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STAR - Q4 2015 istar Inc Earnings Call

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PRESENTATION

Operator

Good day and welcome to iStar's fourth quarter and fiscal year 2015 earnings conference call. (Operator Instructions). As a reminder, today's call 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, sir.

Jason Fooks *- iStar, - VP of IR and Marketing*

Thank you, John, and good morning, everyone. Thank you for joining us today to review iStar's fourth quarter and fiscal year 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 investor section. There will be a replay of the call beginning at 12:30 Eastern time today. The dial-in for the replay is 800-475-6701 with the confirmation code of 386538.

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 statements 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 - Chairman and CEO*

Thanks, Jason. Thanks to all of you for joining us today. The last few months have been interesting ones for our market. Weakness and volatility in the public markets have taken a heavy toll on share prices while the private markets for real estate remain relatively strong with historically low interest rates continuing to drive interest in well-located cash flowing assets. The case for owning real estate assets remains intact but a note of caution has reduced the frothiness we saw last summer.

iStar's response as we reported last quarter has been to sell things in favor and buy or invest in things out-of-favor. During the fourth quarter, this strategy led us to sell several assets that had reached a point where the market could see their true value and redeploy those proceeds into significant share repurchases. This process, when successful, represents an attractive redeployment of the balance sheet which we call our gain now, gain later strategy. And I will talk a bit about that in a minute after Dave reviews the quarter and year-end numbers.

But the punchline, it's a solid earnings realization in the fourth quarter from this strategy and a nice push on earnings per share going forward.

On the other hand, our decision to hold significant cash balances and remain pretty selective on new investments will slow earnings momentum in 2016. We have reset our internal goals and now look to grow earnings by 50% from 2015 to 2016 from our previous goal of over 100% growth. This growth will be driven by value realized in our operating property and land portfolios mostly in the mid- to later parts of the year so we will have further updates in the coming quarters.

With that, let's get into the numbers with Dave. Dave?

David DiStaso - *iStar - CFO*

Thanks, Jay, and good morning, everyone. I will begin by discussing our financial results for the fourth quarter and fiscal year 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 and our outlook for the coming year.

For the quarter, our adjusted income allocable to common shareholders was $39 million or $0.34 per diluted common share compared to $28 million or $0.26 per diluted common share for the same quarter last year. The primary reasons for the improvement was a $14 million increase in contributions from our land and development business and a $4 million increase in interest income partially offset by $9 million less of other income compared to the fourth quarter of last year.

Our net income allocable to common shareholders for the quarter was $8 million compared to a net loss of $13 million for the same period last year. In addition to the items I just discussed, net income benefited this quarter from a decrease in impairments and lower depreciation expense.

For the full-year 2015, our adjusted income allocable to common shareholders was $84 million or $0.81 per diluted common share compared to $109 million or $1.00 per diluted common share last year. The prior year benefited from the sale of two equity method investments which generated $57 million of incremental earnings.

This year we saw the results of our development efforts produce meaningful growth in land revenues. Specifically, our land segment contributed an additional $32 million of gross margin year-over-year. Our net loss allocable to common shareholders for the year was $53 million compared to a loss of $34 million for the same period last year.

In addition to the items discussed, net income in the prior year included a $25 million charge to early extinguishment of debt primarily associated with refinancing our largest secured credit facility. In addition, this year we had an $8 million loss less in depreciation expense. These items were partially offset by $14 million more in provisions and impairments this year.

Now I will turn to investment activity in our real estate and loan portfolios. During the quarter, we funded a total of $93 million associated with new investments, prior financing commitments and ongoing development. We also generated $223 million of proceeds from repayments in sales within our portfolio. This brought us to a total of $663 million of investments and $971 million of proceeds received for the full year.

We have taken a cautious approach, selectively investing throughout 2015 which we think was prudent particularly in light of the recent market volatility. As a result of this approach, we have maintained higher cash balances for the past few quarters and we currently have approximately $650 million of unrestricted cash on hand.

