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Kennedy-Wilson: Reluctant Repurchasers No More?

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We discussed the investment rationale for Kennedy-Wilson (KW) in our past two quarterly letters. We believed that KW's asset value was meaningfully higher than its current share price but expressed frustration on the company's compensation program and its unwillingness to more aggressively repurchase shares. We had the privilege of meeting some of the senior team in Los Angeles earlier this year and the meeting confirmed our belief that:

- The private market value of KW's assets was far higher than current marks
- There is considerable upside to the company's pipeline project
- The Dublin real estate market is on fire
- KW's Vintage Housing program is one of the greatest projects/rackets few have ever heard of
- KW has a formidable fund-raising franchise
- Management was surprised/frustrated at the price of the stock…but still seemed to hold a "guns and butter" approach to capital allocation (we can pay dividends, recycle assets, repurchase shares, save the world – ok, one of those is a bit much)

Obviously, we were delighted with the first 5 but frustrated at the last. On March 20, 2018, KW announced a $250 million buyback program. While we would prefer an even larger buyback, the announcement was clearly a step in the right direction. On April 3, 2018, KW announced that it had already completed roughly 45 percent of the program and retired over 4 percent of outstanding shares in two weeks. We applaud the aggressiveness of the buyback program, as we are convinced they are retiring shares meaningfully below intrinsic value.

Clearly, real estate investors are concerned about higher rates, as the typical REIT now trades at ~15-20% (or greater) discount to their net asset value. While we are not fans of the REIT structure, this gap alone is still interesting, considering that a REIT allows an investor to own a portfolio of real estate assets with daily liquidity. Historically, this benefit has often resulted in small premiums for public REITs versus private market assets. But, KW is not a REIT and therefore can retain capital for growth or share repurchases. Despite this critical advantage, KW trades at a wider discount than office and multi-family REITS. Clearly, these discounts could widen if interest rates quickly move substantially higher. But, even in this inflationary scenario, KW has longer-tenure, fixed rate debt and an asset base with better pricing power than most. While the path may not be straightforward, we suspect investors will eventually view KW more favorably, especially as the Irish pipeline projects convert into net operating income. Substantial value can be created if this appreciation coincides with a substantially lower share count.

The preference for LUK and KW buybacks would seem to contrast the wisdom of the broader business press that has warned that buybacks are a sign of the market top. The preference would also contrast with the strong preference for dividends in a low interest world. There is empirical evidence that companies are generally poor in timing buybacks – purchasing when a stock is expensive, but thumb sucking when it is weak. Some of this is the result of an economic cycle as companies are generally flush with cash during periods of expansion (when multiples tend to be higher) and more pressed during recessionary periods (when multiples are lower). That said, part of the problem is simply that many companies likely spend little time making an estimate of intrinsic value and instead simply repurchase when they have cash and stop when they have less. Without some calculation of value, how can a team judge the relative return from repurchasing stock versus an acquisition? Clearly, a valuation estimate is not a precise figure but a general range and this needs to be compared/ contrasted versus the current share price. Considering broader index valuation levels, share buybacks in the aggregate may not earn fantastic returns, but this does not mean that all buybacks are ill advised. In fact, well timed buybacks can be among the most value accretive capital allocation decisions any management team can execute. LUK and KW appear inexpensive relative to any reasonable estimate of value and therefore are prime candidates for more aggressive buybacks.