

The St. Joe Company (JOE)

Mired in Swamp

We are short shares of The St. Joe Company, a Florida Panhandle developer with overhyped real estate holdings and a controlling shareholder who will soon be forced to liquidate part of his investment. For more than a decade, St. Joe has lured investors with the promise of unlocking value in large tracts of undeveloped land near Panama City Beach. Every year, however, this promise has remained unfulfilled, because St. Joe's purported plan for the land is pure fantasy. Once owners of 1 million acres of undeveloped Florida real estate, St. Joe has sold off most of its valuable property. The 177k acres that remain are not adjacent to the Gulf of Mexico; rather, they are mainly inland in swampy, remote, desolate areas occupied by industrial pine.

St. Joe's cash flow from current operations is minimal – the interest earned from its portfolio of junk bonds exceeds the income from actual real estate development. The bull thesis for St. Joe rests on the company's ability to transform remote land, which no one can feasibly develop over an investment lifetime, into a world-class destination for retirees and businesses. There has been little progress on this plan for over 15 years. Management preaches patience and urges investors to maintain a long-term view; however, the reality is that the holdings are too unattractive to develop in the timely manner needed to justify any valuation close to current trading levels.

Drawing on extensive conversations with securities lawyers and experts, we believe a negative catalyst will ironically come from St. Joe's largest shareholder, the Fairholme Fund. Much like St. Joe's land holdings, Fairholme is a tiny vestige of its former self. Years of poor stock selection and high redemptions have taken a fund that once held over \$16bn in net assets to just \$1.6bn. It has also created an unsustainable dynamic: as net assets have receded, the fund has sold its most liquid securities to raise cash, leaving its massive position in St. Joe far in excess of SEC guidelines for illiquid holdings.

The Fairholme Fund is an open-end fund that offers daily liquidity and must meet redemptions within 3 days. Two months ago, the SEC instituted rules that limit such funds from holding more than 15% of net assets in illiquid securities. We estimate that The Fairholme Fund, holders of 22.7m shares, 70x average daily trading volume, has over 27% of its net assets in St. Joe. This gross violation of the new SEC liquidity rules has negative implications for St. Joe shareholders. Fairholme must reduce its stake by 10m shares to comply with rules that go into effect on December 1st. Given insider trading and volume restrictions, there are not enough trading days between now and December 1st for Fairholme to reduce its position in an orderly manner. Fairholme's impending demise, and the need to comply with the new SEC regulations, subjects St. Joe shareholders to the painful overhang of a forced seller.

St. Joe is valued as if a new metropolis will soon emerge from rural forest and swamp. As liquidity risks mount for its largest shareholder, investors will see values sink back into mud. We value shares at \$10.50 representing downside of -42%.

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I. Research Highlights

Valuation Makes No Sense – Real Estate Holdings are Worth Much Less than Share Price Implies while Current Operations are Insignificant

- Management has sold investors on the promise of a **50-year plan to transform a vast, desolate swath of pine trees and shallow swamp into a thriving destination for retirees**. According to local developers, the plan has been nothing but hype and delay. **The project has seen no progress for over a decade.**
- **St. Joe has already monetized most of its beachfront land near Highway 30A.** St. Joe's future is dependent on vast amounts of *interior* land which, even at its closest proximity to the Gulf of Mexico, is on the wrong side of 2 highways. The land St. Joe owns northwest and east of the intersection of SR 79 and Route 98 is remote. Much of the land closer to the Gulf is populated by small, highly seasonal beach communities that can't support major retail and commercial development.
- **Optimism for higher recurring revenue from commercial real estate leasing is misplaced.** Commercial retail development closer to the heart of Panama City Beach, such as Pier Park North, is a saturated market with low returns confronting secular challenges. Industrial growth opportunities at VentureCrossings are limited and will be painfully slow to develop given the area's remoteness and challenged demographics. Contributions of recurring revenue from new commercial ventures are immaterial.
- Beyond its real estate holdings, St. Joe's current operations account for a small fraction of its current market valuation. **JOE shares are ludicrously valued at 83x EBITDA, 74x Free Cash Flow and 136x P/E.** No reasonable set of development assumptions points to upside for the stock.

New SEC Rules Will Force St. Joe's Largest Shareholder to Reduce its Stake

- St. Joe's largest shareholder is the Fairholme Fund, managed by Bruce Berkowitz. The fund owns 22.7m shares worth ~\$410m. As of the end of January 2018, the investment represented 24% of the Fairholme Fund's net assets.¹
- Based on conversations with three securities lawyers, including a former senior counsel in the Enforcement Division of the SEC, **Fairholme must comply with new SEC liquidity management rules that limit illiquid investments to 15% of net assets.**²
- **Fairholme must significantly reduce its ownership of JOE.** We estimate Fairholme must divest 10m shares (~\$180m) to comply with regulations. **The hypothetical disposal of 10m shares would take over 150 trading days without affecting price.**³
- Fairholme is restricted by insider and affiliate trading rules. There are not enough trading days before the December 1, 2018 compliance deadline for an orderly unwind.
- **Risk for St. Joe shareholders is mounting.** The Fairholme Fund's net assets have declined from nearly \$17bn in 2010 to \$1.6bn.⁴ The fund is already down -8% year-to-

¹ [2017 Fairholme Funds, Inc. Annual Letter](#). We estimate at present the position has climbed to over 27%.

² SEC Rule 22e-4, [Investment Company Liquidity Risk Management Programs](#).

³ 30d avg. daily trading volume of 290k per Bloomberg. Assumes Fairholme limits selling to 20% of daily volume.

⁴ [2010 Fairholme Funds, Inc. Annual Letter](#). Net assets as of November 30, 2010 were \$16.8bn. According to Morningstar Research, fund assets were \$1.6bn at the end of February 2018.

date. Without selling investments to raise liquidity, we estimate Fairholme has less than 6 months of cash on hand to meet the pace of recent cash outflows.

- **Fairholme disclosures are inconsistent and deceptive.** The Fairholme Allocation Fund, which holds only \$8m of St. Joe stock, deemed the investment illiquid. The Fairholme Fund, with over \$400m of stock, unjustifiably, did not.⁵

The Relationship Between Fairholme and St. Joe is Riddled with Conflicts of Interest

- Berkowitz is Chairman of St. Joe's board. Two Fairholme directors also sit on the board of St. Joe. The relationship poses conflicts of interest, a potential breach of fiduciary duty and **subjects both companies to possible litigation** given Fairholme's need to comply with the new SEC liquidity rule.
- Despite St. Joe being a money-losing investment for a decade, Berkowitz never attempted to mitigate the consequences of the long-anticipated liquidity rule by recusing himself.
- **Under Berkowitz's direction, St. Joe invested and likely lost money in Sears Holdings Corp.**, a company Berkowitz sat on the board of until October 2017.⁶
- The SEC, St. Joe, and Berkowitz have crossed paths in the past. In 2011, Fairholme and Berkowitz were investigated by the SEC as part of a broader investigation into St. Joe's real estate accounting practices. In October 2015, the SEC charged St. Joe and several former top executives with failing to take required write-downs of properties negatively affected by the financial crisis.
- If Fairholme and its two directors resign from the board to alleviate trading restrictions, we foresee a negative market reaction.

JOE is Not Cheap on an EV / Acre Basis; Population Growth in and of Itself Does Not Constitute an Investment Thesis

- Bulls improperly cite the implied value of St. Joe's total acreage embedded in the current share price (~\$6,000 EV / per acre) as evidence of the attractiveness of shares. **In fact, at the present EV / Acre, JOE shares trade at the same valuation as immediately prior to the bursting of the real estate bubble.**
- EV / Acre has been steadily declining since JOE sold 383k acres in 2014 for just \$1,475 an acre – 1/4th the current implied EV / Acre of JOE and the closest comparable transaction for St. Joe's undeveloped land.
- JOE's market capitalization is the same today as when it held 3x more acreage and generated 3x more EBITDA. **There is no margin of safety at the current valuation.**

⁵ [2017 Fairholme Funds, Inc. Annual Letter](#). See footnote "(b)" on p. 28 referencing the Fairholme Allocation Fund's position in St. Joe. Per the footnote, "Security is deemed an illiquid security pursuant to the Funds' liquidity guidelines." This note is missing from the description of the St. Joe position for The Fairholme Fund on p. 12.

⁶ St. Joe 3Q17 10-Q. \$9.2m and \$0.2m of Sears corporate debt securities and preferred stock, respectively were held in a St. Joe Investment Management Account supervised by Berkowitz.

St. Joe Doesn't Make Money from Real Estate Development

- St. Joe exemplifies exceedingly poor quality of earnings. Over the last three years, **total operating income from JOE's supposed core competency of real estate development is negative.**
- JOE's reported net income has come from non-real estate investment gains, an insurance settlement, and interest income from a large junk bond portfolio. **Without one-time gains on non-real estate investment and interest income, St. Joe does not generate meaningful cash.**
- St. Joe has recently booked impairments to its non-investment grade debt portfolio and reduced its size by -35%.⁷ Declines in the high-yield market since the beginning of the year portend further losses.
- **St. Joe deliberately shuns transparency.** The company has reduced the transparency of public disclosures, suspended quarterly earnings calls, does not attend investor conferences, and is covered by only one equity research provider.

