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STAR - Q4 2013 Istar Financial Inc Earnings Conference Call

EVENT DATE/TIME: FEBRUARY 20, 2014 / 3:00PM GMT

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CORPORATE PARTICIPANTS

Jason Fooks *iStar Financial Inc - VP of IR and Marketing*

Jay Sugarman *iStar Financial Inc - Chairman & CEO*

Dave DiStaso *iStar Financial Inc - CFO*

CONFERENCE CALL PARTICIPANTS

Michael Kim *CRT Capital Group - Analyst*

Jade Rahmani *Keefe, Bruyette & Woods - Analyst*

PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by and welcome to iStar Financial's fourth-quarter and FY13 earnings conference call.

(Operator Instructions)

As a reminder, today's conference is being recorded. At this time for opening remarks and introductions, I'd like to turn the conference over to Mr. Jason Fooks, Vice President of Investor Relations and Marketing.

Jason Fooks - *iStar Financial Inc - VP of IR and Marketing*

Thank you John, and good morning everyone. Thank you for joining us today to review iStar Financial's fourth quarter and FY'13 earnings report. With me today are Jay Sugarman, Chairman and Chief Executive Officer, and Dave DiStaso, our Chief Financial Officer.

This morning's call is being webcast at istarfinancial.com in the "Investor Relations" section. There'll be a replay of the call beginning at 12:30 PM Eastern time today. The dial-in for replay is 1-800-475-6701 with a confirmation code 319108.

Before I turn the call over to Jay, I'd like to remind everyone that statements in this earnings call which are not historical facts will be forward looking. iStar Financial's actual results may differ materially from these forward-looking statements, and the risk factors that could cause these differences are detailed in our SEC reports.

In addition, as stated more fully in our SEC reports, iStar disclaims any intents or obligation to update these forward-looking statements, except as expressly required by law. Now I'd like to turn the call over to iStar's Chairman and CEO, Jay Sugarman. Jay?

Jay Sugarman - *iStar Financial Inc - Chairman & CEO*

Thanks Jason, and thanks to those of you joining us this morning. Our fourth quarter saw continued signs of the steady progress we have been able to make on many fronts. Our investment activity was solid with over $200 million in fundings in the quarter, and another approximately $200 million in early January.

Our capital strength continued to grow, with lower cost refinancing and ongoing deleveraging, enabling us to sit at the low end of our leverage targets with overall debt cost well below prior quarters. We reenergized our net lease business by partnering with a sovereign wealth fund, giving us more clout on larger transactions and the ability to maintain diversity in our portfolio.

While we are still working hard to get overall earnings back to full profitability, we are pleased that the finance, net lease, and operating property segments all showed profitable metrics for the quarter and for the year. With several land developments expected to come online in 2014, we should be able to reduce the historical losses in that segment and start seeing some level of return on the capital we have invested there over the past few years.

Let me do a brief overview of our various business lines. In real estate finance, increased investment activity helped put some of our large cash balances to work, with transactions in Chicago and New York City accounting for the bulk of the activity, and the January closing of a large development loan in Times Square giving us further momentum. Segment profit increased to $10.8 million from $5.9 million last quarter, and to $23.5 million for the year versus $11.1 million last year.

In net lease, the big news was obviously the closing of our $500 million joint venture with a sovereign wealth fund. Combining our long-standing track record as the leader in the net lease industry with the increased financial strength our partner provides, we expect our net lease team to be able to cast their net further and wider, and with an increased ability to tackle larger transactions. In fact, we closed on the first transaction for that venture in December, a $94 million investment backed by a 12-year investment-grade lease in a top-notch location with future development potential. Segment profit was $9.8 million for the quarter, an increase from $8.6 million last quarter; while full year was $38.2 million versus $59.2 million in the prior year.

Profit in the operating portfolio was below last quarter, primarily due to a gain from the sale of a commercial property last quarter and some year-end cost items. Segment profit was $5.5 million versus $17.5 million last quarter, and $73.4 million for the full year versus $10.7 million last year.

