Bluerock Residential (NYSE: BRG)

$9.54

Two buyout offers, a 7% dividend and over 13,500 attractive apartment units are three reasons to invest in Bluerock Residential, an underperforming, yet compelling Real Estate Investment Trust.

Due to a vaguely written 13D filing, no one seems to have noticed that a large investor is trying to buy BRG. Whether it is due to an increasingly automated and index investing dominated world, or to the declining ranks of small cap investors, who knows? Sit back, clip the 7% dividends and wait for the fireworks to come in 2019.

Attractive Apartment Assets in Great Markets

BRG owns over 13,500 apartment units (43 fully owned properties, 32 operating properties where they are majority owner) in very attractive markets such as Austin, Texas, Atlanta, Georgia, Charlotte, North Carolina and Denver, Colorado. These are all fast-growing markets that have been growing demographically for over thirty years and still have years of growth ahead. BRG's portfolio is approximately 95% occupied at this time. Here is a recent company presentation from June 2018:

http://ir.bluerockresidential.com/Cache/1001237883.PDF?O=PDF&T=&Y=&D=&FID=1001237883&iid=4214866

The company also makes preferred equity and mezzanine loan investments for projects under development as a way to earn high returns and have an opportunity to buy into projects while earning high interest rates while they are being developed. The company has approximately $240 million in these investments, representing approximately 13% of the company's asset base.

Harbert Management Offers Twice to Buy the Company, Management Says No

On October 29th, the Harbert Special Opportunity Fund quietly filed a 13D announcing a 5.7% position in BRG. No press release accompanied the filing, no news stories were written, and management did not comment on it.

Buried in the 13D was this:

The Reporting Persons believe that the Issuer has struggled to generate meaningful long-term shareholder value, as measured by total return since the Issuer's initial public offering, relative performance to its peer group, and the sustained discount to net asset value. The Reporting Persons or their representatives have attempted to engage with management of the Issuer to discuss the reasons for this underperformance and to propose a potential solution. More

specifically, the Reporting Persons firmly believe the status quo will result in continued underperformance, and that a sale of the Issuer is in the best interest of shareholders. ***To that end, the Fund recently made a bona-fide non-binding proposal to acquire the Issuer in an all-cash transaction at a substantial premium to the 60-day moving average, which was later revised to offer an even higher premium, subject to confirmatory due diligence (the "Proposals"). The Issuer's Board of Directors (the "Board") summarily rejected the Proposals without any substantive discussion with the Fund, and, as a result, the Fund withdrew its Proposals in their entirety.***

The 60-day moving average prior to this filing was approximately $9.55 per share. What would one consider a substantial premium? My best guess is 20%. That would indicate an initial offer of approximately $11.50 per share. And if I had to guess again, when that offer was rejected, Harbert then offered $12 per share, which was also rejected.

Harbert manages $6.2 billion in assets as of November 2018 and could easily handle an estimated $300 million acquisition. If Harbert was not fully committed to this, there would no reason for Harbert or any other large investor to file a 13D. Why file a 13D and then not do anything?

More importantly there was no market reaction to this filing, which to this fundamentally driven analyst, was a very bullish sign. Consider the largest holders besides Harbert: Blackrock and Vanguard. Together those two funds own nearly 12% of the company.

Harbert probably sees opportunity in refinancing the expensive preferreds, especially the Series A which has an 8.25% yield and the series C, which has a 7.625% yield. Why is BRG financing apartments with an 8.25% preferred security in a world where the 10-year treasury is below 3%? It seems baffling until you realize that those preferreds are being run through related parties.

Management is Double Dipping with Related Parties by Using Expensive Preferreds

BRG is exactly the kind of company that is in dire need of activism. Since going public in 2015, the stock has gone nowhere but down from its initial price of $15 to its current low price of around $9 per share.

The company has been financing apartment acquisitions and renovations with issuance of expensive preferred shares. But as if that isn't enough of a disservice to common shareholders, BRG has been paying fees for these preferred share issuances to a related party owned by the CEO.

