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STAR - Q2 2014 iStar Financial Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen and welcome to iStar Financial's second-quarter 2014 earnings conference call. (Operator Instructions). As a reminder, today's conference is being recorded. At this time for opening remarks and introductions, I would like to turn the conference over to Mr. Jason Fooks, Vice President of Investor Relations and Marketing. Please go ahead.

Jason Fooks - *iStar Financial Inc. - VP, IR & Marketing*

Thank you, John and good morning, everyone. Thank you for joining us today to review iStar Financial's second-quarter 2014 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 on our website at iStarFinancial.com in the Investor Relations section. There will be a replay of the call beginning at 12:30 PM Eastern time today. The dial-in for the replay is 1-800-475-6701 with a confirmation code of 331938.

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 on our SEC reports, iStar disclaims any intent or obligation to update these forward-looking statements except as expressly required by law. Now let's turn the call over to iStar's Chairman and CEO, Jay Sugarman. Jay?

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

Thanks, Jason. Thanks to everyone for joining us this morning. Our second quarter was a positive and profitable one as we began to realize on some of the heavy lifting done on a number of legacy investments and continue to position our balance sheet to be more flexible and better structured for our business moving forward. In addition, our investment activity remained steady as we selectively sought out new places to deploy our still sizable cash balances.

Let me do a brief review of our major business lines. In real estate finance, segment profit exceeded $33 million versus $9 million last quarter, benefiting from recent investment activity and improved outcomes on legacy NPL loans in the land and European portfolios. Yields on new investments were attractive as we continue to focus on areas where we believe we have competitive advantages.

In net lease, we committed to a new $200 million investment that is expected to close during the third quarter and will be part of the joint venture with our sovereign wealth fund partner. As a reminder, under that JV, iStar will fund just over half the investment with our partner funding the remainder. The transaction is with an existing customer in the bowling sector and gives us a mission-critical position in the capital structure of the dominant player in the industry. It comes with four-wall EBITDAR coverage of our rent of close to 3 to 1. Net lease segment profit for the second quarter was $10.3 million versus $11.3 million last quarter, reflecting primarily the timing and impact of transferring our AT&T investment into the JV last quarter.

Segment profit in the Operating Portfolio was $6.7 million versus $11.3 million in the first quarter. With fewer units remaining in inventory in the residential for sale segment, quarterly profits will naturally vary, but we are bringing on a new project in Waikiki that we expect to be a strong performer. The commercial segment also saw progress on certain assets with improved leasing prospects enabling us to take one of our industrial projects to market in the rapidly improving Oahu marketplace.

In our land portfolio, our East and West coast teams are both working to move projects into a position where we can start generating more meaningful revenues in 2015 and beyond. With sales in progress in only a handful of communities, segment loss was $16.6 million, slightly improved from $17.9 million last quarter. And with that, let me turn it over to Dave to review the numbers. Dave?

Dave DiStaso - *iStar Financial Inc. - CFO*

Thanks, Jay and good morning, everyone. Let me begin by discussing our financial results and capital markets activities for the second quarter before moving on to investments and the performance of our business segments. For the quarter, our adjusted income grew to $29 million, or $0.34 per common share, from $4 million or $0.05 per common share for the same quarter last year. There were several factors that contributed to the improvement in adjusted income. Revenues increased by $30 million, including $13 million of additional interest income related to new loan originations and the amortization of a discount on a loan approaching payoff, which was offset by the recovery of $7 million of interest on a nonperforming loan recognized in the prior year.

We also generated $16 million of incremental other income this quarter primarily associated with the sale of several nonperforming loans above their carrying value. Operating lease and land sales income contributed an aggregate $8 million of additional revenues year over year. Further, we generated $23 million of earnings this quarter from assets sold by one of our strategic investments versus $7 million of higher earnings from an individual fund in the prior-year quarter resulting in a $16 million net increase in earnings from equity method investments.

Interest expense was $13 million lower year over year due to a reduction of approximately $500 million in total weighted average debt outstanding, as well as our successful efforts to lower our cost of debt through multiple refinancings over the past year. The second quarter of last year also included a $12 million cash loss on early extinguishment of debt associated with debt refinancings. These improvements were partially offset by a $17 million less of income from sales of residential property as we continue to sell down our remaining inventory and a G&A expense increase of $7 million primarily relating to the timing of expense recognition for our performance-based compensation program. In addition, we recorded an $8 million gain from discontinued operations in the prior period.