Lastly, the land team is beginning to gain approvals to begin construction on several projects, which we highlighted in the press release. While we'll continue to take time to extract value out of this portfolio, it feels good to start seeing some of the projects beginning to gain momentum and head into production.

We'll have more to talk about in this portfolio throughout the year, but for now the quarterly drag remains stiff, with segment loss this quarter $22.6 million versus $19.1 million last quarter, and a loss of $75.5 million for the full year versus $80.8 million last year. Let me turn it over to Dave now to review the numbers for the quarter in more detail. Dave?

Dave DiStaso - *iStar Financial Inc - CFO*

Thanks Jay, and good morning, everyone. Let me begin by discussing our financial results for the fourth quarter and full year 2013, as well as capital markets activities, before moving on to discuss investments and the performance of our business segments.

For the quarter, our adjusted income was a loss of $19 million, or $0.23 per common share, compared to a loss of $23 million, or $0.28 per common share, for the same quarter last year. One of the main drivers of the improvement in adjusted loss was a $22 million decrease in interest expense resulting from lower debt levels, combined with our ability to refinance outstanding debt at lower rates throughout the period.

Also, the fourth quarter of 2012 included $23 million of cash underwriting and prepayment fees associated with our bank facility refinancing and note issuances. These items were partially offset by lower earnings from equity method investments, as our prior-year period included $24 million associated with LNR, which was sold earlier this year. In addition, our strong pace of condominium sales at certain luxury projects have approached sellout, reducing our overall inventory and resulting in $13 million less income from sales of residential properties compared to the prior year.

Our net loss allocable to common shareholders for the quarter was $58 million, or $0.68 per diluted common share, compared to a loss of $87 million, or $1.04 per diluted common share for the same period last year. In addition to the drivers I mentioned before, the year-over-year improvement was the result of a $12 million reduction in our provisions, impairments, and loss on transfer to venture. The prior period also included $12 million of non-cash loss on early extinguishment of debt associated with refinancing transactions.

For the full year 2013 we reported an adjusted loss of $22 million, or $0.26 per diluted common share, compared to a loss of $54 million, $0.64 per diluted share, in 2012. The improvement was driven by several factors, including a reduction in interest expense of $89 million, as our debt balance decreased by over $1 billion and our weighted average cost of debt declined approximately 60 basis points as a result of several refinancing transactions.

In addition, operating lease income increased by $18 million, due to additions to our operating properties portfolio as well as releasing activities, while gains recorded on the sale of our condominium assets increased by $23 million above the prior year. This was partially offset by a $25 million decrease in interest income due to a smaller overall loan portfolio, and $61 million less of earnings from equity method investments, primarily as a result of a sale of LNR, as well as the sellout of our Paramount Bay condominium venture.

During the fourth quarter, we issued at par $200 million of 1.5% convertible senior notes due November 2016, which convert into shares of our common stock at an initial conversion price of $17.29. We used the net proceeds from this offering, along with cash on hand, to redeem the remaining $201 million of our 5.7% senior unsecured notes due March 2014 and to pay a $2 million prepayment fee.

Concurrent with this offering, we also repurchased 1.7 million shares of our common stock with cash on hand at the prevailing market price of $12.35 per share. At December 31, 2013 we had $29 million remaining under our share repurchase program.

Additionally, we repaid $97 million on our 2013 secured credit facility during the quarter, bringing the remaining balance to $1.4 billion at the end of the quarter. We also repaid $8 million on our 2012 secured credit facility, bringing that remaining balance to $432 million at year end.

Overall in 2013, we closed five capital markets transactions, including repricing our larger secured credit facility, issuing several series of unsecured and convertible notes to reduce our cost of debt and extend our maturity profile, and as well as raising convertible preferred equity to provide us additional growth capital. As a result of these transactions, our weighted average cost of debt for the fourth quarter improved to 5.7% from 6.5% for the same period last year. In addition, we reduced our leverage to 2x at December 31, 2013, down from 2.5x at the end of 2012, and at the low end of our targeted range of 2.0x to 2.5x.

