News: National

May 27, 2015

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Q&A: California's Dire Need for Water, Playing into Burl East's CRE Investment Strategy

CEO of American Assets Capital Advisers Focuses on Sectors Where Tenants are Denied Choice

Earlier this month, California regulators approved unprecedented water cutbacks for the state's residents and imposed water restrictions on farmland as it tries to deal with the state's worst drought in more than a century.

San Diego-based Burl East, CEO of American Assets Capital Advisers (AACA), is directly impacted by the drought and the cutbacks as a resident, business owner and as a major investor in one of the state's largest landowners (Cadiz Inc.)

East has been involved in real estate for more than 30 years. He also currently serves on Leadership Council at USC's Lusk Center for Real Estate and is on the board of directors of Excel Trust Inc., a NYSE listed equity REIT.

Over the course of his career, East has raised $15 billion in capital from investors globally in 142 large-scale real estate transactions including 26 initial public offerings, 40 follow-on offerings, 19 private equity transactions as well as numerous converts, preferred stocks, bond offerings, tenders, mergers, strategic advisory assignments and mezzanine debt placements.

His firm currently serves as subadvisor to the Altegris/AACA Real Estate Long Short Fund (RAAAX), which has about $110 million in assets under management.

As CEO of American Assets Capital Advisers, East has been managing the current fund since its inception as a hedge fund in 2011 through its conversion to a mutual fund in early January 2014, to the present. The fund's specific investment approach focuses on owning companies in real estate sectors where the tenant is denied choice, which could entail few sector participants; high barriers to entry for new owners/developers; high barriers to exit for tenants; or high secular demand.

This unusual investment approach is evident in his choice of investments. Among the top five holdings of RAAAX as of Dec. 31, 2014, include data centers, water and cell towers: QTS Realty Trust Inc., representing 6.64% of the fund's holdings; Cadiz, 6.37%; and CyrusOne Inc., 6.11%.

CoStar News caught up with East to discuss his investment principles in real estate and real estate-related companies, including finding potential solutions to combat the now four-year drought in California.

Q: From a real estate fundamentals perspective, where do you see the market currently and how does it drive your investment strategy in the short- and mid-term?

East: In general, we are bullish on commercial real estate and real estate securities. With certain exceptions, real estate had been under-supplied since about 2009 and we're seeing this general state of affairs continue today. Demand resulting from the general uptick in the economy, albeit slow, is meeting limited supply.

In addition, the structural underpinnings of the industry have changed. Typically in a normal recovery, the full weight of the supply chain in real estate would be working hard toward over-building by now, five years into a recovery. However, this is not happening during this cycle. The legislative and regulatory changes resulting from the great recession have reduced lending capacity and appetite, and generally reduced the pace at which development has rebounded. In our opinion, this will lengthen the real estate recovery.

Q: As sub-adviser of the Altegris/AACA Real Estate Long Short Fund, what are your goals and strategies? Its holdings are not the typical REITs you might find in a REIT mutual fund.

East: Our goal is to manage the portfolio in a way that creates the optimum blend of risk and return for our investors. We define our universe as real estate securities, which includes REITs in addition to C corporations, like Hilton or Vail. At a very basic level, we have a larger sandbox than some of our peers, who limit themselves only to REITs.

More importantly, we believe our investment-underwriting process is different in a very decided fashion. Some managers start with the components of the index and make adjustments from that starting point, without being meaningfully off-index. For instance, if industrial REITs are 10% of their index, they start with that anchor. Perhaps they are more bullish or less on industrial and may add or subtract from that. Then, once they allocate to the sector, they may buy either: A) the cheapest stocks in the sector, or B) the best stocks in the sector.

This process is repeated across the sector components of the index. So, potentially what you get across the more than 75 sponsors in the area, are returns that very closely mimic the index.

Our process is to overweight sectors and companies in which the basic structure of the industry sub-group creates a natural advantage in favor of the landlord over an extended time period.

Specifically, we look for sectors that are characterized as having either a monopoly, duopoly or oligopoly; with very high barriers to entry; tenant barriers to exit; and secular demand drivers. Together, these characteristics create a structural landlord advantage that is generally self-perpetuating and non-cyclical in nature.