The Pace of Development of Will Continue to Disappoint

- Brick-and-mortar retail stores are closing at a historic rate.⁸ **5 anchor tenants in Pier Park North are national/regional companies that have had to reduce store counts to cut costs.**⁹
- Anchor tenants in Pier Park, an outdoor mall across the street from Pier Park North, are the struggling department stores J.C. Penney and Dillard's.
- Benefits from the much-celebrated GKN Aerospace facility are at risk due to its hostile takeover by an asset-stripping turnaround specialist late last month.¹⁰
- Baby Boomer retirees have vastly different tastes and preferences from the generation that fueled the success of the Villages. Developing a retirement community in the remote backwoods of Panama City Beach is fraught with risk.
- **Bay County suffers from demographic challenges that hinder St. Joe's ability to turn forest and swamp into an attractive destination for retirees and businesses:**
 - Bay County has a "brain drain" problem – recent net migration flows have been negative, and per capita personal income is -10% lower than that of Florida.¹¹
 - Panama City Beach is one of the most dangerous cities in America based on violent crimes and property crimes.¹²

⁷ St. Joe 2017 Form 10-k, Note 4. Investments. Corporate debt securities of \$66m, down from \$101m in 3Q17.

⁸ <https://sourcingjournalonline.com/retail-apocalypse-2018-cushman-wakefield-prediction/>

⁹ [The Fresh Market](#), [Bed Bath & Beyond](#), [Mattress Firm](#), [Pier 1 Imports](#), and [Cost Plus World Market](#)

¹⁰ [Engineering giant GKN sold to Melrose for £8bn.](#)

¹¹ [Net migration data](#) per U.S. Bureau of the Census retrieved from FRED, Federal Reserve Bank of St. Louis.

Income data per [Florida Office of Economic and Demographic Research](#).

¹² <http://www.nwfdailynews.com/news/20170822/panama-city-beach-makes-list-of-most-dangerous-cities-in-us>

II. Investment Overview

Capitalization and Summary Financials									
<i>\$ in Millions, except per Share Data</i>									
Capitalization (as of 12/31/17) ⁽¹⁾				Summary Financials					
Share Price	\$18.00								
Basic Shares Outstanding	65								
Market Capitalization	\$1,176								
		Net Revenue		FY 2015A	FY 2016A	FY 2017A	FY 2018E	FY 2019E	
		Change YoY (%)		104	96	99	87	95	
Cash	182								
Investments	111	Operating Income (EBIT)		(6)	2	2	5	5	
		EBITDA		4	11	11	15	17	
Total Debt	56	Margin		3%	11%	11%	17%	18%	
Net Debt	(238)								
Total Enterprise Value	\$938	Adj. Net Income ⁽²⁾		(2)	8	9	7	7	
		Capex		17	13	40	78	50	
Total Acreage ('000s)		FCF ⁽³⁾		5	0	16	(60)	(29)	
2006	805								
2013	567								
Current	177								
EV / Acre		Valuation:							
2006	\$5,689	EV / EBITDA		268.0x	88.0x	83.3x	63.3x	55.3x	
2013	\$3,172	Adjusted P/E		NM	173.2x	135.8x	161.4x	163.2x	
Current	\$5,302								

Source: St. Joe SEC filings and earnings press releases, Kerrisdale estimates.

1. St. Joe 2017 10-K, Note 15. Balance sheet cash and shares outstanding adjusted for .5m shares repurchased for \$10m subsequent to December 31, 2017.
2. Adjusted for one-time gains associated with insurance settlements, gains on sale of assets and investments, tax credits.
3. CFO less Capex. Per St. Joe 2017 10-K, 2018 capital expenditure budget is \$129.6m. Projected capex for 2018 as shown based on 60% discount to budget, consistent with 2015-2017 average ratio of capex / original budget.

St. Joe shares are valued as if the company is destined for incredible growth. Yet the company's present operations generate virtually no income and its remaining land holdings are not well-situated. This disconnect is obvious to anyone who has spent a few minutes analyzing the cash flow potential of the Bay-Walton Sector Plan or taken a drive down State Road 79. At only \$2m of operating income in 2017, St. Joe's earnings from real estate development are insignificant relative to the company's \$1bn valuation. Shareholders have predicated their investment on a rising level of recurring income from activities such as commercial leasing and the economic potential of vast, undeveloped timberland. While promoting a reasonable sounding thesis of patience and long-term potential, bullish investors have failed to recognize that being decades early in an investment is the same as being wrong.

Arrested Development

"This particular area – we're watching it, that's all we're doing. We don't see a big growth. We know of the hype, but that's it. It's a great dream, great vision, wrong area – I don't see it."

— Senior Project Manager, \$18bn Market Cap. Nationwide Homebuilder

The plan to transform St. Joe's land in Bay and Walton counties into a thriving destination for retirees and businesses is known as the Bay-Walton Sector Plan ("the Plan").¹³ The Plan is named after the two counties in northwest Florida where the St. Joe land is located. While shareholders are quick to describe access to the white sand of the Gulf of Mexico, they omit the fact that the land is not actually on the Gulf of Mexico – it sits on the far side of two highways, one of which is a major 4-line interstate (Route 98). Turn off Route 98 and drive up State Roads 79 and 388 into the interior of the Plan, where most of the land is situated, and its remote emptiness becomes apparent.



¹³ <http://bay-waltonsectorplan.com/about.aspx>

As a local realtor described, “it gets desolate, quick.” There are no local businesses. There is barely even a shoulder on the highway. Drive mile after barren mile and one realizes just how distant and unlikely a vision for the area the Bay-Walton Sector Plan represents.

Under the Plan, St. Joe is entitled to develop over 170,000 homes and 22 million square feet of commercial space on 110,500 acres of land.¹⁴ To provide perspective on the size of this plan (and how easily investors can be fooled into its potential) – 170,000 homes is 1.7x the number of housing units that currently exist in all of Bay County, Florida.¹⁵ 110,500 acres is nearly 8x the size of Manhattan. The theoretical peak population envisioned by the plan is 350,643 (7x the current combined population of Panama City Beach and Panama City).¹⁶ Entitlements are a procedural formality – they have little bearing on what will ever actually be built and who will live there.

One major red flag for investors is how long St. Joe has discussed developing this land without any real progress. The Bay-Walton Sector Plan originally began as the West Bay Sector Plan, a project encompassing 75,000 acres immediately surrounding West Bay, and was approved 15 years ago.¹⁷ The Bay-Walton Sector Plan added over 40k acres to the west of the West Bay Sector Plan and received final approval from state and local agencies in June 2015.¹⁸ Despite promises to break ground on an initial community by the end of 2016¹⁹, to date there has been zero progress.

St. Joe’s 2018 capital budget calls for an increase in residential real estate development but our checks have confirmed this will not be spent on the Bay-Walton Sector Plan. The next step called for by the plan is the buildout of a sub-division, known as a Detailed Specific Area Plan (DSAP). At present, none of the activity that would signal serious advancement of a DSAP is taking place. According to a local developer, “it is a straight, dead, flatline” in terms of building department inquiries, permit filings, and public hearings. Nothing new has been filed with relevant local authorities and there is nothing pending. In short, there is no reason to think the Plan is any more feasible now than it was when it was first proposed over a decade ago.

The increase in St. Joe’s capital budget is going toward developments such as Watersound Origins and Breakfast Point. We visited both neighborhoods last month and observed sizable new land clearings. At Watersound Origins, dump trucks were seen bringing dirt to the site suggesting more expensive elevation work was being done as part of development of the rough land. Watersound Origins felt like an empty-shell of a community. Despite the pleasant, sunny day there was no one on the golf course, virtually no one on the streets, and no one at the pool.

¹⁴ St. Joe 2017 10-K.


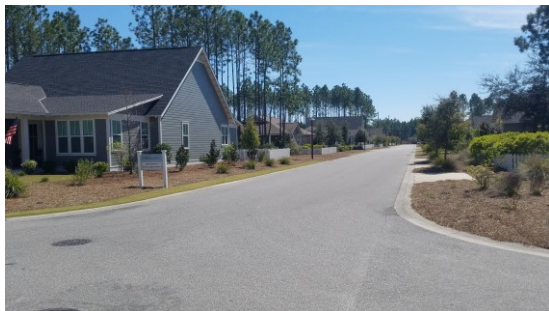
¹⁵ <https://www.census.gov/quickfacts/fact/table/baycountyflorida/PST045216>

¹⁶ [Bay-Walton Plan Sector Summary Analysis](#), p. 47.

¹⁷ *Ibid*, the West Bay Sector Plan was approved by Bay County in 2003.

¹⁸ <http://www.newsherald.com/1.494778>

¹⁹ <http://www.newsherald.com/1.475899>

Watersound Origins	
Watersound Origins Phase 4	Watersound Origins
	
Source: Kerrisdale photographer, 3/15/18.	