Our net loss allocable to common shareholders for the quarter was $16 million, or $0.19 per diluted common share, compared to a loss of $26 million, or $0.31 per diluted common share for the same period last year. In addition to the reasons I described earlier, the year-over-year improvement in net loss included a reduction of $5 million in loan loss provisions and impairments, as well as the recognition this quarter of $23 million of previously incurred costs associated with the refinancing of our secured credit facility, which are included in loss on early extinguishment of debt.

During the quarter, we issued $1.3 billion of unsecured notes, including $550 million of 3.5 year notes at 4% and $770 million of five-year notes at 5%. We use the proceeds from the offering, together with cash on hand, to fully extinguish our 2013 secured credit facility. The transaction accomplished the key corporate goal of our long-term strategy to become primarily an unsecured borrower. The refinancing allowed us to reduce the percentage of secured debt outstanding to just 16% of total debt from 49% prior to the transaction. Having access to the unsecured markets, combined with a largely unencumbered balance sheet, provides us added financial flexibility.

Through the transaction, we were also able to unencumber $2 billion of collateral, which included more than $1.5 billion of net lease assets and performing loans. Furthermore, the transaction provides us with additional liquidity as we will now retain 100% of proceeds from the sales and repayments of these previously encumbered assets rather than directing them to repay the 2013 secured credit facility.

Our only remaining secured credit facility is our 2012 secured credit facility, which was paid down by $26 million during the quarter bringing the remaining balance to $392 million. Our weighted average cost of debt for the second quarter continued trending lower, decreasing to 5.5% from 5.6% for the first quarter of 2014 and down from 6% for the second quarter of last year. Our leverage remained flat at 2.1x from the first quarter of this year and still remains at the low end of our targeted range of 2.0-2.5x.

Let me now turn to investment activity in our real estate and loan portfolios. We invested $167 million during the second quarter, including $117 million of new originations and $50 million associated with ongoing developments and prior financing commitments. We generated $170 million of proceeds from our portfolio this quarter, which included $116 million from repayments of sales of loans in our real estate finance segment, $48 million from sales of operating properties and $7 million in proceeds across other segments. We ended the quarter with $357 million of cash, which we expect to primarily use to fund future investment activity.

At the end of the second quarter, our portfolio totaled $5.3 billion, which is gross of $443 million of accumulated depreciation and $31 million of general loan-loss reserves.

Let me discuss each of our four business segments. Our real estate finance portfolio totaled $1.5 billion at the end of the quarter. The portfolio includes approximately $1.4 billion of performing loans comprised of $727 million of first mortgages or senior loans and $666 million of mezzanine or subordinated debt. The performing loans generated a weighted average effective yield for the quarter of 8.5%, which excludes $5 million of interest income that we recognized in the quarter related to the amortization of a discount associated with a loan expected to repay in the short term.

At the end of the quarter, we had $94 million of nonperforming loans, a decrease of 54% from the $203 million at March 31. The resolutions during the quarter included sales of several NPLs for which we booked $19 million of gains above their carrying value. In addition, we took title to property with the intention of creating value through our operating property strategy and repositioning expertise.

For the quarter, we recorded a $3 million reversal of the loan-loss provision compared to a provision for loan losses of $5 million in the second quarter of 2013. Our total reserve for loan losses at June 30 was $138 million, comprised of $107 million of asset-specific reserves and $31 million of general reserves.

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 $1.6 billion of net lease assets gross of $352 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 more than 11 years. For the quarter, our total net lease portfolio generated an unleveraged weighted average yield of 7.7%.

Next, I will turn to our operating properties portfolio. Our operating properties totaled $992 million gross of $87 million of accumulated depreciation. The portfolio was comprised of $765 million of commercial and $227 million of residential real estate properties. 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 $29 million of revenue offset by $21 million of expenses during the quarter.

At the end of the quarter, we had $133 million of stabilized commercial operating properties. These properties were 82% leased resulting in a 9% unleveraged yield for the quarter. The remaining $632 million of commercial operating properties are transitional real estate properties that were 62% leased and generated a 3.1% unleveraged yield for the quarter. We are continuing to actively lease these properties in order to maximize their value. During the quarter, we executed commercial operating property leases covering approximately 32,000 square feet.

