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STAR - Q1 2017 iStar Inc Earnings Call

EVENT DATE/TIME: MAY 04, 2017 / 2:00PM GMT

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PRESENTATION

Operator

Good day, Ladies and gentlemen and welcome to iStar's First Quarter 2017 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, sir.

Jason Fooks - *iStar Inc. - VP of IR & Marketing and Head of Marketing*

Thank you, John, and good morning, everyone. Thank you for joining us today to review iStar's First Quarter 2017 Earnings Report. With me today are Jay Sugarman, Chairman and Chief Executive Officer; and Geoff Jervis, our Chief Operating Officer and 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 the confirmation code of 423394.

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'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. iStar disclaims any intent 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 S. Sugarman - *iStar Inc. - Chairman of the Board and CEO*

Thanks, Jason. As we've noted in our prior calls, iStar's 2017 earnings were going to be driven by extracting gains from our legacy asset portfolio, by making further progress in monetizing unproductive assets and by identifying attractive new investment areas that play to our strengths. While the first quarter was a quiet one on paper, with limited investments and negative earnings, we saw many of those goals achieved shortly after the quarter closed. And locking pockets of value created over the past several years. Two key events set the table for the substantial increase in 2017 earnings guidance. First, we had our long running court case involving land in Prince George's County reach a final affirmative judgment in our favor. This was an expensive and time-consuming process that went on for over 9 years, with our initial success in court challenged on appeal. With the appeal's court judgment in hand, we have received a meaningful proportion of the original judgment and await the outcome of a further appeal to settle the final part of the judgment, and then the awarding of legal fees to close out this investment. The long process has been a substantial drag on the company's earnings and resources and we look forward to now being able to put it behind us for good.

Also, during the first quarter, we took the first steps to unlock the significant value embedded in a particular part of our Net Lease portfolio, what we call our Ground Net Lease business. This is a business we've invested in over many years and now would like to grow more significantly. We have filed a registration statement and are in our quiet period prior to an IPO, so we cannot go into further detail. However, by completing a debt financing transaction on this portfolio and an equity transaction with our sovereign wealth partner and another institutional investor, we have been able to highlight the value of this portfolio and recognize gains from past work.

Together these 2 projects will create a substantial gain for the second quarter and for the year. We are raising our guidance for targeted adjusted earnings approximately 100%, from $1.50 to a range of $3.00 to $3.50 per share. More work remains to capture the full potential value for iStar in both situations. We are pleased to be able to provide this positive earnings upside, early in the year. Our ongoing goals are to further refine the portfolio and tailor our investment strategies to enable iStar to target areas in which we believe we can be a leader and avoid areas where capital is driving increasingly commodity like returns. We'll have more to say on that in the coming quarters, but let me turn it over to Geoff now for more details. Geoff?

Geoffrey G. Jervis - *iStar Inc. - CFO and COO*

Thanks, Jay, and good morning, everyone. This morning we reported earnings for the first quarter. Recognizing a net loss of $27 million or $0.38 per diluted common share, and an adjusted income loss of $12 million or $0.16 per share. The quarter's results reflect the evolution of the iStar balance sheet, as we continue to monetize non-core assets and reinvest proceeds into our core Net Lease and Finance businesses. In Q1, we did not have any significant monetizations, and the balance of core investments has not achieved the scale necessary to drive profitability in isolation. As we have said many times before, because our profitability is dependent upon gains for now, we guide investors towards full-year income, where the quarter-by-quarter volatility is less acute. Case in point, while the first quarter did not have any material gains, as Jay mentioned, and as we highlighted in this morning's press release, a couple of significant events occurred subsequent to quarter end that will positively affect our second quarter earnings and as a result allow us to materially increase our earnings guidance for the year. First, we're very pleased to announce that the U.S. Court of Appeals for the Fourth Circuit affirmed in its entirety, the District Court's judgment relating to our 2008 dispute with Lennar. The dispute is over the purchase and sale of land in Maryland, that we refer to as Bevard. The court found that we were entitled to specific performance under the contract to sell the land to Lennar, and we were rewarded the remaining purchase price of $114 million, simple interest on the unpaid amount at a rate of 12% annually since May of 2008, recovery of the real estate taxes we paid and our attorneys' fees and costs. We have since transferred title of the property to Lennar and received net cash proceeds of $231 million, which represents the total court mandated balance due, except for legal fees. Lennar however, has filed a petition disputing approximately $30 million of the judgment. And as a result, after giving effect to our 4.3% partner, we expect to recognize income of approximately $90 million in Q2. In the event of successful resolution of the $30 million interest item, as well as a collection of our legal fees, we expect to recognize additional income in subsequent periods.