For instance, American Tower, SBAC and Crown Castle formed a limited oligopoly, with barriers to entry, which are overwhelmingly high. It would be very difficult to replicate their networks of cell towers. Meanwhile, the tenant, AT&T, simply can't leave. If they did, their costumers' phones wouldn't work. Lastly, mobile demand is growing in a secular fashion. So, for us, this makes much more sense as an investment strategy than allocating to industrial simply because it's part of the index.

The driver of our historical success is that we start and end our day searching for a frustrated tenant, rather than endlessly discussing relative value for stocks that are in a cyclical, highly generic business like industrial. We have no industrial exposure, as we do not consider it a valuable business.

Q: One of the holdings you like is Cadiz Inc. that owns over 70 square miles of property with significant water resources. Briefly describe how Cadiz's land holdings and water recovery project played into your investment decision.

East: Cadiz is effectively a monopoly, owning an aquifer about 400 feet under the Mojave Desert, which contains about as much water as Lake Mead, the largest reservoir in the U.S. Water is in perpetual under-supply in California.

In short strokes, most of the water California uses is in the north, and most of the population is in the south, which has little native water supply.

The drought has captured the attention of the national media and has certainly exacerbated the supply problem, yet the lack of water is not solely a function of this drought. In the last three decades, California's population has doubled. Effectively, 30 million people have been relying on infrastructure built in the 1960s for 15 million people.

Net-net, Southern California finds itself short of water. Many long-term solutions are needed, and we believe Cadiz is one of them.

The company has been working on the groundwater management and mitigation program for about five years, and they now have government approval to sell 50,000 acre feet per year, the amount of wate that is annually replenished, to a group of public water districts under 50-year contracts. This should provide water for roughly 100,000 people, partially alleviating some of Southern California's problem.

Q: There has been some discussion lately that Cadiz's main water project faces some serious regulatory and budgetary concerns. Real estate investing always involves some risk, adding those natural resource recovery concerns adds even more challenges in making such investments. How do you balance the rewards vs. the risks of such investments?

East: For starters we believe those that maintain this point of view are incorrect. The project was approved by both the Santa Margarita Water District and San Bernardino County, two government agencies, after a full CEQA (California Environmental Quality Act) review. An environmental group filed six lawsuits against the two governmental agencies in Orange Country, and after two weeks of testimony an Orange County Judge dismissed all six suits. The environmental group is appealing.

Although there are no guarantees, we are confident the Appeals court will find with the Orange County Superior Court towards the end of this year, which we hope will clear the way to start construction on the project.

The present value of Phase 1 of the project (which is the sale of 50,000 acre feet/year of water under take or pay contracts) is about $650 million ($25/share) and the total enterprise value of the company (inclusive of debt) is $236 million (the stock was traded at $8.55 per share on May 27, 2015). So, the stock, in our opinion, is undervalued by a factor of more than 3x just on phase 1.

In addition to this, Cadiz has a plan to use the aquifer, which holds about 24 million acre feet for underground storage of water and water banking of 1 million acre feet of water. Water banking allows municipalities to store and trade water between one another and is a large and deep existing market. The value of phase two is about $1 billion to $1.5 billion or another $50/share.

We have spent many hours in permitting hearings and speaking to water experts, and strongly believe Cadiz's project is both environmentally beneficial as well as a valuable business.

Q: Give readers outside of California some perspective on the drought in California and the water cutbacks. And what impacts are they having on commercial real estate operations, and values from your perspective?

East: The California drought is one of the worst experienced in the history of this country. Now in its fourth year, it has cost the state's agricultural sector billions of dollars in losses, and affected the country's largest state population in prompting mandatory water-use cutbacks.

The average commercial real estate company likely believes it is already efficient with in-place energy and water conservation measures built-in to most modern buildings, so finding another 35% will not be easy. Industrial landlords that cater to the food or produce industry would be most at risk.

So far values have been steady among the public owners who tend to own coastal assets. However among assets in the central valley, there have been large job losses and credit deterioration, and this has to affect values.