At the end of the fourth quarter, our portfolio totaled $5.1 billion. Our real estate finance segment generated $16 million of segment profit for the quarter, in line with the fourth quarter of the prior year. For the year, real estate finance generated $72 million of segment profit also consistent with last year. The portfolio totaled $1.6 billion at the end of the quarter. The performing loans were comprised of 56% senior loans and 44% mezzanine debt which generated a yield of 8.3% for the quarter and had a weighted average last dollar loan to value of 67%.

Our NPLs decreased to $60 million at the end of the fourth quarter from $83 million in the prior quarter. Our total reserve for loan losses at the end of the quarter was $108 million including $36 million of general reserves and $72 million of specific reserves.

Now let me provide an update on key metrics pertaining to our net lease portfolio. Net lease generated $40 million of segment profit this quarter, an improvement from $20 million in the same quarter during the prior year. For the full year, net lease segment profit grew to $93 million from $54 million for the prior year. During the quarter, we received $61 million in proceeds predominantly from the sale of one net lease asset and recorded $24 million in gains. While our net lease assets are generally held for the long-term, we were approached with an attractive bid and sold this asset at a favorable cap rate.

At the end of the quarter, we had $1.6 billion of net lease assets. This portfolio is 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 8.4%.

Next, I will discuss our operating property portfolio.

Our operating properties totaled $709 million and were comprised of $572 million of commercial and $137 million of residential real estate. We have reduced the portfolio by over 20% over the past year as we have executed our strategy to capture value from our repositioning and asset management efforts.

The commercial properties generated $26 million of revenue offset by $20 million of expenses during the quarter. At quarter end, we had $124 million of stabilized commercial operating properties. These properties were 89% leased resulting in an 8.8% unleveraged yield for the quarter. The remaining $448 million of commercial operating properties are transitional real estate properties that were 65% leased and generated a 2.8% unleveraged yield for the quarter.

We are continuing to actively lease these properties in order to improve their yields. Within our 4 million square feet of commercial operating space, this quarter we executed leases and lease extensions covering approximately 83,000 square feet.

During the quarter we sold 19 condos for a total of $15 million in proceeds and recognized $4 million of income from these sales. In addition, we recorded $3 million of carry costs associated with the remainder of the residential portfolio.

The overall operating properties segment approximately broke even for the quarter versus $15 million of profit in the fourth quarter of last year. For the full year, the segment generated $37 million of segment profit versus $55 million for the prior year. These decreases were primarily due to fewer condominium sales year-over-year as the overall portfolio is smaller resulting from our progress in monetizing these assets over the past few years.

That brings me to our land and development portfolio. At the end of the quarter, this portfolio totaled $1.1 billion and included 11 master-planned communities, 13 infill land parcels, and six waterfront land parcels. We had seven land projects in production, 10 in development and 13 in the predevelopment phase. We invested $25 million into our land and development portfolio during the quarter.

We have been pleased to see our development efforts within this portfolio translate to increasing sales activity, both in terms of lot sales and parcel sales. For the full year, our land and development portfolio recorded $100 million of revenue and $67 million of cost of sales. We also earned $17 million from our land equity method investments. This resulted in total gross margin from our land and development portfolio increasing to $50 million from $17 million in 2014.

During the quarter, we sold two land parcels for $63 million of revenues and recorded a $24 million gain. In addition, we expect to receive approximately $6 million of additional net proceeds on the completion of certain easement agreements associated with one parcel sale.

The land and development segment generated profit of $11 million for the quarter versus $2 million during the fourth quarter last year. For the full year, our land segment loss decreased to $21 million from a $48 million loss in the prior year. Assuming residential market conditions remain favorable, we expect that land and development will contribute more significantly to earnings growth over the next couple of years.

I will finish by providing an update on our capital markets activities and outlook for the year.