The residential operating properties were comprised of 584 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 112 condos for $48 million in proceeds, resulting in $20 million of income offset by $8 million of expenses.

That brings me to our land portfolio. At the end of the quarter, our land portfolio totaled $1 billion and included 11 master-planned communities, 11 infill land parcels and six waterfront land parcels. Master-planned communities generally represent large-scale residential projects that we may entitle, plan and develop. We currently have entitlements at these projects for approximately 25,000 lots. Our infill and waterfront parcels are currently entitled for 6,000 residential units and select projects include commercial, retail and office.

The projects in the portfolio are well-diversified in locations such as California, the New York Metro area, Florida and several markets in the Mid-Atlantic and Southwest regions. At the end of the quarter, we had six land projects in production, 10 in development and 12 in the predevelopment phase. During the quarter, we generated $4.5 million of land sales revenues offset by $3.6 million of cost of land sales. We also invested $25 million in our land portfolio through capital expenditures. We look forward to keeping you apprised of future progress. With that, let me turn it back to Jay. Jay?

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

Thanks, Dave. I wanted to just circle back on the continued progress we're making in the land and operating books and specifically point out two new projects that we think will be quite profitable for us. I mentioned our project in Waikiki, one of the strongest markets in the U.S. right now, with prices on ocean view condominium product rising well above $1,000 per foot. We have been successful working with multiple stakeholders to get approvals to move forward with an exciting 176 unit project at the top of the historic Ilikai Hotel and we look forward to finishing the renovation work in the coming quarters and getting those units into the market.

I'd also highlight the successful completion of a new joint venture in Chicago that will see the contribution of a well-located iStar urban land asset as part of the development of a high-quality multifamily project in conjunction with a smart and experienced local developer. iStar will own both a debt position and an equity position in the project with attractive economics on both based on current projections. While we believe selling the land now would have generated a healthy profit, the diminishing supply of well-located sites for multifamily in Chicago provided us an opportunity to extract additional value and continue expanding our capabilities in key markets around the country. Both of these transactions take advantage of our full spectrum of capabilities in the finance and investment areas and we look forward to sharing their progress with you on future calls. Okay, operator, let's open it up for questions.

Operator

(Operator Instructions). Michael Kim, CRT Capital Group.

Michael Kim - *CRT Capital Group - Analyst*

Hi, good morning, everyone. You guys have done a great job resolving your nonperforming loans and just wanted to get a little granular on what specifically caused the dramatic decline in both the carrying value and the reserve and just wondering if you could walk us through a bridge in terms of like what was sold, how much and the type of asset that you took title to?

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

Well, it's a mixed bag, obviously, Michael. We are doing things somewhat opportunistically, so there are pieces of the puzzle that we don't want to go into right now, but we had a couple successful resolutions, one on a land loan we've been working on for quite a while, one on a European situation. Those both came out on the favorable end of the spectrum for us.

In terms of taking back one collateral piece, when we take assets back, we not only put them out of the NPLs, but we also take the specific reserves and eliminate those. So the bridge you are looking for is a combination of the asset moving onto the balance sheet and eliminating the specific reserves attached to it. So I am sure you can follow up with Dave and he will give you the individual numbers, but generically the combination of both selling some of the NPLs and resolving one by taking title is what happened this quarter.

Michael Kim - *CRT Capital Group - Analyst*

Got you. Okay, yes, I will follow up with Dave. Just wondering if you could talk about the Settler Crossing asset? I know there was a favorable ruling in the US District Court of Maryland earlier this month after almost more than six years of litigation and understanding that there are some things that you may not be able to speak to given it is ongoing, but I was just wondering what the initial ruling means for iStar. Is it fair to say that you are entitled to some sort of lump payment associated with a specific performance under the purchase agreement with potential for default interest and penalties?

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

Obviously, we prefer not to speak about litigation until it is fully resolved. But, as you said, Michael, we are somewhat gratified after six years. In a very well-considered opinion, the judge came down in our favor. We will continue to work through that process to the conclusion, but that was a property that was under contract. We had a loan against it. There were specific performance provisions that included penalties for not closing and it is our goal to try to collect what we think is the appropriate number there.

Michael Kim - *CRT Capital Group - Analyst*

Got you. And just in terms of our understanding, where is that on the balance sheet if we wanted to just gain that understanding?