Long-suffering investors who have waited years for progress should be prepared to wait longer – St. Joe continues to struggle in its attempt to monetize its land at a pace that can remotely justify its current valuation. We asked local developers why St. Joe is progressing at such a slow clip. The response was that while local market conditions are improving, growth remains modest. In their view, the company continues to delay breaking ground because it is struggling to convince partners to buy into the economic feasibility of such remote land. Who can blame them? The terrain and risks inherent in developing are downright intimidating. As former CEO Peter Rummell once described, “A big, thick pine forest with a lot of undergrowth is a pretty forbidding place. It scares a lot of people.”²⁰

Bay-Walton Sector Plan Valuation

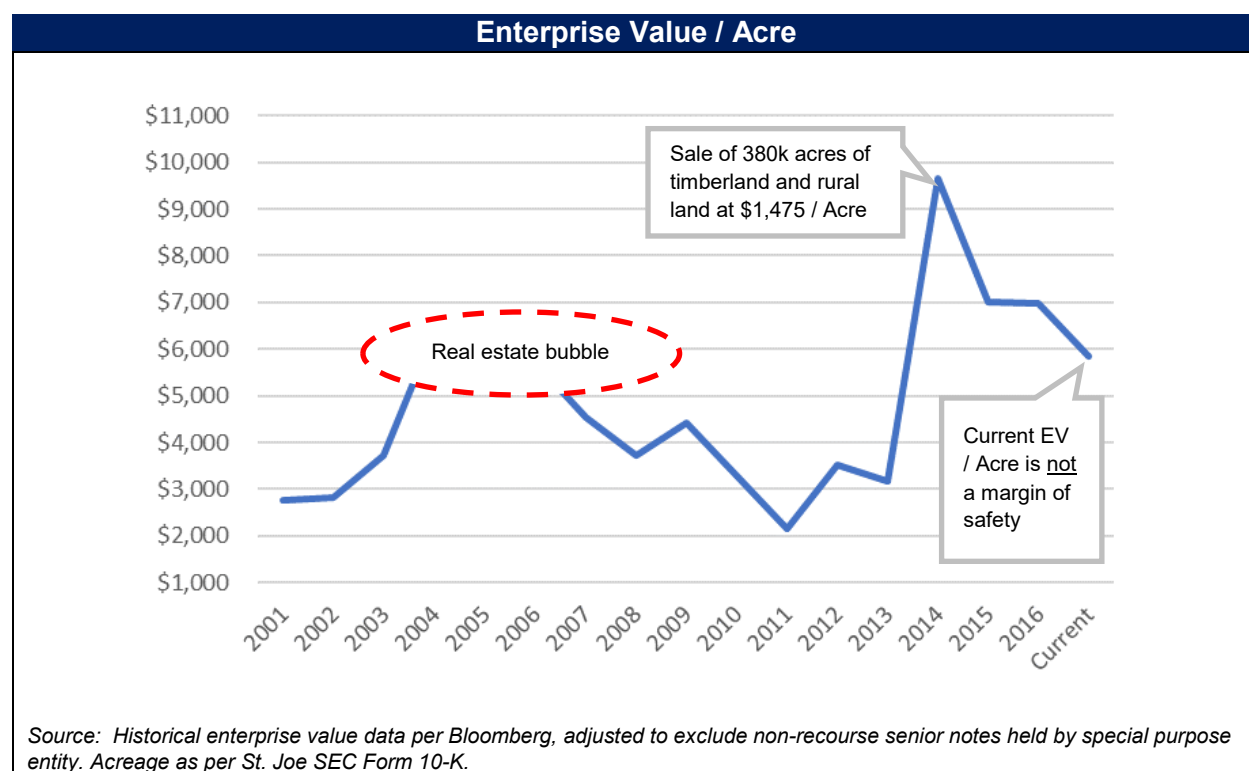
To properly value St. Joe, one must assess the purported uses for its undeveloped land, apply an appropriate estimate for what the market will bear in terms of annual absorption, and then discount the implied future value to present terms. Long-term population growth in and of itself is not a valid investment thesis. The population of Florida has more than doubled since 1980 but much of inland Panhandle is still miles of emptiness.²¹ Assuming rural land that is not directly situated on the Gulf of Mexico becomes developed within a reasonable investment horizon is not a sure bet. Population growth in the coastal areas of Bay County will indeed continue, but St. Joe has already monetized most of its prized beachfront property along Highway 30A. There is a massive difference between being on the beach, or even near it, and where St. Joe’s remaining undeveloped land sits.

Bulls who view St. Joe’s implied EV / Acre of ~\$6,000/acre as attractive relative to market prices for small plots of rural land that range between \$10k-\$50k fail to account for vast differences in liquidity. The inability of a market to absorb development of hundreds of thousands of acres is what drives volume discounts when valuing large tracts of land. The most obvious evidence of this discount and the best transaction comparable for St. Joe’s remaining undeveloped land

²⁰ <https://www.nytimes.com/2005/08/22/us/in-florida-a-big-developer-is-counting-on-rural-chic.html>

²¹ U.S. Census Bureau. The population of Florida in 1980 was 9.7m. The current population is 20.9m.

comes from St. Joe itself. In late 2013, the company sold a massive parcel, 383k acres, for \$565m, an implied value of just \$1,475 / acre.²²



Without accounting for illiquidity, investors can make wildly incorrect assumptions for the value of a company. The tendency of investors to make this mistake was once nicely summed up by Warren Buffet²³:

“People sometimes get very confused... they’ll look at some huge land company, like Texas Pacific Land Trust, which has been around over 100 years and has got a couple million acres in Texas. And they’ll sell 1% of their land every year, and they’ll take that and come up with some huge value compared to the market value. But that’s nonsense if you really own the property. You can’t move 50% of the properties or 20% of the properties. It is way worse than an illiquid stock. So, you get these, I think, you get some very silly valuations placed on a lot for real estate companies by people who don’t really understand what it’s like to own one and try to move large quantities of property.”

The company’s current implied valuation of ~\$6,000 EV / Acre does not represent a margin of safety. The company has traded far below this level in the past. In fact, on an EV / Acre basis,

²² [St. Joe Press Release, November 7, 2013](#).

²³ [Warren Buffett lecture](#) at the University of Florida School of Business, October 15, 1998.

St. Joe trades at the same level it did prior to the bursting of the real estate bubble, when it owned nearly 1m acres of land.

To account for the illiquidity of the land contained in the Bay-Walton Sector Plan, we discount the future cash flows from projected annual residential and commercial development. This is the approach used by the sole equity research analyst who covers St. Joe.

The biggest driver of the analyst's neutral rating on St. Joe stock is the DCF he employs for the entitlements in the Bay-Walton Sector Plan.²⁴ His analysis is not demand-driven, but rather a top-down, hypothetical exercise driven by the total entitlements St. Joe has been allowed, spread evenly over 50 years. The analyst assumes that 2,723 homesites and 448k square feet of commercial space are sold every year from 2020 to 2069, creating instant, machine-like growth in cash flow. No gradual ramp to this level of sales velocity is assumed; it is achieved in the very first year. To highlight how unrealistically aggressive these assumptions are, 2,723 homesites would mean the Bay-Walton community immediately becomes the top-selling master-planned community in America.²⁵ It took the Villages, a retirement community in central Florida, decades to achieve a commensurate level of annual sales. The forecast of 448k square feet of commercial real estate is more retail and office space absorbed than in the entire Panhandle market in 2017.²⁶

The level of build-out in the analysis will never actually be attempted. St. Joe is currently developing ~360 residential lots not far from the edges of the Bay-Walton Sector Plan boundary at Watersound Origins. In speaking with local developers, the level of activity in communities such as SouthWood and Breakfast Point is a couple dozen to 80 lots. Putting in many thousands of lots is well beyond current development plans as the number of units would take far too long to be absorbed.

Yet, even with the analyst's outrageous, purely hypothetical assumptions for rapid success, the analysis only returns a \$370m valuation for the Bay-Walton Sector Plan and net asset value per share for St. Joe of only \$5.66. More realistic, yet still highly aggressive, assumptions for the Bay-Walton project, such as a gradual ramp to 2,250 homesites and annual commercial space absorption of 130k sq. ft – still representative of highly successful development – yields a valuation closer to \$170m, or just \$2.60 NAV per share for St. Joe.²⁷

Lastly, to the extent St. Joe ever makes progress on the Plan, we do not believe it will deliver material recurring revenue. The lead architects of the Plan cite the success of the Villages, a privately owned, master-planned community in Florida with an estimated 125,000 retired residents spanning 33,000 acres. The community caters to the retirement community, relying on golf carts as the primary mode of transportation and offering extensive activities targeted at

²⁴ Rating as of report dated March 2, 2018. DCF analysis is contained in analyst's model.

²⁵ According to the [RCLCO Top-Selling Master-Planned Communities of 2017](#), the Villages, Florida was the top-selling master-planned community in 2017 with 2,231 homes sold.

²⁶ [CBRE Florida Panhandle MarketView Snapshot H2 2017](#)

²⁷ See Section III – Valuation for price target derivation and Bay-Walton Sector Plan Valuation Analysis.

retirees, such as golfing, tennis, pickleball and live shows. In addition to sales of lots, the owners of the Villages earn income from operating businesses like vacation rental management, restaurants, and golf cart dealerships. But the Villages took decades to develop and benefited from a concept and ambience that was differentiated at the time. Today, similar options abound for retirees looking to settle in Florida and throughout the Southeast. As a developer told us, “Every major homebuilder has a 55+ model.” The appetite of Baby Boomers for a similar cookie-cutter master-planned community is questionable relative to the tastes of the preceding generation.

Growth from Commercial Leasing is Immaterial

Increasing the contribution of recurring revenue from commercial leasing is a key initiative for the company in 2018.²⁸ \$83m in 2018 is earmarked for commercial leasing and sales.²⁹ Some investors have taken this budget as a sign St. Joe is “getting serious” about recurring revenue.³⁰ However, just because St. Joe budgets an amount for commercial development does not mean it will spend it as outlined or that it produces meaningful economic value.

In the last 3 years, St. Joe has underspent its original budget by an average of 40%.³¹ This is not unusual in the construction business; capital budgets are highly discretionary and subject to delay/cancellation. Nevertheless, below we analyze the estimated cash flows and returns from a \$60m commercial retail project in the Panama City Beach area.