Secondly, several months ago we formed a subsidiary named Safety, Income and Growth, or Safety, in order to capitalize our ground lease business. And we've contributed a portfolio of 12 assets, with a depreciated book value of $156 million to the subsidiary.

During the first quarter, we completed a $227 million 10-year financing on the Safety portfolio, with all of the proceeds that the finance -- financing being paid to iStar. Subsequent to the end of the quarter, 2 institutional partners acquired a 51% interest in Safety, for $57 million. While we retained a noncontrolling 49% interest and serve as a day-to-day manager of Safety. As a result, our remaining interest in Safety will be accounted for, as an equity method investment. The sale will trigger a second quarter gain of approximately $150 million, net of realized and anticipated costs. And combined with the proceeds from the financing, generated cash for iStar of approximately $275 million, net of fees and expenses.

Subsequently, Safety has filed a public registration statement with the SEC for a potential initial public offering. The registration statement is publicly available on the SEC's website. Since Safety is in the SEC registration process, we are not able to discuss the possible IPO, other than to refer you to the filed registration statement, which contains details about Safety, its assets and its business plan. We look forward to being able to discuss Safety in more detail in future quarters.

In total, these recent events provided us with over $500 million of cash proceeds and will generate approximately $240 million of gains the second quarter. This gain translates directly to increases in our shareholder's equity, as we will use our NOLs to shield the gain from taxation and/or dividend distribution requirements. While both of these transactions were on our radar screen and were included as potential events when we provided earnings guidance last quarter, our expectations earlier in the year regarding timing and magnitude, represented a range of possibilities. Accordingly, we are increasing our net income target for the full year to a range of $2.15 to $2.65 from $0.65. And our adjusted income target to a range of $3.00 to $3.50 from $1.50. These transactions also resulted in some material improvements to some of our key balance sheet accounts and credit metrics.

Pro forma for these recent transactions, our adjusted book value per share increased over 25%, from $742 million to $928 million. On a per-share basis, the increase in adjusted book value per share was approximately $2.70, increasing adjusted book value per share from $10.29 to nearly $13 per share.

In addition, our leverage decreased from 2x to 1.5x and total availability -- sorry, total available liquidity sits at $1.1 billion, as of today. Needless to say, in light of and armed with this new material positive information, we will be meeting with the rating agencies in the near term.

Let me switch gears for a moment. This morning, we published our first ever earnings supplemental to our website. This represents the continuation of our commitment over the past year to enhance our disclosures. As a result, we moved many of the charts and tables that we have previously included in our earnings release to the supplemental, allowing us to focus the release on the most important, quantitative and qualitative information for the quarter. We look forward to hearing from the market as to how we can improve our disclosures, specifically, with respect to the new supplemental and the revised press release format.

On the Outreach front, our Annual Shareholder's meeting will be the morning of May 16, in New York City. In addition, we are planning on attending a number of equity and high-yield conferences next month, as we continue to increase our profile in the market.

We're also happy to report that we've added additional research coverage for iStar. For those that may not have seen the initiation report, Steve Delaney and Ben Zucker from JMP Securities launched coverage on us during the first quarter. We welcome JMP and look forward to working with them going forward.

In terms of investment activity, Q1 was a quiet quarter. While our business generally has a degree of seasonality with Q1 been slow, the issue was exacerbated for us, as we did not find any attractive opportunities in a market that feels more and more full, made more difficult by a relatively high cost of capital.