Let me now turn to investment activity in our real estate and loan portfolios. We invested $218 million during the fourth quarter, including $159 million of new investment originations committed during the quarter.

We have been ramping up our origination activity, and over the past nine months, including January 2014, we have closed approximately $750 million of new investments and financing commitments. We generated $164 million of proceeds from our portfolio this quarter, which included $78 million from repayments and sales of loans in our real estate finance portfolio, $49 million from sales of operating properties, and $37 million in proceeds across other segments.

After giving effect to the investment funding and venture contribution we made in January of 2014, we had approximately $400 million of cash, which we'll use primarily to fund future investment activity. At December 31, 2013, our total portfolio had a carrying value of $5.2 billion, gross of $425 million of accumulated depreciation, and $29 million of general loan loss reserves.

Let me discuss each of our four business segments. Our real estate finance portfolio totaled $1.4 billion at the end of the quarter. This includes approximately $1.2 billion of performing loans that had a weighted average LTV of 72% and a weighted average maturity of just under three years.

They were comprised of $619 million of first mortgages or senior loans and $576 million of mezzanine or subordinated debt. The performing loans generated a weighted averaged effective yield for the quarter of 8%.

At the end of the quarter we had $204 million of NPLs, a reduction of 60% from the $503 million of NPLs we had at the end of last year. Our remaining NPLs are mainly comprised of 38% entertainment/leisure, 37% land, and 13% retail.

For the quarter, we recorded $100,000 of loan loss provisions compared to a provision of [$21 million] (corrected by company after the call) for the fourth quarter of 2012. For the full year, our loan loss provision was $5.5 million, a significant reduction from $82 million of provisions recorded in 2012.

Our total reserve from loan losses at the end of 2013 was $377 million, consisting of $348 million of asset-specific reserves and $29 million of general reserves. We expect that the rate of provisions and the level of NPLs will continue to fluctuate.

Now let me provide a brief update on certain key metrics relating to our net lease portfolio. At the end of the quarter, we had $1.7 billion of net lease assets, gross of $339 million of accumulated depreciation.

Our net lease portfolio totaled 20 million square feet across 33 states. This portfolio was 94% leased at the end of the quarter, with a weighted average remaining lease term of 12 years. For the quarter, our total net lease portfolio generated an unleveraged weighted average effective yield of 7.5%.

Next I'll turn to our operating properties portfolio. Our operating properties totaled $965 million, gross of $82 million of accumulated depreciation.

The portfolio was comprised of $742 million of commercial and $223 million of residential real estate properties. Over the past year we sold $270 million of residential assets and $92 million of commercial properties, which resulted in $101 million of gains. We saw a net reduction in this portfolio by approximately $200 million from a balance of $1.2 billion at the end of last year.

The commercial properties represent a diverse pool of real estate assets across a broad range of geographies and property types such as office, retail, and hotel properties. They generated $30 million of revenue offset the by $21 million of expenses during the quarter.

At the end of the quarter we had $135 million of stabilized commercial operating properties. These properties were 85% leased, resulting in an 8.3% unleveraged weighted average effective yield for the quarter.

The remaining $607 million of operating properties are transitional real estate properties that were 57% leased and generated a 2.7% unlevered weighted average effective yield for the quarter. We are continuing to actively lease these properties to maximize their value. During the quarter, we executed commercial operating property leases covering approximately 170,000 square feet.

The residential operating properties were comprised of 616 condominium units remaining in inventory at the end of the quarter. These units are generally located in projects characterized as luxury buildings in major cities throughout the United States. During the quarter, we sold 88 condos for $47 million in proceeds, resulting in $14 million of income, offset by $4 million of expense and a $6 million impairment.

That brings me to our land portfolio. At the end of the quarter our land portfolio totaled $965 million and included 11 master plan communities, 10 infill land parcels, and 6 waterfront land parcels. Master planned communities generally represent large-scale residential projects that we plan to entitle, plan, and develop. We currently have entitlements at these projects for more than 25,000 lots.

