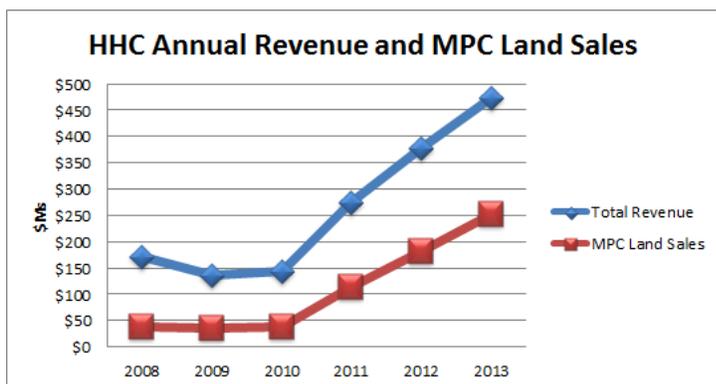


# Howard Hughes' Share Price Reflects Strong Summerlin Land Sales

Neutral

We are Neutral on The Howard Hughes Corporation (HHC). Howard Hughes has recovered from the bottoms of the 2008-09 financial crisis. Howard Hughes saw its revenues bottom out in 2009 at \$136.3M, which included \$34.6M in Master Planned Community land sales. Howard Hughes exceeded our 2013 revenue projections of \$460M in total revenue (Howard Hughes achieved \$475M) and \$230M in MPC sales (Howard Hughes achieved \$251M). If Howard Hughes can continue its recent run of impressive growth, it could potentially achieve or exceed its prerecession highs of \$548.7M in total revenues last achieved in 2006. At the same time, we were surprised that the performance of its operating assets was soft in 2013 as it previously served as Howard Hughes' stabilizing force while Howard Hughes' MPC land sale performance was soft from 2007 to 2010.



Source: Howard Hughes's [2010-13 Annual Reports](#)

Howard Hughes enjoyed continued strong performance in 2013. Howard Hughes's net reported loss narrowed by 42.5% year-over-year due to increased operating income, increased income from equity method affiliates and reduced losses from warrant liabilities and tax indemnity recoverable reductions. Other observations included the following:

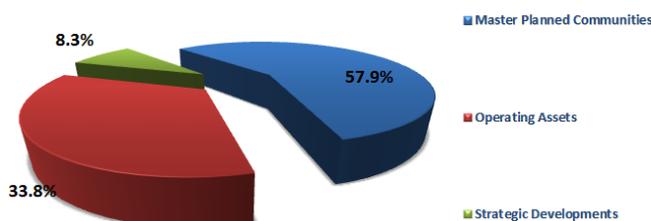
- Howard Hughes' warrant liability losses decreased by \$3M even though its share price increased by 64.5% in 2013. Its warrant liability loss would have been wider but there was a lower amount of warrants outstanding, which resulted from the warrant transactions by Brookfield, Fairholme and Blackstone in Q4 2012.
- Howard Hughes generated \$9.9M from its KR Holdings relating to activities involving

the ONE Ala Moana Tower Condominium Project

- Howard Hughes incurred a \$1.2M non-cash loss on the reduction of its tax indemnity receivables related to its Tax Matters (Spin-off) Agreement with GGP in 2013 (\$20.3M in 2012). GGP indemnified Howard Hughes against 93.75% of all losses, claims, damages, liabilities and reasonable expenses to which it is subjected, in each case solely to the extent directly attributable to certain taxes related to sales of certain assets in its MPC segment prior to March 31, 2010, in an amount up to \$303.8M, plus interest and penalties related to these amounts so long as GGP controls the action in the Tax Court related to the dispute with the IRS.

Howard Hughes saw strong year-over-year reported revenue growth in 2013. Howard Hughes' reported revenue growth was due to increased superpad site sales at Summerlin of \$70.7M resulting from significantly improved market conditions. This more than offset revenue headwinds from its operating asset segment due to Superstorm Sandy, tenant vacancies at its Riverwalk Marketplace mall and revenue declines from its other MPC properties (Columbia and The Woodlands).

### HHC Revenue % Division

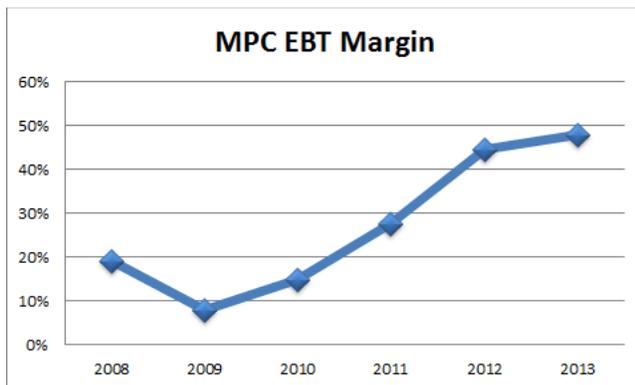


Source: [Howard Hughes Q4 2013 Earnings Report](#)

**Master Planned Communities:** Howard Hughes's MPC segment is Howard Hughes's largest segment in terms of revenues, profits & asset base and is the engine of Howard Hughes's performance.