²⁸ St. Joe 2017 10-K, Business Strategy.

²⁹ *Ibid.*

³⁰ Seeking Alpha, March 29, 2018.

³¹ In its 2014 annual report, St. Joe outlined a \$30.6m capital budget for 2015 and spent \$17.5m. In its 2015 annual report, St. Joe outlined a \$23.1m capital budget and spent \$12.8m. In its 2016 annual report, St. Joe outlined a \$62.8m capital budget and spent \$39.8m.

Commercial Retail Leasing Discounted Cash Flow Analysis

Assumptions

Gross Capital Investment (\$M)	\$60	Terminal NOI	\$10.8
\$/Sq Ft Development	\$100	Terminal Growth rate	2.5%
Developed Sq Ft	600,000	Terminal Cap Rate	6.5%
		Terminal Value	\$167
Financing (\$M)	\$42	Disc. Terminal Value	\$73
% Financed	70%	Disc. Value of Interim FCF	(\$10)
Cost of Financing	4.25%	Implied Enterprise Value	\$63
		Implied ROI	5%
Equity	30%		
Equity Cost	9%	Incr. in Value per JOE Shr.	\$0.05
WACC	5.68%	% of Current JOE Share Price	0.3%

Sensitivity Analysis

		WACC			
		4.68%	5.18%	5.68%	6.18%
Terminal Cap Rate	5.5%	\$0.51	\$0.37	\$0.25	\$0.13
	6.0%	\$0.38	\$0.26	\$0.14	\$0.03
	6.5%	\$0.27	\$0.16	\$0.05	(\$0.06)
	7.0%	\$0.18	\$0.07	(\$0.03)	(\$0.13)
	7.5%	\$0.10	(\$0.00)	(\$0.10)	(\$0.19)

	Projected											
Year	0	1	2	3	4	5	6	7	8	9	10...	15
Square Feet Leased		200,000	200,000	200,000	0	0	0	0	0	0	0	0
Cumulative		200,000	400,000	600,000	600,000	600,000	600,000	600,000	600,000	600,000	600,000	600,000
% Occupancy		33%	67%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Annual Lease Rate (\$ / Sq. Ft.)		\$20.50	\$20.93	\$21.37	\$21.82	\$22.28	\$22.74	\$23.22	\$23.71	\$24.21	\$24.72	\$27.42
% Increase		2%	2%	2%	2%	2%	2%	2%	2%	2%	2%	2%
Annual Lease Revenue (\$M)		\$4.1	\$8.4	\$12.8	\$13.1	\$13.4	\$13.6	\$13.9	\$14.2	\$14.5	\$14.8	\$16.5
Operating Income @ 70% Margin		\$2.87	\$5.86	\$8.98	\$9.16	\$9.36	\$9.55	\$9.75	\$9.96	\$10.17	\$10.38	\$11.52
Less: Taxes @ 5.8%		(0.2)	(0.5)	(0.7)	(0.8)	(0.8)	(0.8)	(0.8)	(0.8)	(0.8)	(0.9)	(1.0)
Net Operating Income		\$2.6	\$5.4	\$8.2	\$8.4	\$8.6	\$8.8	\$8.9	\$9.1	\$9.3	\$9.5	\$10.6
Less: Maintenance Capex @ 20% of NOI		(0.5)	(1.1)	(1.6)	(1.7)	(1.7)	(1.8)	(1.8)	(1.8)	(1.9)	(1.9)	(2.1)
Less: Financing Cost		(1.8)	(1.8)	(1.8)	(1.8)	(1.8)	(1.8)	(1.8)	(1.8)	(1.8)	(1.8)	(1.8)
Annual Cash Flow		\$0.3	\$2.5	\$4.8	\$4.9	\$5.1	\$5.2	\$5.4	\$5.5	\$5.7	\$5.8	\$6.7
Growth			684%	91%	3%	3%	3%	3%	3%	3%	3%	3%
Discounted Value of Annual Cash Flow		(\$60)	\$0.3	\$2.4	\$4.3	\$4.2	\$4.1	\$4.0	\$3.9	\$3.8	\$3.6	\$3.1

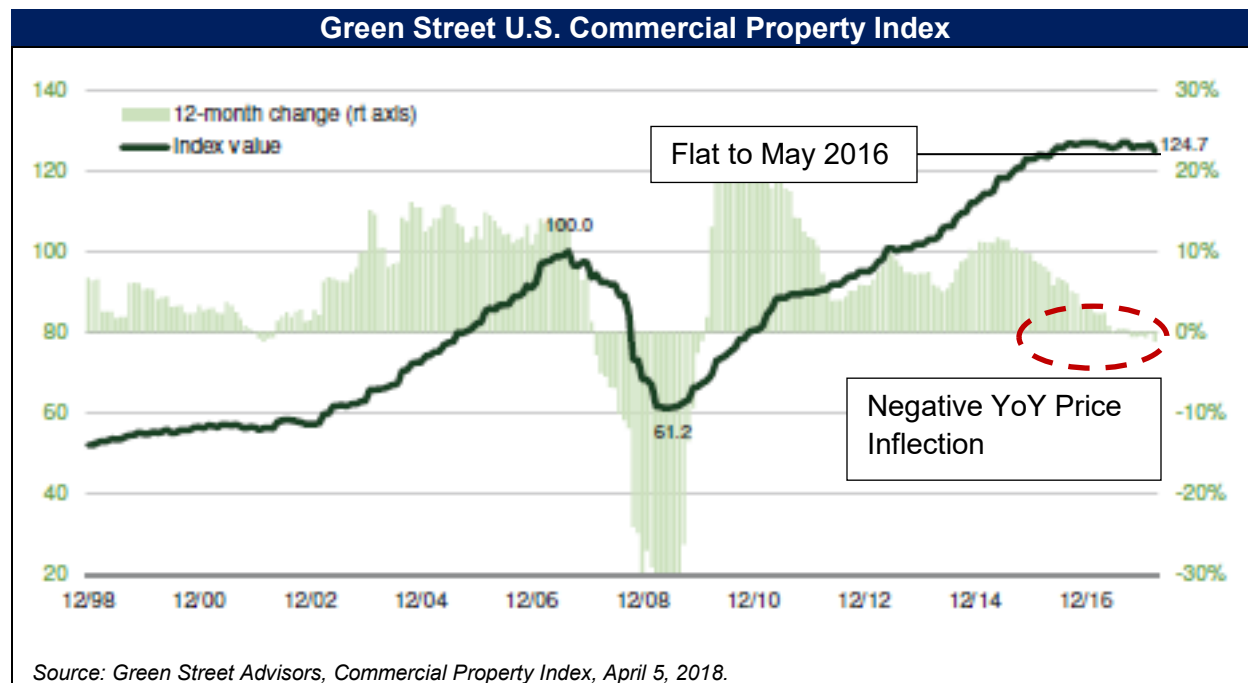
Source: Kerrisdale estimates and analysis. Key assumptions discussed further below.

Key inputs in the analysis were developed in consultation with local commercial real estate experts and a real estate investment banker familiar with the current financing terms. Based on \$100k per sq. ft. of development costs, we assume \$60m is spent on 600k sq. ft. of commercial retail space. Assuming 3 years to reach and maintain 100% occupancy, annual 2% price escalators, and 70% operating margins for 15 years, the project yields a modest ROI of 5%. The investment banker we spoke with found the result consistent with prevailing market conditions for generic big-box retail space. Note that 600k sq. ft. is equivalent to adding 2 more Pier Park North shopping centers, St. Joe's marquee commercial retail JV, to the Panama City Beach area within 3 years. This is highly aggressive given that the trailing 12-month retail absorption in Panama City Beach was only 77k sq. ft.³² Even assuming these favorable conditions, the project is a low-return venture which nets only \$3m in incremental enterprise value. In short, it is inconsequential to the overall value of St. Joe.

The environment for commercial development is also not without obvious risks. While our analysis has generously assumed perfect occupancy and steady pricing for 15 years, on a macro level commercial property pricing growth has stalled and may be starting to correct. According to a recent report by real estate analytics provider, Green Street Advisors, "Over the past couple of years, commercial property pricing has cooled as investors take stock of record

³² [CBRE Florida Panhandle MarketView Snapshot H2 2017](#)

prices, slowing fundamentals, and higher treasury rates.” The biggest negative driver for the “ho-hum” overall pricing environment has been the retail sector, which is down -10% from its peak as malls and strip malls struggle with declining foot-traffic. In the past 12 months, Green Street’s sector level price index for Malls and Strip Retail are down -14% and -5%, respectively. The categories are the two worst performing sectors in the index.³³



This poor retail backdrop should be of concern to St. Joe investors. Within Pier Park North are the following anchor tenants: [The Fresh Market](#), [Bed Bath & Beyond](#), [Mattress Firm](#), [Pier 1 Imports](#), [Men’s Wearhouse](#), and [Cost Plus World Market](#).³⁴ Each one has announced store closures to cut costs amid declining brick-and-mortar sales. Across the street from Pier Park North is Pier Park, an outdoor shopping mall with Dillard’s and J.C. Penney as key anchor tenants. These too have struggled in recent years with store closures. We estimate nearly 1/3 of the fashion retail stores in Pier Park are operated by companies struggling with weak sales. Several are facing or already in bankruptcy.³⁵

We visited both properties last month on a sunny afternoon, with spring breakers lining Front Beach Road a few hundred yards away. The parking lots were as barren as St. Joe timberland, and the stores were equally empty.