Our infill and waterfront parcels are currently entitled for 6,000 residential units, and select projects include commercial, retail, and office space. The projects in the portfolio are well diversified, with our largest exposures in California, the New York Metro area, Florida, and several markets in the Mid-Atlantic and Southwest regions.

During the quarter, we invested $16 million in our land portfolio through capital expenditures, and sold one bulk last asset in Hawaii for $15 million, recognizing a nominal gain. At the end of the quarter we had 5 land projects in production, 11 in development, and 11 in the predevelopment phase.

As Jay just discussed, and as we highlighted in our earnings release, we have made important headway on our land properties by partnering with both national and regional homebuilders and entering into several strategic ventures. We plan to continue those efforts in 2014, and are poised to accelerate development activities and capital investment in our land portfolio with the objective of further enhancing their value.

We look forward to updating you on our efforts and results this year. With that, let me turn it back to Jay. Jay?

Jay Sugarman - *iStar Financial Inc - Chairman & CEO*

Thanks, Dave. And as I hope you can see, we continue to be busy on all fronts. As Dave said, we'll look forward to providing additional information and spotlighting various projects and investments as they come to fruition throughout this year. Let's go ahead and open it up for questions, operator.

QUESTIONS AND ANSWERS

Operator

Certainly.

(Operator Instructions)

And first go to Michael Kim with the CRT Capital Group. Please go ahead.

Michael Kim - *CRT Capital Group - Analyst*

Thanks for taking my question. Nice quarter. I really appreciate the disclosure of the progress being made with specific assets in the portfolio. Jay, I guess my first question, I was just wondering if you could discuss the net lease venture with the sovereign wealth fund in more detail on several fronts.

I know you'll own about 52% of the venture. How much cash did iStar contribute to the venture? Can you provide any specifics on the promote and management fee, targeted yield through the venture, or any sort of ramp-up of assets being contributed?

I guess the ultimate strategy of the venture, will you target net lease assets with investment-grade tenants? How does it split between development versus acquisition of stabilized assets? And will there be an opportunity for iStar to actually contribute some of your own transitional properties to the venture as well?

Jay Sugarman - *iStar Financial Inc - Chairman & CEO*

Hello Michael, thanks. The venture is really intended to give us a little more flexibility about where we can go in the net lease market. As you know, we've struggled a little bit with some of the frothiness in that market, and we still see some opportunities that are either too concentrated or too big for us.

So we have been looking for the right partner for quite a while. I think we have a great partner now, very interested in the net lease business, in our capabilities there.

Pretty free form. I think -- the first deal was an investment-grade deal. It had a little piece of future development opportunity attached to it.

That's kind of in our wheelhouse. The returns are nice and solid, given where senior debt is pricing these days.

So I think from a return standpoint we are certainly looking to put money out in low- to mid-teens, long-term stable duration assets on a modestly levered basis. The partner is paying us a management fee and a promote.

I won't go into too many details there, but I think it's a great relationship for us long term. Not just in the net lease business, but it also gives us a partner who is quite interested in a lot of the other fronts that we're looking at actively.

So we hope it's a relationship that grows and builds, and certainly the net lease is going to be the core of it. But we're hoping it has the potential to expand in lots of other directions as well.

Michael Kim - *CRT Capital Group - Analyst*

Right. I appreciate that. And I guess shifting to the land side, with the venture with KB Home to jointly development the first phase of Spring Mountain Ranch, I guess could you describe that venture in a little bit more detail, and if it could be applicable to other land that you own?

I guess how many lots are in the first phase, or the timing of development, or even the economics of that venture? Is it more of a rolling-lot option contract? I guess how should we think about this in terms of the structure, and could that be applied to the other projects you have in the portfolio?

Jay Sugarman - *iStar Financial Inc - Chairman & CEO*

Good question. You know, I think the truth is, each one of these is bespoke. Depends on the market, depends on the property, depends on our business plan.

This is a large property in Riverside. It's over, I think it's about 1400 units. It works from some low elevations up into some hills where it's reasonable costly.

