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STAR - Q3 2015 istar Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen and welcome to iStar's third-quarter 2015 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 Jason Fooks, Vice President of Investor Relations and Marketing. Please go ahead, sir.

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

Thank you, John and good morning, everyone. Thank you for joining us today to review iStar's third-quarter 2015 earnings report. With me today are Jay Sugarman, Chairman and Chief Executive Officer and David DiStaso, our Chief Financial Officer.

This morning's call is being webcast on our website at istar.com in the Investors section. There will be a replay of the call beginning at 12:30 p.m. Eastern time today. The dial-in for the replay is 1-800-475-6701 with a confirmation code of 371425.

Before I turn the call over to Jay, I would like to remind everyone that statements in this earnings call which are not historical facts will be forward-looking. iStar'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 and our investor presentation, which is posted on our website. iStar disclaims any intent or obligation to update these forward-looking statement except as expressly required by law. Now I would like to turn the call over to iStar's Chairman and CEO, Jay Sugarman. Jay.

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

Thanks, Jason. Thank you all for joining us today. The third quarter played out pretty much as expected with profitable asset realizations in the equity portfolio and steady but cautious levels of new investment on the finance side, generating growing earnings and offsetting a still significant percentage of noncontributing assets.

Stock market weakness and a successful tender for all of our HPU common stock equivalents enabled us to ramp up our repurchase activity and led to an increase of a size of our repurchase authorization. While our cash balances are already high, we will continue to look to monetize assets where we feel the pricing is right and we'll continue to watch warily as lenders offer increasingly lender-unfriendly terms to win new deals.

Earnings for the quarter were on track with adjusted income of about $0.25 per share, helped by some good momentum in the transitional operating property book. We see more opportunities in our equity portfolio to take advantage of a strongly bid market and while timing is never easy to predict, we hope to see some more realizations on repositioned assets as we head into 2016.

We also continue to explore areas where we think iStar can provide uncommon capital to borrowers, partners and projects that need our blend of skills to unlock value. These efforts may take time to reach scale, but we think are important long-term value creators that are worth the R&D efforts we are putting into them now. With that overview, let me turn it over to Dave for the financials. Dave.

David DiStaso - *iStar Inc. - CFO*

Thanks, Jay and good morning, everyone. Let me begin by discussing our financial results for the third quarter of 2015 before moving on to investment activity and the performance of our business segments. Finally, I will finish with an update on recent capital markets activity.

For the quarter, our adjusted income allocable to comment shareholders was $28 million or $0.25 per diluted common share compared to $58 million or $0.48 per diluted common share for the same quarter last year. The primary driver of this change was due to a gain on the sale of an asset in the prior year, which generated $33 million of additional earnings from equity method investments. We also monetized several operating properties over the past year, resulting in a $5 million decrease in operating lease income.

These items were offset in part by positive trends over the past year such as a $6 million decrease in real estate expenses, a $3 million increase in land and development gross margins as sales increased and a $3 million rise in interest income from new originations. Our net loss allocable to common shareholders for the quarter was $6 million compared to net income of $22 million for the same period last year.

Let me now turn to investment activity in our real estate and loan portfolios. During the quarter, we funded a total of $219 million associated with new investments, prior financing commitments and ongoing development. We also generated $283 million of proceeds from repayments and sales within our portfolio this quarter. We ended the quarter with $657 million of cash that may be used for future investments.

At the end of the third quarter, our portfolio totaled $5.2 billion. Our real estate finance segment generated $22 million of segment profit for the quarter, an improvement from $14 million for the same quarter in the prior year. The increase was primarily driven by growth in interest income and additional other income. The portfolio totaled $1.6 billion at the end of the quarter, including approximately $1.5 billion of performing loans comprised of $824 million of first mortgages or senior loans and $712 million of mezzanine debt. Our performing loans generated a yield of 8.7% for the quarter and had a weighted average last dollar loan to value of 67%.

Within real estate finance, we invested $168 million and received $165 million of proceeds during the quarter. Our NPLs remained essentially flat from the end of the second quarter at $83 million. The $8 million provision for loan losses recorded this quarter was primarily the result of establishing general reserves associated with new originations. This brought our total reserve for loan losses at the end of the quarter to $129 million, including $33 million of general reserves and $96 million of specific reserves.