³³ <https://www.greenstreetadvisors.com/insights/CPPI>

³⁴ [Pier Park North store map](#)

³⁵ Out of 48 fashion retail stores per [Simon Property Group](#) the following are part of struggling retail chains: [American Eagle Outfitters](#), [Payless](#), [Charlotte Russe](#), [Journeys](#), [Lids](#), [Charming Charlie](#), [Chico’s](#), [Lane Bryant](#), [Loft](#), [Victoria’s Secret](#), [Zales](#) and [Kay Jewelers](#).

Commercial Retail Risk in Panama City Beach	
Dillard's	J.C. Penney
	
Source: Kerrisdale photographer, 3/15/18.	

Industrial commercial leasing is another bulwark of the St. Joe long thesis. Touted by bulls as evidence of recurring revenue potential, St. Joe's recent manufacturing space success with GKN Aerospace should be viewed in proper context. The two main tenants at the company's new industrial park VentureCrossings, GKN and defense contractor Harris Corporation, are both tied to aerospace/defense; this is to be expected given the relative proximity to several Air Force and Navy installations, such as nearby Tyndall Air Force Base. Situated in the woods with not a single local business in the vicinity, and in a county where the percentage of individuals with bachelor's degrees is 500bps lower than that of Florida, we're skeptical that this business park will ever become a hotbed for high-paying tech manufacturing.³⁶

Venture Crossings	
GKN Aerospace	Harris
	
Source: Kerrisdale photographer, 3/15/18 (Wednesday, 3:30pm)	

We suspect bulls may not be following the latest developments at GKN. The company suffered management turnover following profit warnings last October and November, caused by problems in US aerospace manufacturing.³⁷ As a result of this turmoil, late last month GKN lost its fight against a hostile takeover by Melrose Industries, a turnaround specialist with a

³⁶ Florida Office of Economic and Demographic Research, December 2017. Bay County % of bachelor's degree or higher: 22.5%. Florida: 27.9%.

³⁷ [GKN Drops Incoming Chief Executive Before He Takes Up Role.](#)

reputation for improving troubled companies through aggressive “asset-stripping.”³⁸ It remains to be seen what impact the Melrose acquisition will have on the new facility in Bay County (at the very least, the pace of job creation appears at risk) but the situation highlights the undiversified, vulnerable nature of St. Joe’s commercial operations. Investor expectations should be tempered accordingly.

Finally, we spoke with an individual familiar with local development about St. Joe’s announced JVs for a 240-unit multi-family apartment complex and value-oriented chain hotel.³⁹ After factoring in development costs and JV economics, these projects simply will not move the needle for a \$1bn market cap company. In his view the deals are “meaningless” when it comes to driving true shareholder value.

New SEC Liquidity Rules Will Require Fairholme to Reduce Stake

New SEC rules that restrict investment in illiquid assets by registered open-end funds will act as a catalyst for the downward re-rating of St. Joe stock. Under these rules, an open-end fund, such as St. Joe’s largest shareholder, the Fairholme Fund, must “limit the fund’s investment in illiquid investments that are assets to no more than 15% of the fund’s net assets.” The rules define an “illiquid investment” as “any investment that a fund reasonably expects cannot be sold or disposed in current market conditions in seven calendar days or less without the sale or disposition significantly changing the market value of the investment.” Funds must be proactive in establishing liquidity management programs and reporting illiquid holdings to the Commission. Under new rule 30b1-10 and Form N-LIQUID, funds must “confidentially notify the Commission when the fund’s level of illiquid investments that are assets exceeds 15% of its net assets” within one business day of the occurrence.⁴⁰

Fairholme has a serious problem. As of January 26, 2018, St. Joe represented 24.4% of the Fairholme Fund’s net assets.⁴¹ The size of Fairholme’s stake, 22.7m shares, is 70x St. Joe’s 30-day trailing average trading volume. There is no credible way Fairholme can deem the position liquid. In fact, as shown below, The Fairholme Allocation Fund, part of the Fairholme series of funds and owners of less than \$8m worth of St. Joe stock, labeled the security illiquid. A similar footnote is curiously missing, however, from the Fairholme Fund which holds 22.7m shares worth over \$400m.⁴² According to a securities lawyer we spoke with, the omission constitutes a “disclosure and procedural error that is quite substantial and [Fairholme] may be violating their own rules. If I was a Fairholme investor, I would be contacting a lawyer.”

³⁸ [GKN Loses Fight. Engineering giant GKN sold to Melrose for £8bn.](#)

³⁹ St. Joe Company press releases on April 13, 2017 and October 26, 2017 for JVs with HomeCorp and InterMountain Management, respectively.

⁴⁰ SEC Rule 22e-4, [Investment Company Liquidity Risk Management Programs](#), p.1.

⁴¹ [2017 Fairholme Funds, Inc. Annual Letter](#), page i.

⁴² Ibid. See footnote “(b)” on p. 28 referencing the Fairholme Allocation Fund’s position in St. Joe. Per the footnote, “Security is deemed an illiquid security pursuant to the Funds’ liquidity guidelines.” This note is missing from the description of the St. Joe position for The Fairholme Fund on p. 12.

St. Joe is Clearly an Illiquid Security

THE FAIRHOLME ALLOCATION FUND

SCHEDULE OF INVESTMENTS
November 30, 2017

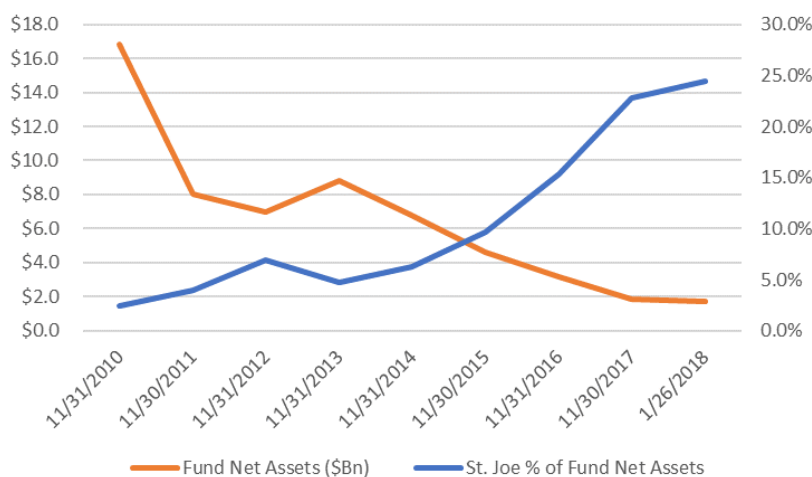
Shares	Value	Shares	Value
DOMESTIC EQUITY SECURITIES — 36.3%		RIGHTS — 0.0%	
REAL ESTATE INVESTMENT TRUSTS — 24.5%		METALS & MINING — 0.0%	
687,318 Seritage Growth Properties	\$ 27,973,843	2,239,153 Imperial Metals Corp., Expire 12/22/2017 ^(c)	\$ 43,389
REAL ESTATE MANAGEMENT & DEVELOPMENT — 6.9%		TOTAL RIGHTS (COST \$0)	43,389
426,748 The St. Joe Co. ^{(a)(b)(c)(d)}	7,835,093	WARRANTS — 0.2%	
426,748 The St. Joe Co.		08/08/2017-09/05/2017	\$ 8,066,747
			\$18.36

^(b) Security is deemed an illiquid security pursuant to the Funds' liquidity guidelines.

Source: 2017 Fairholme Funds, Inc. Annual Report.

Fairholme Fund net assets at the end of January were \$1.7bn, down from \$2.2bn six months earlier and \$16.8bn in 2010.⁴³ According to Morningstar Research, the fund has endured outflows every month since March 2011.⁴⁴ Over the last 5 years, the Fairholme Fund has underperformed the S&P 500 by a staggering -75%.⁴⁵ Given the unrelenting redemptions, a once manageable position in St. Joe has now become an irresponsibly large one. Like most open-end funds, the fund must honor redemptions within three days.⁴⁶ The new SEC rules were implemented precisely to avoid this set of circumstances and reduce the risk an underperforming fund is unable to meet its redemption obligations.

St. Joe as a % of the Fairholme Fund Net Assets



Source: Fairholme Fund Annual Letters. Data as per fund's fiscal year end, November 30th.

⁴³ [2010 Fairholme Funds, Inc. Annual Letter](#). Net assets as of November 30, 2010 were \$16.8bn.

⁴⁴ Morningstar Analyst Report, March 5, 2018.

⁴⁵ Bloomberg.

⁴⁶ The Fairholme Fund Prospectus, March 29, 2018.

Fairholme Fund (FAIRX) NAV vs. S&P 500



Source: Bloomberg.

The Fairholme Fund continues to underperform and is down -8% year-to-date. Below are price charts for Fairholme's top 4 equity holdings excluding St. Joe, all of which have struggled:

Fairholme Fund Top Equity Holdings⁴⁷

Federal Home Loan Mortgage Corp.



Federal National Mortgage Association



Sears Holdings



Seritage Growth Properties



Source: Bloomberg.