During the fourth quarter through today, we have repurchased a total of 9.2 million shares of common stock for $102 million. This brings the total shares of common stock and common stock equivalents repurchased since the beginning of 2015 to $12.5 million or approximately 14% of iStar's common equity for which we spent $132 million or an average of $10.59 per share.

Earlier in February, our Board of Directors approved an increase in our share repurchase authorization to $50 million which we have begun to utilize. Our weighted average cost of debt for the fourth quarter was 5.4%, down from 5.5% in the fourth quarter of last year. Our leverage was 2.1x at the end of the quarter and remains at the low end of our targeted range of 2.0-2.5x.

Let me walk through our expected primary sources and uses of liquidity for 2016. I will start with our liquidity sources for the year. As of today, we have approximately $650 million of unrestricted cash on hand. In addition, we currently expect to receive approximately $1.2 billion from repayments on loans and sales of operating and land assets, the latter of which will be a significant contributor to the earnings growth we expect in 2016.

In regard to liquidity uses, we expect to fund approximately $300 million on previously originated real estate finance transactions. We will remain selective in originating new investments and the volume of our originations will be largely determined by trends in the real estate and finance markets.

In addition, we currently expect to invest approximately $225 million to $300 million on development projects within our operating and land portfolios although a significant portion of that is discretionary. We have $926 million of debt maturities including $400 million of convertible notes, half of which have a strike price of $11.77 per share.

One of the important advantages that our unencumbered balance sheet affords us is the flexibility to generate liquidity and raise capital beyond just the unsecured market. For example, we can access the secured debt market, sell incremental assets, syndicate our loans or mortgage individual assets. For our 5 7/8 notes due in March, we are of evaluating options including retiring them with cash or possibly refinancing them.

With that, let me turn it back to Jay. Jay?

Jay Sugarman - *iStar - Chairman and CEO*

Thanks, Dave. Let me walk you through the gain now, gain later dynamic in a little more detail. During the fourth quarter, we sold two sizable assets. Together these assets had a net book value of around $45 million. They generated relatively little free cash flow. We sold them for $89 million and generated approximately $44 million in gains. That is the gain now part.

We then took those proceeds and compared investing them in a pipeline of deals available to us with a sizable share repurchase. We chose the share repurchase path and repurchased approximately 8.5 million shares. With a 50% increase in adjusted earnings per share in 2016, we think those shares would earn roughly $1.25 per share. As we think about it, we took assets with low book value and little cash flow, created significant value and gains upon sale and then repurchased shares with implied adjusted earnings north of $10 million and perhaps higher going forward. That is the gain later part.

So our goal in 2016 is to continue working to create this accretive dynamic and bring assets to market where value has been created over the past several years, generate gains and then redeploy proceeds into further earnings positive investments in the market or in our own capital structure.

With that, let's go ahead and open it up for questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Jade Rahmani, KBW.

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

Thank you very much. Regarding upcoming maturities, how much of the $926 million do you think you would refinance or pay off with cash on hand?

David DiStaso - *iStar - CFO*

We look through our balance sheet to find the lowest cost of capital available to us. Obviously we have lots of cash and paying down debt with that is accretive. But we also have lots of other sources in the book and we continually look at the secured and unsecured markets to really try to find an appropriate balance on term, maturity, price, structure so it is probably too premature to talk about the rest of year but certainly we are focused on the first couple of maturities and we have built a cash balance that gives us the ability to take those out pretty simply with cash.

We do think the markets will start to recognize some of the things we have got in place and towards the later end of the year I'm sure we are going to be looking at lots of different alternatives.

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

In terms of secured debt, what form or forms would that be likely to take based on your current vantage point? Are you talking about secured credit facilities?

Jay Sugarman - *iStar - Chairman and CEO*

No, I think more as we season assets on our portfolio, as we bring some of the operating property portfolios up to full stabilization, it gives us a lot more choices on individual assets, how to extract relatively low-cost financing. So we've got lots of different things that we are looking at. As Dave kind of went through the list anywhere from selling those assets to figuring out a way to JV them, to sell participations, to sell off A-notes.