Now let me provide a brief update on key metrics pertaining to our net lease portfolio. Net lease generated $19 million of segment profit this quarter versus $12 million in the prior year. The increase was primarily due to gains realized on the sale of net lease assets. At the end of the quarter, we had $1.6 billion of net lease assets. This portfolio was 96% leased with a weighted average remaining lease term of approximately 15 years. For the quarter, our net lease portfolio generated and unleveraged yield of 7.8%. During the quarter, we received $15 million in proceeds from sales and distributions and recorded $7 million in gains.

Next I will turn to our operating properties portfolio. Our operating properties totaled $706 million and was comprised of $573 million of commercial and $133 million of residential real estate properties. The segment generated $15 million of profit this quarter versus $22 million in the prior year due to fewer condominium sales as the overall residential operating properties portfolio has decreased.

The commercial operating properties generated $25 million of revenue, offset by $20 million of expenses during the quarter. At quarter-end, we had $112 million of stabilized commercial operating properties. These properties were 87% leased resulting in a 7.8% unleveraged yield for the quarter. The remaining $461 million of commercial operating properties are transitional real estate properties that were 59% leased and generated a 2.7% unleveraged yield for the quarter.

We are continuing to actively lease these properties in order to improve their yields. Within our 5 million square feet of commercial operating space, this quarter, we executed leases and lease extensions covering approximately 350,000 square feet. As we've previously discussed, the strategy within our operating property segment is to first create value by repositioning our assets and then realize that value through monetization.

During the quarter, we sold Raintree Corporate Center, a transitional operating property in Scottsdale, Arizona. The property had a basis of $42 million and was sold for $69 million to a venture in which we have a 50% interest. We recognized a $14 million gain on the 50% interest sold. This deal serves as a good example of that strategy and highlights what can happen to good real estate that's been capital-starved.

Prior to taking ownership, capital constraints at the property prevented proper marketing, leasing efforts and improvements. By investing needed funds, we were able to sign a dozen leases and as the local market has strengthened, we've entered into a strategic venture aligning ourselves with a highly respected nationwide office property manager with a successful track record in the Scottsdale market in order to capture full value for this asset. The residential operating properties are comprised of luxury condominium units located in major cities throughout the country. During the quarter, we sold 23 condos for a total of $25 million in proceeds and recorded $70 million of income offset by $3 million of expenses.

That brings me to our land and development portfolio. At the end of the quarter, this portfolio totaled $1.2 billion and included 11 master planned communities, 15 infill land parcels and 6 waterfront land parcels. At quarter-end, we had 7 land projects in production, 12 in development and 13 in the predevelopment phase. We invested $26 million into our land and development portfolio this quarter.

We've been pleased to see our efforts within this portfolio translate to increasing sales activity. Year-to-date, our land and development portfolio generated gross margins and earnings from equity method investments of $20 million compared to just $1.6 million for the first three quarters of last year. Assuming market conditions continue to remain positive, we expect that land and development will contribute more significantly to earnings growth over the next couple of years. However, with only a third of the land portfolio in production and producing revenues, the segment still generated an overall $8 million loss for the quarter, including direct and allocated expenses, an improvement from a $16 million loss for the same quarter in the prior year.

Let me finish by providing an update on our capital markets activities. Through the successful completion of our HPU exchange offer and our share repurchases, we reduced common stock and common stock equivalents by 3.2 million for $30 million in cash. This represents approximately 3.5% of total equity. During the third quarter, we used a significant amount of our buyback authorization and in September, our Board of Directors increased the size of our share repurchase program back to 50 million. At the end of the quarter, we had remaining authorization of 49 million.

Our weighted average cost of debt for the third quarter was 5.4%, down from 5.5% for the third quarter of last year. Our leverage was 2 times at the end of the quarter and remains at the low end of our targeted range of 2 to 2.5 times. With that, let me turn it back to Jay. Jay.

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

Thanks, Dave. Why don't we go ahead and open it up for questions, operator?

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions). Jade Rahmani, KBW.

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

Thanks for taking my questions. Firstly, on capital deployment, I was wondering if you could give any color on your thoughts on how you prioritize capital, particularly given the cautious commentary around investment and the lending market in particular. Are you starting to ramp up investment too late in the cycle and do you think iStar may be chronically overcapitalized given the frothy pricing environment?

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

Look, here's the scenario we see. We see asset prices being bid up. We see finance terms being bid down and we see stock market weakness. So the response is pretty clear. We are going to sell assets into that strong asset bid. We are going to go look for new non-commodity areas to finance and we're going to buy shares when the stock is weak.