This is hardly an inspiring portfolio. Senior investment professionals are not sticking around to see things out. The Director of Research at the fund's adviser, Fairholme Capital Management, left the firm last December after 6 years, joining two analysts who left in the second half of 2017.⁴⁸ The recent performance of the fund means redemptions will likely continue. As of January 26, 2018, 25.9% or \$440m of the fund was held in cash and equivalents. According to Morningstar, net assets at the end of February had further shrunk to \$1.6bn.⁴⁹ The pace of net

⁴⁷ As of November 27, 2017, Fairholme owned \$479m of preferred equity securities in Federal Home Loan Mortgage Corp (FMCC) and Federal National Mortgage Association (FNMA). The graphs shown are of the largest issues Fairholme owns, FMCC Series Z and FNMA Series S, which combined constitute 85% of the total position.

⁴⁸ Fairholme's Morningstar Analyst Rating is Cut to Negative report, March 1, 2018.

⁴⁹ *Ibid.*

asset erosion implies that cash on hand will be exhausted within 6 months, unless further investments are liquidated. According to Morningstar, from 2011 to 2015, Berkowitz raised cash to meet redemptions by selling liquid stocks like AIG, Bank of America, and Berkshire Hathaway. The portfolio no longer holds any similarly liquid stocks.⁵⁰ Fairholme's predicament is getting worse by the day.

We estimate that the St. Joe stake is now over 27% of the Fairholme Fund, up from the 24.4% reported at the end of January, because of declines in core holdings suffered in February and March. The compliance deadline for the liquidity-related provisions of the new SEC rules is December 1, 2018.⁵¹ Fairholme must be under the 15% threshold by this date or promptly notify the SEC and the fund's Board of Directors of a breach. Within one business day, the fund must explain the extent and causes of the breach to the Board and how it plans to be at or below 15% within a reasonable period of time. If the amount is above 15% of net assets 30 days from the occurrence (and at each consecutive 30-day period thereafter), Fairholme's Board must assess whether the plan presented continues to be in the best interest of the fund.⁵² We estimate that in order to be in compliance, Fairholme must reduce its stake by at least 12% of current net assets, an amount equivalent to \$180m or roughly 10m shares. We estimate the hypothetical disposal of 10m shares would take over 150 trading days without affecting share prices.⁵³

Market-based solutions are complicated, however, by Fairholme's status as a St. Joe insider and affiliate.⁵⁴ Berkowitz is Chairman of St. Joe's board and two Fairholme directors also sit on the board of St. Joe.⁵⁵ Fairholme is therefore subject to insider trading rules that govern the timing and conditions under which it can sell shares when in possession of material, non-public information. As an affiliate of St. Joe, the number of equity securities Fairholme may sell during any three-month period cannot exceed the greater of 1% of shares outstanding or the average reported weekly trading volume during the four weeks preceding the filing of a Form 144 notice of sale.⁵⁶ The average weekly trading volume over the last four weeks is roughly 1.5m shares, meaning it would take 6 quarters for Fairholme to reduce the position to an acceptable level.

As a result, there are simply not enough trading days for Fairholme to avoid non-compliance with the rule. Insider trading restrictions apply even if Fairholme wished to sell part of its stake in any non-market, negotiated transaction to an interested party. St. Joe could also be breaching its fiduciary duty if it used the cash resources held for the benefit of *all* its shareholders to assist a single, large, affiliated shareholder address an SEC violation not of St. Joe's own making. Fairholme and St. Joe have created a mess. The investor bases of both St. Joe and Fairholme have been placed at risk, and both companies have exposed themselves to litigation. As a

⁵⁰ Morningstar Analyst Rating Report, February 27, 2018.

⁵¹ SEC File No. S7-03-18. [Investment Company Liquidity Risk Management Programs](#). Fairholme, at present, meets the definition of a "larger entity" defined as funds with net assets of \$1 billion or more. Certain reporting and disclosure requirements will go into effect June 1, 2019 for larger entities or December 1, 2019 for smaller.

⁵² [Investment Company Liquidity Risk Management Programs](#), p.237.

⁵³ Assumes Fairholme limits selling to 20% of 30d average daily volume of 290k.

⁵⁴ St. Joe 2017 Form 10-K. "FCM and its client The Fairholme Fund, a series of the Fairholme Funds, Inc., may be deemed affiliates of the Company."

⁵⁵ *Ibid.*, "Both Mr. Cesar Alvarez and Mr. Howard Frank are members of the Company's Board and also serve as directors of Fairholme Fund, Inc."

⁵⁶ [Rule 144: Selling Restricted and Controlled Securities](#).

former SEC Enforcement Division lawyer said to us, “Berkowitz should just call it a day and leave the country.”

Fairholme’s violation will not go unnoticed. Unlike insider trading or accounting fraud which can be difficult to determine and detect, Fairholme must notify the SEC on Part B of Form N-LIQUID within one business day of being in violation.⁵⁷ Compared to the massive volume of corporate filings made daily, the Commission staff estimates it would receive on average only 30 reports per year filed in response to funds breaching the limit.⁵⁸ The notification of an obvious violation, involving a well-known fund manager, under the exact conditions for which the rules were designed means the likelihood of enforcement action is material.

There are no grandfathering provisions or exemptions that allow Fairholme to avoid the rule or find a way out of its “Catch-22” predicament. Furthermore, there is no reason to think the Commission will waive any of its rules prohibiting insider trading or its rules regarding volume limitations (or otherwise bend its rules to accommodate Fairholme’s self-made problem). According to the former Senior Counsel in the SEC’s Enforcement Division that we spoke to, “Volume restrictions and prohibitions on insider trading very well may preclude Fairholme from complying with the new limitations on illiquid holdings. But, the problem is of Fairholme’s own making; such a predicament does not excuse non-compliance with any other SEC regulation, old or new.” The SEC, St. Joe, and Berkowitz have crossed paths in the past. In 2011, Fairholme and Berkowitz were investigated by the SEC as part of a broader investigation into St. Joe’s real estate accounting practices.⁵⁹ In October 2015, the SEC charged the St. Joe company and several former top executives with failing to take required write-downs of properties negatively affected by the financial crisis. St. Joe agreed to pay \$2.75m to settle the [charges](#). As a result, we have been advised that the SEC will treat the parties involved as repeat offenders, reducing the likelihood the SEC will grant leeway in resolving the breach.

Based on multiple conversations with securities lawyers, we believe Fairholme’s best option is to take steps to distance itself from St. Joe. Berkowitz and the two other directors that also sit on St. Joe’s board must step down. This would possibly ease insider and affiliate trading restrictions and allow for a more reasonable disposition of St. Joe shares. It would also, however, send a distinctly negative signal to the market, and we believe that St. Joe’s share price will not go unscathed.

According to the new rules, failure by a fund to maintain a sufficiently liquid portfolio, “calls into question the fund’s ability to fulfill the representations (explicit or implicit) made in its prospectus regarding its ability to meet obligations... such failure thus potentially exposes the fund, the investment adviser that manages the fund, and the persons responsible for the sale of the fund’s securities to the possible application of the antifraud provisions of the securities laws...”⁶¹ In the event Fairholme and its investment advisers fail to demonstrate reasonable compliance with the rules, the SEC can place the fund in receivership and assume control of unwinding the position.

⁵⁷ SEC Rule 22e-4, [Investment Company Liquidity Risk Management Programs](#). See Rules as to Use of Form N-LIQUID, p. 454.

⁵⁸ *Ibid.*, p. 420.

⁵⁹ St. Joe Form 8-K, July 1, 2011.

⁶¹ [Investment Company Liquidity Risk Management Programs](#), p.21.

Time is running out for the Fairholme Fund. An investment strategy of concentrated positions in illiquid assets is an inherent mismatch when operating a fund with daily liquidity. New SEC rules will correct this mismatch and force Fairholme to either limit an investment that has gotten out of control, or cease operating as an open-ended fund. Until the situation is resolved, St. Joe's shareholders are at risk and the stock faces a material overhang.

St. Joe's Core Operations are Unprofitable

St. Joe exhibits abysmally poor earnings quality. For a company that is ostensibly in the business of real estate development, St. Joe has recorded a grand total of negative \$(2)m in operating income over the last three years. Reported net income has been buoyed by one-time investment gains and investment income from a portfolio of non-investment grade corporate debt and preferred securities. Strip away these contributions and despite years of cost cutting and a gradually improving real estate market, St. Joe's core operations still do not generate meaningful cash.