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

It is in the land assets.

Michael Kim - *CRT Capital Group - Analyst*

Okay. All right, that's right, yes. Perfect. And just lastly, I know you previously mentioned just giving some specific land metrics that you would be communicating to the market later this year. Not sure if you have any of those metrics to offer today or any sort of sense of potential sales activity over the next year in terms of like launch dates and I know you had previously mentioned Magnolia Green and Tetherow were currently selling land and just curious if the current quarter represents those two assets or if there is something else kind of coming online as well? Thank you.

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

So for the second quarter, those two are most of the home sales. I think in terms of the metrics, we'd like to share and we had a transaction we announced in Asbury Park on 28 townhome units. We are going to start sharing with you kind of basis and some of the numbers from those things with some context around them. Not a lot in the second quarter productive enough to talk about, but, as I say in my notes, we feel like we're making good progress on a number of projects and as they come out of the ground and as we get homebuilders engaged on those, we will be able to share I think some more meaningful numbers both in terms of just size of the numbers, but also in terms of the metrics we can provide.

Michael Kim - *CRT Capital Group - Analyst*

Okay. And is there any sort of update on the venture with KB Home or is it too early to say right now?

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

We have very nice renderings. The houses are getting set, but we don't have anything to share just yet.

Michael Kim - *CRT Capital Group - Analyst*

Okay. I appreciate it. Thank you.

Operator

Jade Rahmani, KBW.

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

Thank you for taking the questions. Could you comment on the size of the lending pipeline and your expectations for new originations and as well as the competitive outlook in the lending space? In your comments, you did mention attractive yields in the assets you are targeting. So looking for some color there.

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

Sure, Jade. I think it's a little bit of trying to be selective and so the things that we are closing we quite like. We think the yields are attractive, but I will tell you volumes are certainly suppressed by the competitive nature of the market right now. So there's a bunch of stuff we are not doing. I think Dave has shared in the past $200 million a quarter of total investments is a good number. It will bounce around obviously. As we mentioned, we are under contract on a fairly sizable net lease deal. Those are going to be lumpy. They have long lead times and are a lot less predictable. The lending pipeline is a little more steady rate, but again we are not putting our foot to the pedal. We don't think the market opportunity is wide open. We think it is a selective market and the stuff we have closed we like. So I think you can trade off volume right now for quality. I think we'd like to be somewhat selective here and find things that we like the risk return on.

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

Okay. In terms of what you previously disclosed as having letters of intent, what should we expect as to the timing of those future closings and can you say how much there is left of that?

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

We talked a little bit about what was coming primarily because we were just starting to ramp up the investment process here. I think as we move into more of a steady-state, we will talk less about letters of intent and just about things we have closed. So this quarter, it was about $120 million of new stuff and about $50 million of ongoing under previous commitments and existing transactions. That feels like a pretty good run rate, $200-ish million a quarter. So the pipeline certainly makes us believe that feels fine. To the extent we are able to close more of the deals in the pipeline or decide there are better opportunities in the marketplace, we could certainly accelerate that, but if we don't see what we like, we are not feeling constrained to have to do any number per quarter.

So I will tell you the pipeline is fine. We have got plenty of stuff we quite like. Whether it gets closed or not was really a function of a bunch of variables right now that we can't predict, but I wouldn't try to pin us down too much on what letters of intent we have out. Look at the couple hundred million a quarter target and that is what we are going to try to hold ourselves to if it makes sense.

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

Okay. On the financing side, we are seeing a pickup in securitization, including CMBS and CLO issuances from some of your peers. So I think since you guys have said you are pursuing primarily an unsecured strategy, I thought it might be helpful to get your views on securitization and if eventually you view that financing as potentially attractive or what you view as the major drawbacks.

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

Look, I think the CMBS and CDOs certainly have their place for a lot of the assets in the marketplace. We've always focused on a little bit more of a custom tailored approach. We tend to work with larger transactions. They don't fit quite as naturally into those and frankly they are less commodifiable, if I can use that term. We think if you use a street-based product for your financing, you are going to end up really with that as your taskmaster in terms of structuring your deals. We have always been on the other end of the spectrum trying to understand our borrowers' needs and really custom tailor to that.