So I think whether we are in the early part of the cycle, late part of the cycle, those indicators tell us pretty clearly what we should be doing and then we are going out and doing that. I don't think we are trying to push money out the door. One of the questions we ask is are other deals getting done that we think are great that we are missing and the answer is no. We can win as many deals as we want right now. We think unfortunately the market is competitive and some of the terms don't make sense to us, not necessarily on pricing, but on some of the stuff that really creates the essence of our business, call protection, duration, convexity.

So I think these periods come and go in our market. We are fortunate we have lots of other engines of growth. We will use those engines to continue to push earnings until we find places that we think are quite interesting and where the risk/reward is in our favor.

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

Thanks for that. Can you give any color on the land market apartment deal? Just specifically how much cash you expect to receive on a net basis and if that will trigger any gains?

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

That's a loan deal that we have been receiving repayments as the Company monetizes assets, so it's not a gain situation. We are receiving a very significant current return and when they fully pay us off, that will stop.

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

And you're expecting full payoff in 4Q?

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

I don't know exactly what the timing is going to be, but, yes, they are in the process of some transactions that should fully pay off that position.

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

Can you just talk to unfunded commitments, 2016 debt maturities and how you expect that to play out, including the 1.5% converts?

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

We are looking at 2016 maturities. Obviously, we have some things in there that are rolling off at some pretty high rates that will free up some assets under one of our secured deals. Later in the year, we have some unsecured stuff coming due. We think it's some relatively manageable sizes throughout the year and we will try to pick market windows where we can be pretty effective at extending our maturities and lowering our costs.

Right now, the viewpoint is we expect to have a pretty sizable investment pipeline throughout next year, but we've also got, as I said, a number of asset sales that we think probably are reaching a price point that's quite interesting as well. So you will probably see us monetize some assets, create some liquidity there. We are obviously sitting on a lot of liquidity right now and as the market conditions look attractive, we will start pushing out some of those maturities in the most cost-effective way we can.

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

Do you think there's any prospect of initiating a dividend in 2016 given the earnings that you expect?

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

I think the earnings story is going to be quite good, but I don't think a dividend component is really something we are focused on right now. That can change, but right now we see the opportunity to put that money to work at some pretty interesting returns.

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

Just turning to the earnings goals that you've laid out that you did at your investment presentation, obviously this quarter was a strong one for asset gains. In terms of walking from the $0.75 EPS goal you gave for 2015 to the $1.75 in 2016, are the key drivers continued asset gains or a more material ramp in the pace of regular way land sales?

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

I think we said the number of land projects are reaching a point where we can start thinking about different ways to monetize them, whether that's a longer-term retail strategy or a shorter-term wholesale strategy. We definitely expect some meaningful gains to come out of that book over the next 12 to 18 months. So, yes, that's part of the 2016 story. I also think with the strong asset bid in the market, some of the stuff in our equity portfolio are certainly ripe to be monetized and realized upon and that will be part of the story.

I think the wildcard for us a little bit is what we see on the finance side. We are making some of these smaller I will call them R&D investments because we don't know how big they could grow into, but they look attractive right now; they seem less competitive. The risk/reward seems more favorable. If those are opportunities to scale a little bit, that would be great, but I would say that's the piece of the story we are still refining to figure out what that finance piece will look like. I think you will definitely see activity on the land side. You will definitely see activity on the equity portfolio side.

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

In terms of the condos, how much remaining duration is there in that book?

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

We are down to the last couple hundred units. It's been a great run. There's still some nice gains in there and so we will continue to realize those, but they won't be at the same level they were in the past.

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

And then just on the land side, are you expecting any additional projects to go into active production in 2016 and labor has been a significant issue in the homebuilding market? Is that going to weigh on results at all?

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

The only thing I would say is whether it goes into production or whether it is ready to be monetized and can be sold are kind of the same question for us. We may take it all the way through the retail components or we may try to monetize if we think there's a strong enough bid. So I will say that we think more things will be in that position next year. Whether we actually take them into production and become the person putting the capital into finish them out is a different question.

I think interestingly to us, there are things going on in the land market. Labor a little bit. I wouldn't say that's the biggest one on our mind. I would say California and the water situation, we've been spending quite a bit of time on that. Hopefully, some of the tougher regulations that are being proposed and are being implemented, if they can get some rain, maybe it'll be rolled back, but that's one we have to keep on the radar.