St. Joe's Real Estate Operations Do Not Generate Income or Cash Flow			
	2015A	2016A	2017A
Reported Operating Income	(\$6.1)	\$2.0	\$2.3
Investment Income, Net	\$22.7	\$17.8	\$35.4
Gain on Sale	5.3	0.8	10.7
Interest and Dividend Income	7.0	6.6	16.4
Reported Cash from Operations (CFO)	\$22.4	\$12.9	\$55.8
Less: Capex	(17.5)	(12.9)	(39.9)
Free Cash Flow	\$5.0	\$0.0	\$15.9
Less: Interest and Dividend Income ⁽¹⁾	(5.6)	(5.3)	(13.1)
Free Cash Flow from Real Estate	(\$0.6)	(\$5.3)	\$2.8

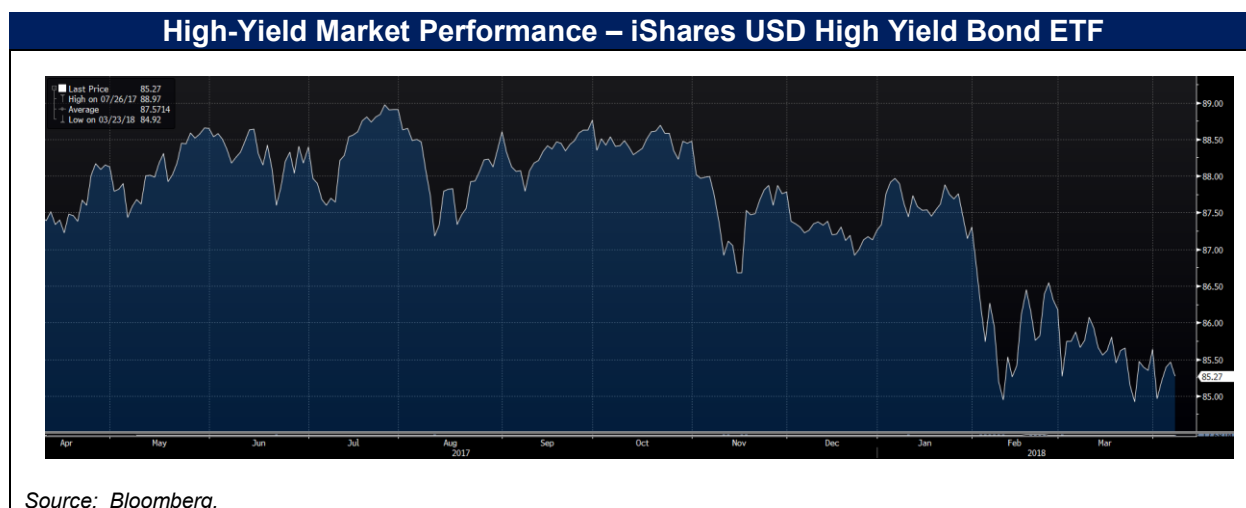
Source: St. Joe 2017 SEC Form-10k.
1. Deducts after-tax benefit of interest and dividend income at assumed 20% tax rate.

St. Joe has funded cash burn by shifting its shrinking investment portfolio more aggressively over time to junk bonds with an implied average yield in the mid-teens.

St. Joe Investment Portfolio							
	2015A	2016A	1Q17	2Q17	3Q17	4Q17	2017A
Investments:	\$191.2	\$175.7	\$175.6	\$167.7	\$145.2	\$111.3	\$111.3
Non-Investment Grade Corporate Debt	6.3	139.1	132.8	96.0	101.5	66.4	66.4
Non-Investment Grade Preferred Stock	0.2	36.6	41.0	40.3	33.7	35.0	35.0
Treasuries	184.7	0.0	0.0	24.9	10.0	9.9	9.9
Common Stock	0.0	0.0	1.8	6.5	0.0	0.0	0.0
Interest and Dividend Income	\$7.0	\$6.6	\$4.5	\$4.0	\$4.4	\$3.4	\$16.4
Less: Assumed Income from Preferred Stock ⁽¹⁾	(0.0)	(2.0)	(0.6)	(0.6)	(0.5)	(0.5)	(1.9)
Interest Income from Non-Investment Corporate Debt	7.0	4.6	4.0	3.5	4.0	2.9	14.5
Implied Annual Yield of Non-Investment Grade Debt	11.7% 12.1% 16.1% 13.8%						

Source: St. Joe 2017 SEC Form-10k.
1. Assumes 5.5% interest rate on preferred stock.

This strategy is obviously not without risk and St. Joe has recently taken steps to reduce its exposure to non-investment grade securities following losses. In 4Q17, the company slashed non-investment grade holdings to \$66m from \$102m the quarter prior and recorded a \$2.3 impairment.⁶⁰ Interest income will be reduced in the coming year and more impairments may be forthcoming given how the high-yield market has performed year-to-date:



Investors who have taken comfort in the share buybacks conducted by the company over the last several years should remember that cash came about only because of the 2013 land sale. The company does not generate recurring organic cash flow nor will it any time soon. Declining cash on the balance sheet has been spent on buybacks in an act of pure financial gimmickry. If capital expenditures rise, cash flow will be pressured, and the company will have to curb its buyback activity. A stock price aided by buybacks will then shift to trading on the fundamentals of a company with no record of generating reliable profits.

Investors in St. Joe aren't buying a stream of quality income producing properties. As shown earlier in this report, the contribution from new real estate initiatives are decades from justifying the current stock price. Investors who wish to gain exposure to real estate public equities have a plethora of attractive options, many with a history of creating value for shareholders and paying attractive dividends as reward for their patience. An investment in St. Joe provides none of those things.

Lack of Transparency and Conflicts of Interest

In reviewing the public filings and transcripts we were struck by the company's secretive nature and how poor the company's disclosures have grown over time. It's bizarre that a publicly-traded company which presumably wants investors to buy into the merits of an attractive development plan, and a large shareholder that could clearly use better marketing of its best

⁶⁰ Per St. Joe 2017 SEC Form 10-K, "During 2017, the Company determined that unrealized losses related to its corporate debt securities and preferred stock were other-than-temporary and recorded an impairment of \$2.3 million for credit-related loss in investment income, net in the Company's consolidated statements of operations."

idea, doesn't host quarterly calls. It should concern investors that basic information such as a summary of land-use entitlements, produced annually by the company until 2011, is no longer included in the annual report.⁶¹ A simple breakdown of residential homesite sales between Primary and Resort, provided in quarterly financials in 2017, was removed in the 10-K. More concerning is the investment portfolio that accounts for much of St. Joe's net income.

In a clear conflict of interest, St. Joe's investment portfolio is managed under an agreement with Fairholme Capital Management and Fairholme Trust Company, both in turn managed by Berkowitz.⁶² An example of the negative consequences of this entanglement is that St. Joe likely lost money investing in Sears, a company the Fairholme Fund owned 11% of last year and Berkowitz sat on the board of until October 2017.⁶³ Given the concentrated and overlapping nature of investments within the Fairholme series of funds, investors should demand greater disclosure of what other potential conflicts of interest Berkowitz has subjected St. Joe shareholders to. For example, there is no granular disclosure of the \$35m of non-investment grade preferred securities owned by St. Joe. Can one be confident that this large preferred holding does not in part mirror Fairholme's large, poorly performing preferred equity investments in Federal National Mortgage Association and Federal Home Loan Mortgage Corp.?⁶⁴ Fairholme's largest positions in these companies are down -23% and -21%, respectively, year-to-date. Is the company responsibly recording impairments or aggressively interpreting accounting rules? Recall, St. Joe is a company with a [checkered past](#) when it comes to properly valuing assets and has been fined once before by the SEC for actions that "deprived investors of critical information with which to make informed investment decisions."

⁶¹ See St. Joe 2011 SEC Form 10-K, Summary of Land-Use Entitlements, p. 6.

⁶² St. Joe 2017 SEC Form 10-K, Note 4 – Investments.

⁶³ [2017 Fairholme Fund Semi-Annual Letter](#), p.iii states Sears Holdings Corp. represented 11.2% of net assets as of June 30, 2017. Per St. Joe 2017 SEC Form 10-K, Note 4 – Investments, "On October 14, 2017, Mr. Berkowitz notified Sears Holdings Corporation that effective October 31, 2017, he would step down from their board of directors. Per St. Joe 3Q17 SEC Form 10-Q, the company owned \$9.4m in Sears corporate debt and preferred.

⁶⁴ [2017 Fairholme Funds, Inc. Annual Report](#), p. 12. As of November 27, 2017, Fairholme owned \$479m of preferred equity securities in Federal Home Loan Mortgage Corp and Federal National Mortgage Association.

III. Valuation

Sum-of-Parts Net Asset Value

St. Joe derives value from 3 primary sources: Net cash and investments on the balance sheet, the Bay-Walton Sector Plan, and the value of its current leasing business. The company's remaining inventory of rural acreage and the present value of ~4,000 homesites round out our sum-of-parts for the company. We value St. Joe at roughly \$10.50, -42% from current trading levels.

St. Joe Sum-of-Parts Net Asset Value			
Net Asset Value (NAV)	12/30/2017	per Share ⁽⁸⁾	% of Total
Net Cash / Other Bal. Sheet Assets ⁽¹⁾	\$189	\$2.89	27%
Bay-Walton Sector Plan ⁽²⁾	172	\$2.64	25%
Leasing/Operating Assets ⁽³⁾	146	\$2.23	21%
Rural Acreage @ \$1,500/Acre ⁽⁴⁾	90	\$1.38	13%
SouthWood ⁽⁵⁾	47	\$0.71	7%
Breakfast Point and Watersound Origins ⁽⁶⁾	28	\$0.43	4%
Windmark JV (Gulf) ⁽⁷⁾	17	\$0.26	2%
Total Net Asset Value	\$688	\$10.53	100%
Discount to Current Share Price		(42%)	

Source: St. Joe 2017 SEC Form 10-K, Kerrisdale estimates.

- \$303m of cash and investments less \$10m spent on share repurchases subsequent to Dec. 31, 2017, less \$56m of total debt and \$49m of net other liabilities.
- See Bay-Walton Sector Plan Discounted Cash Flow Analysis.
- 2018E \$15m of lease operating revenue less \$5m of allocated SGA at 7% cap rate.
- Assumes 60k acres at \$1,500 per acre, in-line with value per acre of St. Joe's 2014 timberland sale.
- 1,900 homesites, \$70k per homesite, 35% present value factor.
- 800 homesites, \$100k per homesite, 35% present value factor.
- 1,300 homesites, \$75k per homesite, 35% present value factor.
- 65.3m shares based on December 31, 2017 shares outstanding less 564k repurchased through Feb 26, 2018 as per Note 15 of St. Joe 2017 SEC Form 10-K.

