Value Investor INSIGHT
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# Exclusive Property

*Unlike many businesses where you can more or less assume a return to normal as the pandemic crisis fades, real estate investors still have to ponder a number of ongoing questions. Baron Funds' David Kirshenbaum offers some guidance.*

While all industries have been turned upside down by the pandemic, the real estate business broadly defined has to be high on the list in terms of disruption. Some industry sectors like housing, data centers and cell towers have prospered, while others like office buildings, retail properties and lodging have been slammed. Complicating the situation for investors: Unlike most businesses where you can assume a return to "normal" when the crisis fully recedes, with real estate it's often harder to decipher what normal will look like. To what extent will office workers return to the office? What happens to business travel? Does the housing boom have legs?

If, as Warren Buffett counsels, "Uncertainty is the friend of the buyer of long-term values," then real estate would appear to be an interesting place to look for ideas. To inform that endeavor, we called on Baron Funds' David Kirshenbaum, an assistant portfolio manager on the real estate team that manages $1.7 billion in assets for the firm, mostly in the Baron Real Estate Fund. "There are a number of themes we find interesting and are investing behind today," he says.

One such theme includes what he considers pandemic recovery beneficiaries, businesses hit hard last year and where the market is slow to price in a rebound. An example is real estate investment trust Douglas Emmett [DEI], which owns and manages commercial-office and multi-family residential properties located primarily in west Los Angeles, the San Fernando Valley north of L.A., and Honolulu. What sets it apart, says Kirshenbaum, is the uniqueness of its asset portfolio, weighted toward properties that zoning restrictions would no longer allow to be built today, and that are in high-demand sections of L.A. like Santa Monica, Westwood and Century City where Emmett commands market shares on average of approximately 40%. "We think pound-for-pound this is the highest-quality portfolio of office and multi-family assets that exists in the public markets today," he says.

**INVESTMENT SNAPSHOT**

**Douglas Emmett**
(NYSE: DEI)

**Business:** Real estate investment trust that acquires, develops and manages higher-end office and multifamily properties located primarily in the Los Angeles area and Honolulu.

**Share Information** (@4/29/21):

| | |
|---|---|
| **Price** | **33.74** |
| 52-Week Range | 22.88 – 34.95 |
| Dividend Yield | 3.3% |
| Market Cap | $6.76 billion |

**Financials** (TTM):

| | |
|---|---|
| Revenue | $888.0 million |
| Operating Profit Margin | 17.8% |
| Net Profit Margin | 5.7% |

**Valuation Metrics**
(@4/29/21):

| | DEI | S&P 500 |
|---|---|---|
| P/E (TTM) | 117.4 | 42.7 |
| Forward P/E (Est.) | 63.3 | 23.6 |

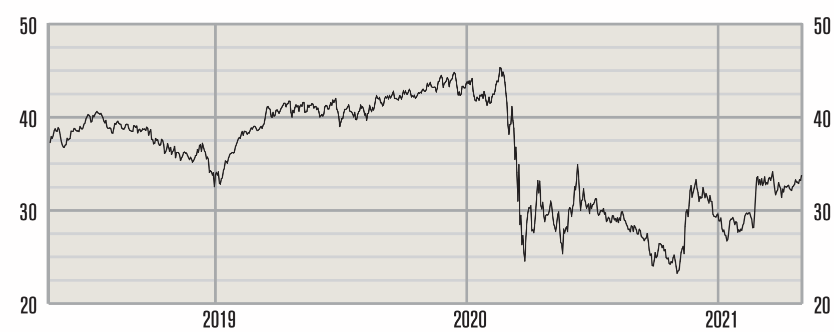
**Largest Institutional Owners**
(@12/31/20 or latest filing):

| Company | % Owned |
|---|---|
| Vanguard Group | 13.3% |
| BlackRock | 9.0% |
| Fidelity Mgmt & Research | 6.6% |
| Wellington Mgmt | 4.8% |
| State Street | 4.1% |

**Short Interest** (as of 4/15/21):

| | |
|---|---|
| Shares Short/Float | 4.7% |

**DEI PRICE HISTORY**




**THE BOTTOM LINE**
With "pound-for-pound the highest-quality portfolio of office and multi-family assets that exists in public markets today," David Kirshenbaum believes the company is uniquely positioned to rebound even in an altered post-pandemic real estate environment. As earnings return to previous levels, he sees at least 33% upside in its stock from today's level.

Sources: Company reports, other publicly available information

While there are legitimate question marks for many office landlords concerning tenant demand post-Covid, Kirshenbaum expects the long-term impact on Emmett to be minimal. Its tenant base relies on smaller, high-end professional-services firms that already don't rent a lot of space and whose principals live near their offices. Competitive supply in most of its sub-markets is constrained. The company also has a healthy pipeline of development and redevelopment projects that can make up for lingering pockets of weakness.

Emmett's shares trade today around $33.75, well off pre-pandemic prices in the mid-$40s. At the current price, the market is valuing the irreplaceable office portfolio at close to $500 per square foot, which is a steep discount to the over $1,000 per square foot prices at which similar properties have traded hands in recent years. Kirshenbaum sees no reason that the company's cash flow within the next two to three years can't at least return to prior levels, and argues that new projects and pricing power in key markets should drive cash flow higher. If cash flow just matches prior levels, he'd expect the share price to return to at least $45. On top of that is a 3.3% annual dividend. He also sees further potential upside from management using its rock-solid balance sheet for bargain-hunting if the real estate M&A market comes back to life.