- MPC segment revenue grew by \$67.7M (33%) year-over-year in 2013 and reached \$274.8M due to increased pad site sales at Summerlin of \$70.7M

- An \$18.6M in revenue declines from its Columbia and Bridgeland MPC properties partially offset its strong Summerlin superpad site sales growth.
- The Woodlands revenue declined 8.8% in 2013 as a 37% decline in the number of acres sold offset 44% increase in average price per acre. Average price per acre rose because of the competitive bid process begun in August 2012 and the scarcity of remaining available residential land in The Woodlands.
- Bridgeland's continued revenue decline was due to pending permits from the U.S. Army Corps of Engineers in order to develop more lots at the property.
- MPC revenue per acre sold decreased by 8.3% at Summerlin and increased by 11.9% at Bridgeland and 44% at The Woodlands
- Variances in price per acre are largely attributable to selling certain product types in different locations.



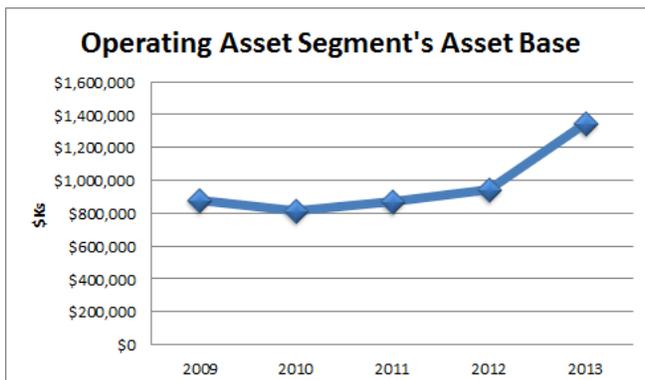
Source: Howard Hughes's [2010-13 Annual Reports](#)

**Operating Assets:** Howard Hughes's most stable segment is its Operating Assets Segment. This segment's adjusted operating income increased by 7% year-over-year due to solid growth from the Ward Centers and because insurance recoveries from Superstorm Sandy offset increased operating losses from the South Street Seaport.

- On a reported basis, this division saw its 2013 revenue decline by 2.7% versus 2012 levels.
- Minimum rents declined by 1.2% as lower minimum rents at the South Street Seaport (\$7.5M due to Superstorm Sandy) and Riverwalk Marketplace (\$3.3M due to vacating tenants as a result of redevelopment) as were offset by \$6.8M of rents related to its

acquisition of Millennium Waterway Apartments and increased occupancy and rental growth at Howard Hughes' other properties.

- Resort and conference revenues showed an incremental 1.5% decline.
- Tenant recoveries declined by 10% and other rental property revenues declined by 2.9%
- Operating Asset Segment EBT was \$9.7M (adjusted) versus \$19.5M profit due to higher operating expenses as well as demolition, depreciation and interest expenses
- Property operating expenses increased by \$4.5M due to increased costs of \$4M relating to the Club at Carlton Woods and HHC placed 3 Waterway Square and One Hughes Landing into service in Q2 2013.
- Bad debt charges were \$835K due to bad debt charges at South Street Seaport related to Superstorm Sandy, which resulted in several tenant terminations.
- Depreciation increased by \$8.1M year-over-year due to depreciation on its acquisition of Millennium Waterway Apartments and Phase One of The Ward Village Shops as well as the increased depreciation expense recorded as a result of the change in useful lives of certain assets approved for redevelopment at Ward Centers. .
- Net interest expense increased \$2.9M due to \$1.4M related to 70 CCC lender's participation right in the property. The participation obligation is fair valued each quarter and HHC records the change in fair value through interest expense. The new 63,985 square feet lease increased the estimated value of the lender's participation during the first quarter of 2013. Interest expense also increased due to higher average debt balances in 2013.



Source: Howard Hughes's [2010-13 Annual Reports](#)

## Strategic Developments:

- Howard Hughes' smallest operating segment is its strategic developments segment.
- It is good that it is the smallest segment because these assets generally require substantial future development to achieve their highest and best use.
- Segment revenues increased by \$34.5M year-over-year in 2013 primarily due to the sale of its condominium rights related to the ONE Ala Moana project and the sale of one of the remaining parcels at Alameda Plaza.
- Expenses relating to these assets primarily relate to carrying costs, such as property taxes and insurance, and other ongoing costs related to maintaining the assets in their current condition.
- Segment EBT increased by nearly \$23M due to the aforementioned sale of its condominium rights and its share of the profit from the ONE Ala Moana condominium venture.