So I think there is certainly a place for secured financing and obviously with rates low, we will continue to look at that for any select opportunities where it makes sense. We've seen some opportunities to do that on the net lease side of our business, but for our core businesses, we have always thought being an unsecured borrower is the right way to serve our segment of the market and we are sticking with it.

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

Just turning to the land side, I think this year's spring selling season housing market has come in softer than expected. Do you view the performance profile of your land projects as dependent on a big improvement in home sale conditions or is it more situation specific and relative to current entitlements and land development work that is underway?

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

Good question. I mean I will say we were a little surprised at the weakness. Certainly we follow what Meritage is saying about the Phoenix market and our long-term strategy here has been much less focused on what quarter-to-quarter dynamics are in 2013 and 2014. We are much more focused on the demographics that suggest there is an undersupply of homes coming relative to the demand we see over the next three to five years when most of our projects will be delivering and in the heart of their selling season.

So we are not paying a ton of attention to the near-term blips in the markets, but we are looking for these long-term systemic trends and the one we've certainly been playing and are sticking with is the demographic demand trends that we see in our core markets continue to suggest there are thousands and thousands and thousands of homes that are going to need to be built. And if they are not getting built now, that is probably not a bad thing for us unless there is something dramatically changing in the home buying patterns in the country and that is what we will be watching.

So we've always said the slower the take-up now inevitably is probably good for us long term because it means the supply demand imbalance when we deliver is going to be better, but we are watching carefully to see whether these trends are being driven by lack of financing availability or homeownership rate changes that are outside the guesses and estimates of everybody we talk to. But right now, we are still feeling like in the markets we are in there should be solid demand when we supply the homes and the lots.

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

Great, thanks. And lastly, I just wanted to ask on profitability since on an adjusted basis this quarter was profitable, including the gains you took. Do you view the potential for gains in coming quarters as significant enough to sort of bridge the runway between now and until operations are profitable on a core earnings basis or on a recurring basis?

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

I think that's certainly one way to think about it. We have worked very hard over the last couple of years to put ourselves in positions for some of these positive surprises to happen. We certainly think the backdrop for that happening has been a good one, low interest rates, improving fundamentals, improving economy. But our long-term goal here is to build a sustainable business and part of that is extracting full value out of assets whether we are selling them or developing them or joint venturing them. So we think some of these gains are a function of the hard work we have done and will continue. Others will be truly surprises and good surprises at that. But the business is not predictable enough to sit here and tell you there will be lots of transactional gains in the next couple of quarters, but we certainly think the portfolio is set up so that there should be positive things coming out of the portfolio on a reasonably regular basis.

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

Great, thank you very much.

Operator

(Operator Instructions). Amanda Lynam, Goldman Sachs.

Amanda Lynam - *Goldman Sachs - Analyst*

Hi, thanks so much for taking the question. Apologies if you've addressed this, but I was hoping you could comment on where you see leverage going over the long term. It looks like your current leverage of 2.1x is at the low end of your range. I know historically covenants had limited how much debt in absolute terms you were adding, you were able to add to the capital structure. But if you could refresh us on your goals with respect to the capital structure in terms of leverage levels, not just the unsecured and secured portion that would be helpful. Thank you.

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

Hey, Amanda. Good question. I mean I think historically we've looked at a grid across all of our business lines and if you look at the business mix that we are prosecuting, somewhere in the 2.0x-2.5x makes sense. As we do more first mortgages, senior lien type product, we will probably be towards the 2.5x part of that range. Right now 2x, 2.1x, 2.2x is appropriate for where we are. So it will depend on our business mix, but I think as we move back into the finance business a little more aggressively, particularly on the first lien side, you could see the 2.5x side be the right number, but it is going to be between those two outer bounds and really depends on business mix.

Amanda Lynam - *Goldman Sachs - Analyst*

Thank you.

Jason Fooks - *iStar Financial Inc. - VP, IR & Marketing*

Are there any other questions?

Operator

At this point, no further questions in queue.

Jason Fooks - *iStar Financial Inc. - VP, IR & Marketing*

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

Operator

Certainly. Ladies and gentlemen, this conference is available for replay. It starts today at 12:30 PM Eastern time. It will last until August 13 at midnight. You may access the replay at any time by dialing 800-475-6701 and entering the access code 331938. That number again 800-475-6701, the access code 331938. That does conclude your conference for today. Thank you for your participation. You may now disconnect.