In just the first nine months of 2018, those fees represented $5.6 million in selling commissions and $2.4 million in dealer management fees. Also, there was additional $0.9 million in connection to the Series B preferred offering. Consider that the company is paying out 10% of the money it raises from preferreds to related parties. That is on top of the 8% yield they are promising to pay investors.

This is a pretty ridiculous way to finance boring apartment assets. It is clear that Harbert sees an opportunity to replace these expensive preferreds and that there is value in stopping this destructive behavior.

The Pressure Will Increase in 2019

With the first activist joining the fray, pressure will only increase in 2019. It is interesting to note that the company controls nearly $2 billion in assets on a small amount of market capitalization. Beyond Harbert, there is plenty of capital including behemoths like Blackstone and others with tens of billions in freshly raised capital searching for opportunities just like this one.

While recent quarterly numbers were good and the company reiterated their guidance for 2018, the stock has not reacted, nor is it recovering in any material way despite offering a superior market dividend.

The company has a buyback in place of nearly $20 million but didn't buy any shares in Q3. My guess is that management will start to deploy this money in attempt to short up the price and appease shareholders. Expect other shareholder-friendly actions to come as well.

Owens Realty and Mis-Pricing in Publicly Traded REITS

Owens Realty (NYSE: ORM) was a mortgage REIT that owned real estate assets that was being mismanaged similar to BRG. An activist named Eric Hovde launched a proxy battle and joined the board. Within 12 months the company was sold to another publicly traded company.

I wrote up ORM as an opportunity that offered a compelling risk/reward profile. Here was a company paying you 5% and while you waited for the activist campaign to work and that sold at a discount to net asset value. Similar to ORM, BRG sells for a discount to its estimated $11.50 Net Asset Value.

BRG is even better, they own superior assets and the dividend is even higher at 7%. BRG has already internalized the management of the REIT, something ORM had not completed prior to the acquisition. And instead of an activist, you have Harbert, who is interested in buying the company.

In June 2017, O'Shaughnessy Asset Management put out a research report that concluded that publicly traded REITs offer a wonderful opportunity for outsized returns (alpha) and remain uniquely inefficient. The top 25 REITs represent half of the market, and the rest of the REITs have tended to be ignored.

Most REIT investing is closet indexing and these small cap REITs tend to move in ways that are uncorrelated to their own fundamentals. Consider that ORM traded down from $18 to $15 on higher interest rates and weakness in overall REIT sentiment, right before it announced it was

going to be acquired. Similarly, BRG has been bouncing around seemingly oblivious to the fact that a large holder has offered *twice* to acquire the company.

Comparable Companies

Most apartment REITs, such as ESS, EQR, CPT, AVB, UDR, AIV and MAA all have yields below 4%. Interestingly, Next Point Living, which is another small cap REIT has a yield of 3.2% with apartments in the same high growth markets as BRG, and NXRT is externally managed.

The only apartment REITs with yields similar to BRG are IRT and APTS. IRT has a much lower quality portfolio in markets that are not as attractive such as Memphis, TN and Columbus, Ohio. APTS is externally managed and despite its name has only 40% of its assets in apartments, the rest is office, grocery retail and student housing. BRG appears to be an outlier in terms of quality of assets, focus on apartments and its high dividend yield among its comparable set.

Summary

In summary, while I'm unsure of the exact timing, I'm excited to keep clipping 7% dividends while there is a takeover battle for BRG and its attractive portfolio of apartment assets. With safe and boring assets and a low downside risk profile, BRG offers nearly a 35% upside return if it trades to $12 and we earn the current 7% dividend. I expect the company to either be acquired or a battle to emerge in 2019. Stay tuned.

Catalysts

- Acquisition by Harbert or another interested party
- Takeover battle becomes more public
- Proxy fight, board seats
- Updated 13D and 13F filing, which may show Harbert bought more shares
- More press releases or stories
- Clipping 7% dividends in a volatile, yet low interest rate environment