So as the portfolio has seasoned, it has created a lot of opportunities to think about those. We still primarily want to be an unsecured borrower so that is always in our minds as well but if the market is not going to give us pricing we think is appropriate then we will look at some of those other strategies.

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

In terms of the change in your earnings goals, is the driver of the lower earnings primarily a higher cash balance and less investment activity or are you anticipating fewer asset sales than you previously expected?

Jay Sugarman - *iStar - Chairman and CEO*

Well, I think it starts with the cash balances. Obviously we came into the fourth quarter with a pretty heavy balance. We are still carrying the majority of that capital so not deploying it is going to take a little bit of a bite, it is just deferring some of those earnings further into the future.

I think the asset sales side, the monetization side, the asset realization side, we still feel quite comfortable with but a lot of those transactions are set up for mid to later parts of the year. So we just think with the increased cash balances, it probably made sense to set a goal of 50% growth rather than something more dependent on putting all of that money to work sooner.

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

Can you quantify maybe some of the spread widening on the finance deals you are looking at, cap rate widening if you are seeing that as yet? And also on the land side, homebuilders have been talking about moderating their appetite for land purchases. Is that affecting anything of what you are seeing in the land side?

Jay Sugarman - *iStar - Chairman and CEO*

Let's take them one at a time. I think the finance markets definitely feel like they took a slight move. We have seen CMBS widen out about 40, 50 basis points on the AAAs. That has ripple down through the rest of the finance markets in the 50, 75, even 100 basis point widening. We don't think it has translated anywhere close to what we have seen in the public market and publicly traded securities so I think the private market is still a lot more stable.

We have seen the same thing on cash flowing assets, we don't see cap rates widening materially for good quality assets in good markets. We think the drop in interest rates has offset some of the spread widening so we are not seeing nearly the kind of volatility we see in the public market.

The land question, I think the homebuilders are probably closer to it than we are but what we see right now is lots of interest. Again, it is a little bit by quality and by market. We do see the markets that we have invested a lot of time and money and still being quite strong. But if the sentiment of the homebuilders changes it will impact us. We are not seeing that just yet.

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

Okay. And wanted to ask about strategically how you think about potential M&A opportunities? Can you say if you have or would bid on portfolios being marketed for sales by REITs that are trading at discounts to NAV or potentially whole companies? And if you would, can use say which REIT sectors potentially are interested -- I don't if you are interested in healthcare, manufactured housing or you previously commented on the demographic which I assumed refer to healthcare such as seniors, seniors housing. So I wondered if you could comment on that?

Jay Sugarman - *iStar - Chairman and CEO*

Yes, we look at the markets and we look where values are relative to what we think they are and if there is a big disparity we get interested. I would say we don't have the best currency right now either so there is no big arbitrage between where we are trading and where others are. We think those who are at a big discount, we unfortunately are trading at what we think is a big discount. So there is no obvious pickup from that.

But anything that we think fits our wheelhouse in terms of our new strategy and some of our business lines is very much of interest. As you know, we have a fairly significant relationship with a sovereign wealth partner so we certainly have the capital if we see something very much mispriced and can take advantage of it, it would be of interest. But nothing eminent, Jade, just in terms of we are watching the market as everybody else is to try to find where value is going to settle.

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

And then just lastly, any update on the Bevard litigation, is that something that you think could come to fruition this year?

Jay Sugarman - *iStar - Chairman and CEO*

It is certainly at hopefully the tail end of the process. We think by the end of the year, we should have some clarity on that but it is in the court's purview of when that decision comes down. So we have been waiting seven years and may have to wait a little while longer.

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

Thank you very much for taking my questions.

Operator

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

Sean Monaghan - *PENN Capital Management - Analyst*

Just a quick questions. Can you break out for me what percentage of sources of cash are going to come from asset sales and principal? Or a rough breakdown?

