Ukraine, British political upheaval, rising inflation and rising interest rates. But we still believe the thesis is intact and Big Yellow is one of our largest holdings.

The general thesis is that self-storage remains an immature asset class outside the U.S., with a long runway for growth as penetration levels increase. We're not assuming everything just replicates the historical experience in the U.S., but the value proposition exists outside the domestic U.S. market and the penetration gap is still very large. The U.S. has around 10 square feet of storage-space capacity per capita, versus closer to 2 square feet per capita in markets like the U.K., Australia and Canada.

Big Yellow is the market leader in the U.K., which we think positions it to disproportionately benefit as the underlying market continues to grow, occupancy rates increase, it rolls up less-efficient mom-and-pop operators, and as operating leverage and the adoption of new technologies like revenue management systems and keyless/touchless entry help expand margins. The stock today [at a recent £9.30] doesn't appear to reflect the potential growth in revenue and free cash flow we estimate over time. In fact, the implied cap rate on the shares of 7.3% makes it the cheapest option in our universe of international self-storage companies.

RD: While we're on the subject of self-storage, I'd also mention our holding in U-Haul [UHAL] in the U.S. While everyone thinks of this as a rental-truck business, the company has been building out its self-storage platform in earnest since 2010. The businesses together make a ton of strategic sense and the self-storage portfolio today is now the third largest in North America at almost 60 million square feet. It's been one of the largest acquirers of closed Kmart stores, repurposing them for storage with great parking access.

At U-Haul's current share price [of around $49.50], if you put a reasonable 6x EBITDA multiple on the core rental-truck business, you back into a storage portfolio valued at $100 per square foot, less than half of where storage REITs are valued. I mention it to highlight how opportunities come in many places at different times. Our interest in Big Yellow is informed by what we've seen in a U.S. market that is ahead of others when it comes to self-storage usage. But even in the U.S. there are opportunities that can still be overlooked and mispriced. VII

P/E Ratio: The price-to-earnings (P/E) ratio is the ratio for valuing a company that measures its current share price relative to its per-share earnings.

Dividend Yield: The dividend yield, expressed as a percentage, is a financial ratio (dividend/price) that shows how much a company pays out in dividends each year relative to its stock price.

EBITDA: EBITDA, or earnings before interest, taxes, depreciation, and amortization, is an alternate measure of profitability to net income.

Earnings growth is not a forecast of the Fund's future performance.

As of 9/30/2023 Corp. Inmobiliaria Vesta SAB de CV was a 5.8% position in the Third Avenue International Real Estate Value Fund.

As of 9/30/2023 Lennar B Shares was a 6.6% position in the Third Avenue Real Estate Value Fund.

As of 9/30/2023 D.R. Horton was a 5.8% position in the Third Avenue Real Estate Value Fund.

As of 9/30/2023 Big Yellow Group PLC was a 4.8% position in the Third Avenue International Real Estate Value Fund.

As of 9/30/2023 U-Haul Holding Co. was a 5.6% position in the Third Avenue Real Estate Value Fund.

Holdings are subject to change and are not a recommendation to buy or sell any security.

FUND RISKS: In addition to general market conditions, the value of the Fund will be affected by the strength of the real estate markets. Factors that could affect the value of the Fund's holdings include the following: overbuilding and increased competition, increases in property taxes and operating expenses, declines in the value of real estate, lack of availability of equity and debt financing to refinance maturing debt, vacancies due to economic conditions and tenant bankruptcies, losses due to costs resulting from environmental contamination and its related clean-up, changes in interest rates, changes in zoning laws, casualty or condemnation losses, variations in rental income, changes in neighborhood values, and functional obsolescence and appeal of properties to tenants. Additionally, for the International Real Estate Value Fund the Adviser's use of its ESG framework could cause it to perform differently compared to funds that do not have such a policy. The criteria related to this ESG framework may result in the Fund's forgoing opportunities to buy certain securities when it might otherwise be advantageous to do so, or selling securities for ESG reasons when it might be otherwise disadvantageous for it to do so. For a full disclosure of principal investment risks, please refer to the Fund's Prospectus.

Past performance does not guarantee future results.

Please see Top Ten Holdings here for the Third Avenue Real Estate Value Fund.

Please see Top Ten Holdings here for the Third Avenue International Real Estate Value Fund.

The fund's investment objectives, risks, charges, and expenses must be considered carefully before investing. The prospectus contains this and other important information about the investment company, and it may be obtained by calling 800-443-1021 or visiting www.thirdave.com. Read it carefully before investing.

Distributor of Third Avenue Funds: Foreside Fund Services, LLC.