So we're having to put in quite a bit of infrastructure. And given the size of the community, we wanted to make sure it kicks off correctly, and certainly with the kind of velocity that will make future phases more valuable to us on an NPV basis.

As we looked around, KB is probably the best partner we could have found. The structure of the deal, they really met the two criteria we had, is one, they were willing it to put capital in side by side with us and two, they provided for a profit participation.

So we think the California market is one that has turned. We're actually seeing some pretty good activity across even some of the Inland Empire markets like Riverside.

So we want to play and keep our foot in the game. But we are very cognizant that velocity is a killer if you don't get it right.

And so KB is somebody who we think has done it right again and again in those local markets, and we wanted them on our team. So the way we'll structure these deals is going to be a little different.

This one has a lot of upfront infrastructure. So having a capital partner is important. In a lot of our other JVs, we won't need any capital partner. It will be much more about expertise, and there will be much less sort of upfront investment for, hopefully, a longer-term payout.

So this one's a little bit unusual. But again, the goal is to find the right partner in lots of different markets.

You will see us talk about deals in other markets throughout the year where there is a lot less capital equation and much more just getting the right partner who can steer the ship. And we'll probably be paying them some sort of promote in lieu of getting their capital.

So each one is going to be different, Michael. I think this one is the right kind of structure for this community. It encompasses about a third of the lot. They have quite a bit of money, but there is no force takedown.

Michael Kim - *CRT Capital Group - Analyst*

I see.

Jay Sugarman - *iStar Financial Inc - Chairman & CEO*

We think they think it's a very attractive community. They are putting their money where their mouth is.

We think they are in a position to help us build a very good entry to the rest of the community, and we look forward to working with them on a number of things, both in this project and elsewhere. So don't want you to think there is any single template, there isn't.

Each one is really a pretty sensitive mix between what our needs are and what our partner's needs are. But you will see us use this structure more often throughout the year.

Michael Kim - *CRT Capital Group - Analyst*

Okay.

Jay Sugarman - *iStar Financial Inc - Chairman & CEO*

In some cases, it's a value maximization game for us. We just want to extract the most profit we can. In other, we are just trying to increase velocity and get our money back.

So sometimes you'll see us try to get a very large participation. In other cases, we don't think the returns are going to be that interesting. We are just trying to get our capital back so we can redeploy it.

Michael Kim - *CRT Capital Group - Analyst*

Understood. I appreciate all the color, and keep up the good work. Thanks.

Jay Sugarman - *iStar Financial Inc - Chairman & CEO*

Thanks, Michael.

Operator

(Operator Instructions)

We'll go to Jade Rahmani with KBW. Please go ahead.

Jade Rahmani - *Keefe, Bruyette & Woods - Analyst*

Thanks for taking the question. On the investment pipeline, can you discuss what you are seeing in terms of opportunities and also competition? Any color on yields, LPVs, and deal types would be helpful.

Jay Sugarman - *iStar Financial Inc - Chairman & CEO*

Yes. I think the market is pretty active, both on the supply and the demand side. I think there is no shortage of capital, but it seems like it's really splitting into the commodity parts of the business, which we certainly can't compete in and don't -- we choose not to compete in.

But there is a big gulf between that business and some of the more entrepreneurial developers and borrowers out there who need sort of bespoke custom-tailored financing. As we've said in the past, we are gravitating to larger deals.

We certainly see the competitive landscape much thinner up there. The Blackstone's and the Starwood's, guys we've partnered with in the past. We certainly see them.

But that's an L +700 and above market. And to do that in size requires a lot of in-house capabilities and talent and experience, and there just aren't that many players who can reach up into those areas.

So you'll see us play up there. We are still seeing pretty good deal flow out of our existing customer base. So you see us continue to try to work that.

But I would say it's an active market. There is a pretty big shift going on as banks get ready for Basal 3, try to put themselves in the best position.

They are ceding parts of the market to folks like us, but they are being pretty strong and pretty aggressive on the parts of the market they do like.

So you've got a dance away from that capital and find where your strengths are. And we think we're starting to see where we can play and generate some pretty interesting returns.