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

And then finally on the non-stabilized operating properties, close to $500 million remaining, over what timeframe do you think those can get to a stabilized occupancy rate and could you quantify the percentage you think you yourselves would take to that stabilized occupancy rate and what percentage you could do similar deals to what you did this quarter, selling participation interest or even the whole asset?

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

Yes, I think we've said in the past, Jade, in our minds, much of that portfolio is a liquidating portfolio. Some of it, we think, will stabilize in a form and in a structure that actually we would like to hold long term, but the majority of that portfolio we are trying to lease up or put in a position where someone will pay us an attractive value for. And we saw a lot of progress on that this year. So we will be testing the market on a number of assets maybe before they are fully stabilized. Can't tell you exactly what the market response will be, but based on what we saw certainly in Scottsdale, we are hopeful that we don't have to take these things all the way to perfect stabilization for people to see the value we've created.

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

Thanks very much for taking my questions.

Operator

(Operator Instructions). Sean Monaghan, Penn Capital Management.

Sean Monaghan - *Penn Capital Management - Analyst*

I'm just curious -- a lot of it's already been answered -- but I'm curious on the condominium side, or sorry, on the unfunded commitment side, how quickly do you guys expect to go through that? I know it can get kind of lumpy, but is there any target that you guys are planning to do a quarter, or does it really depend on completion and --?

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

Yes, if you look at the overall number and you kind of spread it out over the next six, seven quarters, that should run through the entire amount. That's kind of how we look at it. Some of these projects will either speed up or get delayed and in our business, you are usually better to bet on the delay side than the speed-up side. So those numbers might stretch a little bit, but I would say take that number and divide it over the next six plus quarters and you will see it burn -- the existing commitments burn down pretty far.

Sean Monaghan - *Penn Capital Management - Analyst*

Thank you. And in terms of capital markets next year with the A2 tranche, the ability for you guys to look at that, how are you guys thinking about capital markets activity for you guys and the way you guys are going to refinance some of the debt you guys have coming due next year?

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

Well, the two big goals obviously are extend the maturity profile a little bit. We'd like to move that out and spread it out a little more and then to get a cost of funds that allows us to be competitive in larger slices of the market. I think we have an effective cost structure for some of our asset types, but particularly on the finance side, we need a lower cost solution to really compete for a lot of deals that we get shown and we'd actually be probably the right player to provide. But on an ROE basis, we just can't make them work with our current cost of funds. So we are looking at solutions on that front. The more we unencumber the balance sheet, we still have a pocket of assets that we can secure and stay within our 80/20 unencumbered asset to encumbered asset goal. So we'd like to find a cost-effective solution that gives us both lower-cost funds and also gives us a little more flexibility on the maturity side.

Sean Monaghan - *Penn Capital Management - Analyst*

Perfect. And just one more. Are you guys getting more visibility on the land side and what are you expecting for land sales to be in the fourth quarter and are you seeing any visibility into 2016?

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

Yes, you'll probably never hear us predict quarter-by-quarter land sales. As I said, a lot of these projects we are not going to take all the way through retail where we could tell you, hey, we are going to sell 100 lots and we're going to sell 20 pads. We are likely to be a lot chunkier than that because when we get to that moment of truth, there's both tax implications and just general valuation issues. We are going to look at whether it makes sense to sell things in bulk or take components through, whether we go vertical on some of these projects. We've done that in the multifamily space. That's a good REIT asset. It's tax-efficient. When we find the right local partner and we can go vertical, that's been the right choice the last 12 to 18 months.

If I go looking forward on some of these land deals, it's not clear in our mind where we are going to get a bid that makes more sense just to let somebody else take that project on. So it will be lumpy; I can promise you that. We do see some sizable opportunities shaping up to test the market and we will do that. And we expect some fairly significant gains to come out of that book sooner rather than later.

Sean Monaghan - *Penn Capital Management - Analyst*

Thanks, guys. That's all.

Operator

And Mr. Fooks, we have no further questions in queue.

Jason Fooks - *iStar 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. And ladies and gentlemen, this conference is available for replay. It starts today at 12:30 p.m. Eastern time, will last until November 17 at midnight. You may access the replay at any time by dialing 800-475-6701 and entering the access code 371425. That number again, 1-800-475-6071, the access code 371425. That does conclude your conference for today. Thank you for your participation. You may now disconnect.