Bay-Walton Sector Plan Discounted Cash Flow Analysis

Our discounted cash flow analysis of the Bay-Walton Sector Plan entitlements is modeled after the approach used by the lone Wall Street real estate analyst who covers St. Joe. The key differences are a more gradual approach to attaining robust annual homesite sales and treating commercial entitlements as if St. Joe will invest in developing the land for leasing purposes rather than selling acreage. Note, the analysis assumes sustained pricing and volume growth for 10 years in the case of residential entitlements and 20 years for commercial. The analysis never assumes pricing or volume declines for 50 years despite the high likelihood of a downturn at some point during the projection period. We estimate the total present value of cash flows to be roughly \$172m, which is incorporated into the total NAV for the company on the preceding page.

Bay-Walton Sector Plan Discounted Cash Flow Analysis

Period	Year	Residential						Commercial Leasing ⁽⁴⁾		Corporate	Taxes ⁽⁵⁾		PV
		Homesites	Avg. Lot Price ⁽¹⁾	Revenue	Selling Cost ⁽²⁾	Dev. Cost per Lot ⁽³⁾	Dev. Cost (\$)	Sq. Ft.	Ann. Cash Flow		FCF	of FCF ⁽⁶⁾	
1	2019	50	\$61	\$3	(\$0)	\$25	(\$1)	130,000	(13)	(\$12)	\$1	(\$22)	(\$20)
2	2020	100	\$62	\$6	(\$0)	\$26	(\$3)	260,000	(12)	(\$12)	\$0	(\$21)	(\$18)
3	2021	200	\$63	\$13	(\$1)	\$26	(\$5)	390,000	(12)	(\$12)	(\$1)	(\$19)	(\$14)
4	2022	400	\$64	\$26	(\$1)	\$27	(\$11)	520,000	(12)	(\$13)	(\$4)	(\$14)	(\$10)
5	2023	600	\$65	\$39	(\$2)	\$27	(\$16)	650,000	(11)	(\$13)	(\$6)	(\$10)	(\$6)
6	2024	800	\$67	\$53	(\$3)	\$28	(\$22)	780,000	(11)	(\$13)	(\$9)	(\$5)	(\$3)
7	2025	1,000	\$68	\$68	(\$3)	\$28	(\$28)	910,000	(10)	(\$14)	(\$12)	\$1	\$0
8	2026	1,300	\$69	\$90	(\$5)	\$29	(\$37)	1,040,000	(10)	(\$14)	(\$17)	\$8	\$4
9	2027	1,690	\$71	\$120	(\$6)	\$29	(\$50)	1,170,000	(9)	(\$14)	(\$22)	\$18	\$8
10	2028	2,197	\$72	\$159	(\$8)	\$30	(\$66)	1,300,000	(9)	(\$14)	(\$30)	\$32	\$12
11	2029	2,250	\$74	\$166	(\$8)	\$30	(\$69)	1,430,000	(8)	(\$15)	(\$32)	\$35	\$12
12	2030	2,250	\$75	\$169	(\$8)	\$31	(\$70)	1,560,000	(8)	(\$15)	(\$32)	\$36	\$12
13	2031	2,250	\$77	\$173	(\$9)	\$32	(\$71)	1,690,000	(7)	(\$15)	(\$33)	\$38	\$11
14	2032	2,250	\$78	\$176	(\$9)	\$32	(\$73)	1,820,000	(6)	(\$16)	(\$34)	\$39	\$10
15	2033	2,250	\$80	\$180	(\$9)	\$33	(\$74)	1,950,000	(5)	(\$16)	(\$34)	\$41	\$10
16	2034	2,250	\$81	\$183	(\$9)	\$34	(\$76)	2,080,000	(5)	(\$16)	(\$35)	\$43	\$9
17	2035	2,250	\$83	\$187	(\$9)	\$34	(\$77)	2,210,000	(4)	(\$16)	(\$36)	\$45	\$9
18	2036	2,250	\$85	\$191	(\$10)	\$35	(\$79)	2,340,000	(3)	(\$17)	(\$36)	\$46	\$8
19	2037	2,250	\$86	\$194	(\$10)	\$36	(\$80)	2,470,000	(2)	(\$17)	(\$37)	\$48	\$8
20	2038	2,250	\$88	\$198	(\$10)	\$36	(\$82)	2,600,000	(1)	(\$17)	(\$38)	\$50	\$7
21	2039	2,250	\$90	\$202	(\$10)	\$37	(\$84)	2,600,000	19	(\$18)	(\$38)	\$72	\$10
22	2040	2,250	\$92	\$206	(\$10)	\$38	(\$85)	2,600,000	20	(\$18)	(\$39)	\$73	\$9
23	2041	2,250	\$94	\$210	(\$11)	\$39	(\$87)	2,600,000	21	(\$19)	(\$40)	\$75	\$8
24	2042	2,250	\$95	\$215	(\$11)	\$39	(\$89)	2,600,000	21	(\$19)	(\$41)	\$77	\$8
25	2043	2,250	\$97	\$219	(\$11)	\$40	(\$90)	2,600,000	22	(\$19)	(\$42)	\$78	\$7
26	2044	2,250	\$99	\$223	(\$11)	\$41	(\$92)	2,600,000	23	(\$20)	(\$42)	\$80	\$7
27	2045	2,250	\$101	\$228	(\$11)	\$42	(\$94)	2,600,000	23	(\$20)	(\$43)	\$82	\$6
28	2046	2,250	\$103	\$232	(\$12)	\$43	(\$96)	2,600,000	24	(\$20)	(\$44)	\$84	\$6
29	2047	2,250	\$105	\$237	(\$12)	\$44	(\$98)	2,600,000	25	(\$21)	(\$45)	\$86	\$5
30	2048	2,250	\$107	\$242	(\$12)	\$44	(\$100)	2,600,000	25	(\$21)	(\$46)	\$88	\$5
31	2049	2,250	\$110	\$247	(\$12)	\$45	(\$102)	2,600,000	26	(\$22)	(\$47)	\$90	\$5
32	2050	2,250	\$112	\$252	(\$13)	\$46	(\$104)	2,600,000	27	(\$22)	(\$48)	\$92	\$4
33	2051	2,250	\$114	\$257	(\$13)	\$47	(\$106)	2,600,000	28	(\$23)	(\$49)	\$94	\$4
34	2052	2,250	\$116	\$262	(\$13)	\$48	(\$108)	2,600,000	28	(\$23)	(\$50)	\$96	\$4
35	2053	2,250	\$119	\$267	(\$13)	\$49	(\$110)	2,600,000	29	(\$24)	(\$51)	\$98	\$3
36	2054	2,250	\$121	\$272	(\$14)	\$50	(\$112)	2,600,000	30	(\$24)	(\$52)	\$100	\$3
37	2055	2,250	\$123	\$278	(\$14)	\$51	(\$115)	2,600,000	31	(\$24)	(\$53)	\$103	\$3
38	2056	2,250	\$126	\$283	(\$14)	\$52	(\$117)	2,600,000	32	(\$25)	(\$54)	\$105	\$3
39	2057	2,250	\$128	\$289	(\$14)	\$53	(\$119)	2,600,000	33	(\$25)	(\$55)	\$107	\$3
40...	2058	2,250	\$131	\$295	(\$15)	\$54	(\$122)	2,600,000	33	(\$26)	(\$56)	\$110	\$2
...50	2068	2,250	\$160	\$359	(\$18)	\$66	(\$148)	2,600,000	43	(\$32)	(\$68)	\$136	\$1

Source: Kerrisdale estimates and analysis.

- 24% of average new home price of \$250k, 2% annual escalator.
- 5% of sales.
- Assumed \$25k per lot for all land preparation (clearing, excavation, etc.)
- 130k in annual leased square feet for 20 years. 60% NOI margin, 5.8% taxes, \$100 / sq. ft. development costs, \$17.00 / sq. ft. blended lease rate (Retail/Office/Industrial) based on published 2H17 CBRE rates for Panhandle market. Annual development costs financed 70% at 4.25% interest rate. 2% annual escalator for lease rates and development costs.
- 21% assumed federal corporate tax rate per St. Joe 2017 SEC Form 10-K.
- 10% discount rate.

IV. Conclusion

In a sense, the investment debate regarding St. Joe's value comes down to one key concept: time. How much time does it take for the gradual socio-economic improvement of rural land to translate into meaningful shareholder value for a real estate company? How long will it be before the much-delayed Bay-Walton Plan finally breaks ground? When will recurring earnings be impactful for a \$1bn company? These are important questions to ask because without a reasonable assumption for when and how these developments occur, one cannot determine whether an investment provides a satisfactory return or that it's merely speculative. It is our belief that, at the current price, no reasonable set of assumptions for St. Joe's land comes remotely close to meeting the requirements for a sound investment. Investors who view upside from here fail to see that even if the St. Joe's geographic area sees improvement, the benefits are incomprehensibly long-dated and the current starting valuation for the investment is far too high. As Berkowitz has admitted, his greatest failure as an investor is that he suffers from "premature accumulation."⁶⁵ Unfortunately, for Berkowitz, time is now running out. Investors have pulled the plug on the Fairholme Fund and new SEC liquidity rules will force his fund to reduce its stake. St. Joe investors who have based their investment on population growth and patience will come to realize the foundations of their thesis are built on nothing but sand.

⁶⁵ Bloomberg interview, June 19, 2017.

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