David DiStaso - *iStar - CFO*

Yes, Sean, I think when we look at asset sales components, we see three different pieces and really it would be from the commercial operating, it is about $400 million of sales that we would expect. And we would expect somewhere in the neighborhood of $300 million of land sales. Those are the main components. The other piece would be real estate finance repayments which are somewhere right around $475 million based on our current estimates.

Sean Monaghan - *PENN Capital Management - Analyst*

Thanks, guys. Can we just talk about too what kind of assets in the portfolio are eligible for individual mortgages and what terms are you guys looking at right now that are available?

Jay Sugarman - *iStar - Chairman and CEO*

We have certainly got some JV properties in the multifamily sector that have a lot of liquidity attached to them that we have not yet accessed. That will be a place we are certainly going to look at as we move through 2016 and they lease up and stabilize. That market is deep and rich and we think the cost of funds there is quite attractive.

Other stuff, really we look at the market from time to time on almost all our properties both for sale, for financing, for syndication. We have seen some of our loan assets, some of our very large -- we call them track assets that were transitional repositioning acquisition and construction loans that have seasoned now and we have some interest on A notes on a lot of those. So that is another avenue that we could certainly explore.

But given the large cash balance we haven't push the button on any of those yet but that is the list of kind of things we would look out throughout the year.

Sean Monaghan - *PENN Capital Management - Analyst*

And then what kind of dislocation are you guys seeing in the markets right now?

Jay Sugarman - *iStar - Chairman and CEO*

As I said, I think we see a lot of dislocation in the public side. You see a lot less of it in the private side, maybe that is just because it doesn't price every day so some of these dynamics don't get translated immediately. The assets we had for sale in the fourth quarter were not impacted at all. Some of the stuff we have in the market now doesn't really look like it is being impacted. We are seeing significant interest but as those folks go to the market, CMBS market or other markets, we have to see where that kind of financing gets placed.

Right now I would say the spread widening has been offset by the treasuries dropping into the 170 range for the 10 year so we have not seen a material impact on good, solid cash flowing assets. I think some of that frothiness around pie in the sky business plans is off and some of the really high high-end condominiums in New York are kind of the bellwether for that. But we are not seeing the core stuff change in price materially.

Sean Monaghan - *PENN Capital Management - Analyst*

And talking about just what is open to you guys in the capital markets right now, just I know you talked about cash and refinancing. What looks attractive to you right now? Is it the secured market, the unsecured market? I know you guys like to keep your interest expense low but what looks attractive to you guys and what terms do you guys think you would be amenable to?

Jay Sugarman - *iStar - Chairman and CEO*

Well, I can tell you the unsecured market we would be a buyer of our bonds at these prices, not a seller. So I don't think that is something makes a lot of sense for us right now. In the secured market we did a small secure deal earlier last year that we thought the pricing was quite attractive and made sense for the asset types. Really depends on the assets.

We've got four different business lines. I think they have four different personalities in terms of terms and structures that make sense in pricing. But we would compare that kind of facility to some of the things we talked about earlier and certainly I think a multifamily is going to finance a lot cheaper right now than some of the operating properties and land we have.

So it will be a mix of decisions we have to make throughout the year but right now I would say unsecured, we would be a buyer not a seller and there is probably some secured stuff we would do at prices today.

Sean Monaghan - *PENN Capital Management - Analyst*

Okay. That is it for me. Thanks.

Operator

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

Jason Fooks - *iStar, - VP of IR and Marketing*

Thanks, John. Thanks 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 give the conference call replay instructions once again? Thanks.

Operator

Certainly. Ladies and gentlemen, this conference replay starts today at 12:30 PM, will last until March 10 at midnight. You may access the replay at any time by dialing 800-475-6701, entering the access code 386538. That number again, 800-475-6701: the access code 386538. That does conclude your conference for today. Thank you for your participation. You may now disconnect.