Jade Rahmani - *Keefe, Bruyette & Woods - Analyst*

Thanks. Could you elaborate on your expectations around capital deployment? Do you view the pace of announced investment activity as sustainable? And do you expect to fund incremental opportunities solely from cash on hand and cash generation, or would you anticipate accessing the capital markets for growth capital?

Jay Sugarman - *iStar Financial Inc - Chairman & CEO*

Yes. Look, I think from a pacing standpoint, $100 million to $200 million a quarter is very doable and probably can be self-financed. But if we get up to the upper end of that range and don't do some things on the existing portfolio in terms of monetization, there is an opportunity to look to the markets to fund even it more incremental growth.

But I think we are going to let the opportunity set and the market guide us. If we see great opportunities that are valuable to the Company, we'll try to ramp up originations and then look inside our own portfolio for that capital, and if it's even beyond that, then we could certainly go to the outside world.

Right now, though, I would say $200 million per quarter. Probably that would stretch our internal resources. So if it gets much above that, we'll certainly be thinking about alternatives.

This land equation is a big one for us. How much money do we want to commit to that versus harvesting?

If the returns are good, we are going to keep investing in that portfolio. But I think that's one of the big question marks later in the year, is how much do we take off the table versus how much do we redeploy inside that business line? And that will probably govern some of our thinking.

Jade Rahmani - *Keefe, Bruyette & Woods - Analyst*

That's helpful. Just on the land book, I have just two questions. One is a clarification, I think in the way you described the land projects.

This quarter you disclosed 5 projects in production, 11 in development, and 11 in predevelopment totaling 27, which is different from last quarter's 6 in production, 12 in development, and 8 in predevelopment for a total of 26. So could you explain that change? And then also, just more broadly, if there is anything you are seeing on the housing market or land market that would change how you think about the outlook for that business?

Dave DiStaso - *iStar Financial Inc - CFO*

In relation to the land projects, there were some changes quarter over quarter. Notably, we sold the project in Hawaii, which was in production. So that was sold during the quarter.

Also, as Jay mentioned, Spring Mountain Ranch was broken into two. Phase 1 with our development activities was segregated into one piece, and Phases 2 and 3, which are not yet in production, were moved to a separate category. You will see shuffling amongst categories as things play out with the land portfolio.

Jade Rahmani - *Keefe, Bruyette & Woods - Analyst*

Okay, great. And just a follow-up on the outlook for the housing and land market?

Jay Sugarman - *iStar Financial Inc - Chairman & CEO*

It's interesting to us, the numbers came in pretty weak this quarter. We just think every quarter that supply stays constrained is going to be a good quarter down the road.

Rates have come in a little bit. So I think from an affordability standpoint, people are still nervous about how far and how fast.

We are not seeing a ton of impact from that. A little bit of a slowdown in certain markets that moved really fast as people adjust to the new pricing level, but affordability is still good from a historical standpoint.

Rates are very good from a historical standpoint. Supply is constrained from both a historical and recent history standpoint.

So I think other than a demand shock, we still see upward lift across most of the markets we're in. Certainly Southern California is one we're thinking is going to be quite good for us, Southern Florida, good for us.

We'll see what happens in the macro-economy throughout the year. As long as there are no big shocks, we think the trend is certainly still positive.

Jade Rahmani - *Keefe, Bruyette & Woods - Analyst*

Great. Thank you very much.

Operator

Mr. Fooks, no further questions in queue.

Jason Fooks - *iStar Financial Inc - VP of IR and Marketing*

Thanks, John, and thanks, everyone, for joining us this morning. If you should have any additional questions on today's earnings release, feel free to contact me directly. John, would you please give the conference call replay instruction once again? Thanks.

Operator

Certainly, yes. Ladies and gentlemen, the replay starts at 12:30 PM Eastern time, will last until March 6th at midnight. You may access the replay at any time by dialing 800-475-6701. The access code is 319108.

That number again, 800-475-6701. The access code, 319108. That does conclude your conference for today. Thank you for your participation. You may now disconnect.