Kirshenbaum also sees opportunity in housing-related names poised to incrementally benefit from industry tailwinds. One favorite is Installed Building Products [IBP], a leading installer of insulation and other products like rain gutters, shower doors and garage doors. All are what new-home builders might consider "nuisance" products, requiring somewhat specialized expertise and professional installation that is easy and efficient to outsource. Insulation is the biggest business, where IBP is a leader with about a 25% market share.

The company should benefit from multiple drivers of growth, says Kirshenbaum. From a cyclical perspective, the U.S. housing market remains underbuilt, with a recent Freddie Mac study suggesting there are at least four million fewer single-family homes in the U.S. than demand warrants. Housing affordability remains high, with interest rates still near historic lows and household savings significantly up after a year of pandemic. From a secular perspective, the flight to the suburbs led by millennials seeking more space and wanting to work more from home should continue. "We expect a more elongated and steady period of housing-start growth than we have seen for many years," he says.

IBP has company-specific virtues as well. It is a "structural market-share gainer," he says, driven by disciplined execution and by leveraging its scale. It has considerable growth potential in its non-insulation product lines: Only half of the firm's 190 branches offer a full slate of complementary-product installations, and those that do generate 4x the revenue per home as do the insulation-only branches. Management has also proven adept in growing through acquisition, which Kirshenbaum believes can reliably add at least 5% to annual sales growth per year.

All in, he thinks IBP can grow EBITDA by more than 20% annually for the next

## INVESTMENT SNAPSHOT

**Installed Building Products**
(NYSE: IBP)

**Business:** Installer of insulation and other building products, including garage doors, rain gutters and closet shelving; primarily serves U.S. new-home construction market.

**Share Information** (@4/29/21):

| | |
|---|---|
| **Price** | **136.01** |
| 52-Week Range | 44.41 – 136.39 |
| Dividend Yield | 0.9% |
| Market Cap | $3.92 billion |

**Financials** (TTM):

| | |
|---|---|
| Revenue | $1.65 billion |
| Operating Profit Margin | 10.0% |
| Net Profit Margin | 5.9% |

**Valuation Metrics**
(@4/29/21):

| | IBP | S&P 500 |
|---|---|---|
| P/E (TTM) | 40.5 | 42.7 |
| Forward P/E (Est.) | 24.1 | 23.6 |

**Largest Institutional Owners**
(@12/31/20 or latest filing):

| Company | % Owned |
|---|---|
| BlackRock | 11.6% |
| Vanguard Group | 7.9% |
| Baron Funds | 6.6% |
| Dimensional Fund Adv | 3.1% |
| Wellington Mgmt | 2.9% |

**Short Interest** (as of 4/15/21):

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| Shares Short/Float | 4.1% |

**IBP PRICE HISTORY**


**THE BOTTOM LINE**

Its advantaged competitive position and unique firm-specific growth drivers should allow the company to incrementally benefit from current positive cyclical and secular tailwinds in the U.S. housing market, says David Kirshenbaum. Assuming what he considers a reasonable 12x EV/EBITDA multiple on his 2023 estimates, its stock would trade at $200.

Sources: Company reports, other publicly available information several years, potential that he doesn't believe is reflected in today's $136 share price. If the company generates the $475 million in EBITDA he expects by 2023 and trades at what he'd consider a reasonable 12x EV/EBITDA multiple, the stock would trade at closer to $200. One sign of management's confidence in the company's prospects: They last quarter announced the company's first-ever dividend and committed to increasing its share-repurchase program. "That they're expanding capital return even as they plan to invest into rapid growth gives us a sense of how cash flow has inflected," Kirshenbaum says. "That demonstrates to us they're really excited about the next several years, not just the next several months." VII

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**Risks**: In addition to general market conditions, the value of the **Baron Real Estate Fund** will be affected by the strength of the real estate markets as well as by interest rate fluctuations, credit risk, environmental issues and economic conditions. The Fund invests in companies of all sizes, including small and medium sized companies whose securities may be thinly traded and more difficult to sell during market downturns.

Portfolio holdings as a percentage of Baron Real Estate Fund's net assets as of March 31, 2021 for securities mentioned are as follows:
**Douglas Emmett, Inc.** – 2.3%; **Installed Building Products, Inc.** – 1.2%.

Baron Real Estate Fund
Top 10 holdings as of March 31, 2021

| Holding | % Holding |
|---|---|
| Las Vegas Sands Corporation | 4.8 |
| GDS Holdings Limited | 4.2 |
| Wynn Resorts Ltd. | 3.9 |
| Penn National Gaming, Inc. | 3.4 |
| Zillow Group, Inc. | 3.2 |
| Red Rock Resorts, Inc. | 3.1 |
| American Tower Corp. | 2.9 |
| Boyd Gaming Corporation | 2.8 |
| Lowe's Companies, Inc. | 2.7 |
| Equinix, Inc. | 2.7 |
| Total | 33.7 |

**Portfolio holdings are subject to change. Current and future portfolio holdings are subject to risk.**