Project	Status	Type of Property	Total Development Cost (Est \$Ms)	Cost Incurred (Est \$Ms)	Projected Completion	Construction Began
Ward Village	Public Pre-Sales	Market Rate Condo Towers	\$17.1	\$0.0	N/A	Q2 2014
Shops at Summerlin	Construction Began	Mixed Use	\$391.0	\$107.4	Q2 2014	2013
Two Hughes Landing	Construction Began	Class A Office Building	\$49.0	\$20.7	Q2 2014	Q3 2013
One Lake's Edge	Construction Began	Multi-family apartments	\$88.0	\$5.9	Q1 2015	Q4 2013
Hughes Landing	Construction Began	Two Class A Office Buildings	\$172.0	\$8.3	Q4 2015	Q4 2013
Creekside Village Green	Construction Began	Retail	\$19.0	\$1.9	Q4 2014	Q4 2013

Source: [Howard Hughes Q4 2013 Earnings Report](#)

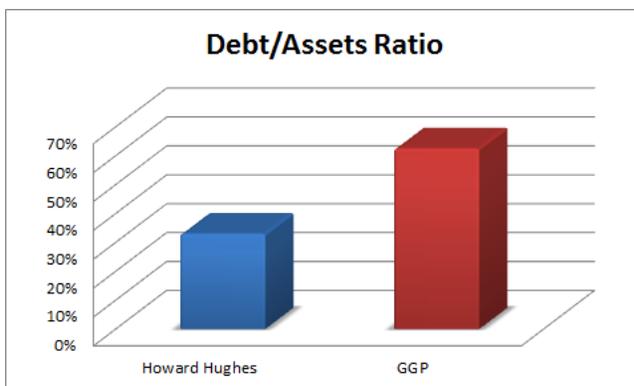
## Institutional Holders

We like the fact that leading institutional investors own the majority of Howard Hughes's stock, which includes Bill Ackman (Pershing Square) and Horizon Kinetics LLC (Peter Doyle, Tom Ewing and Murray Stahl). Coincidentally, [Bill Ackman recently sold](#) his position in Howard Hughes's former parent GGP.

- We like that Howard Hughes is now an independent company, no longer subject to the bureaucracy and capital needs of the highly leveraged GGP and we like Howard

Hughes's portfolio of high-end properties.

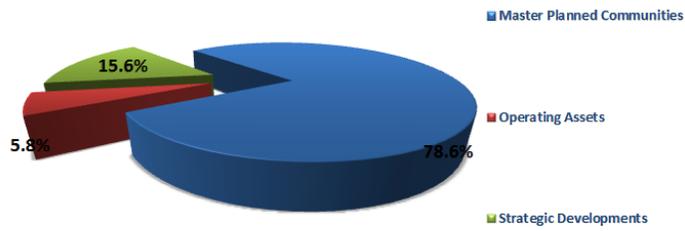
- While GGP is a highly leveraged company that must pay out 90% of its pro-forma taxable income as ordinary dividends to shareholders in order to qualify as a tax-exempt Real Estate investment trust, Howard Hughes utilizes shareholders' equity in order to finance 49% of its assets.
- Mortgages and stock warrant liabilities only account for 33% of asset financing and the company finances the rest through operating working capital liabilities, which are more than offset by cash and operating working capital assets.



Source: Morningstar Direct

In conclusion, we are neutral on The Howard Hughes Corporation. We believe that investors who want to invest in the real estate industry should consider The Howard Hughes Corporation. We like that Howard Hughes has been free cash flow positive in the last couple of years. We like that Howard Hughes has had strong growth from its Master Planned Communities and its business segments have powerful operating leverage that results in the conversion of sales growth to a high level of incremental operating income growth. We find that very few companies can even hope to replicate Howard Hughes's portfolio of high-end master planned communities, retail properties, office buildings and strategic land developments. Since Howard Hughes has gone public, it has outperformed its former parent as well as the iShares Dow Jones US Real Estate ETF (IYR) and the iShares Russell 2000 (Small Cap) Index ETF (IWM). At the same time, we are aware that its premium to book value is now 152%, up from 25% in Q3 2012.

## Howard Hughes FY 2013 EBT % by Division



Source: [Howard Hughes FY 2013 10-K](#)

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***Disclosure: Analyst(s) covering this company is/are long shares of HHC.***

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