Moving over to the balance sheet, our portfolio of investments stands at $4.5 billion and is comprised of our core Real Estate Finance and Net Lease investments, as well as our operating properties in Land and Developed Assets. At quarter end, our Real Estate Finance portfolio was $1.4 billion, generating $13 million of segment profit during the quarter. We break out our Real Estate Finance portfolio into 2 categories: Legacy Loans made pre-2008 and iStar 3.0 Loans made during and after the financial crisis. The vast majority of our loans, $1.2 billion, are iStar 3.0 loans. These loans continue to be 100% performing and generated a yield of 9.2% in the first quarter. For our Legacy Loans, the performing assets continued to repay and the balance of those loans was only $34 million at the end of the quarter. And the remaining $190 million were MPLs, which included $145 million nonperforming hotel loans, that we've discussed in depth during our third and fourth quarter earnings calls. We will provide material updates as appropriate as we work towards resolution.

Our net leased portfolio balance was $1.5 billion at quarter end. Comprised of $1.4 billion of wholly owned investments and a $92 million equity investment in our Net Lease JV. The yield on our overall net lease portfolio was 8.4% in the first quarter, with portfolio occupancy and weighted average lease term of 99% and 14.8 years, respectively. For the period the net lease segment recorded profits of $20 million.

Over to our operating portfolio. Going forward, in light of the small amount of residential operating properties that remain on our balance sheet, $72 million to be exact, we will no longer break the portfolio into residential and commercial categories. The classification of stabilized and transitional, however, will remain. The balance of stabilized assets is $339 million, which generated a weighted average yield for the quarter of 7.9%. Our transitional assets totaled $192 million, the largest of which, is a $98 million Westgate Entertainment district in Glendale, Arizona. While Westgate's retail is almost entirely leased and performing well, there is a fair bit of second-story office that remains vacant, and we are considering some options to reposition it for higher and better use.

And finally, our Land and Development portfolio had a balance of $1 billion at quarter end. And with the sale of Bevard, subsequent to the end of the quarter, this balance will come down by approximately $100 million or 10%. Inclusive of Bevard, we have sold or completed $455 million of land since 2013, representing nearly 50% of the land portfolio balance as of year-end 2013. To date, our land strategy has allowed us to generate approximately $220 million of profit. As we have discussed in the past, we continue to invest capital in the remaining portfolio, and this additional investment inflates the balance of the Land portfolio on our balance sheet. If we excluded the $316 million of capital that we have invested and the $75 million of assets that we've transferred in, since 2013, the balance of our loan -- of our land portfolio, as of today, would be approximately $500 million. Our goal is to continue to liquidate this portfolio and leave only a small group of large-scale development opportunities, which we think have significant long-term potential.

On the right-hand side of the balance sheet, as I mentioned earlier, we remain in a strong liquidity position with over $1.1 billion of cash and available capacity on our revolver. During the first quarter, we successfully repriced our $500 million senior secured credit facility, reducing the coupon by 75 basis points. The facility was repriced at par and now bears interest at an annual rate of LIBOR plus 3.75% with a 1% LIBOR floor. In addition, this quarter, we issued $375 million of new 5-year, 6% unsecured notes due April 2022. The company used proceeds from the offering to repay its $100 million 5.85% senior unsecured notes, at maturity in March. And in April, we early repaid the $275 million 9% notes due in June.

And as I mentioned earlier, we also raised $227 million of secured debt during the quarter on Safety's initial 12 ground net lease portfolio. This debt was transferred to the Safety JV, along with the initial portfolio of assets, subsequent to the end of the quarter. As a result, these liabilities are no longer accounted for at iStar.

Next up, is the $550 million of 4% unsecured bonds that mature in November. We anticipate refinancing these bonds this summer or in the early fall.

In summary, despite a quiet Q1, Q2 has already been extraordinarily productive. For comparison, in all of 2016, a year where we exceeded earnings guidance, we earned a total of $100 million of net income and $112 million of adjusted income. So Bevard and Safety transactions alone, will earn the company $240 million, not to mention the resulting 25% increase in book value, $500 million of cash and reduction in our leverage to 1.5x. As Jay, mentioned over the past few years, we have worked hard to generate these types of gains, and while the timing may not have been as originally expected, the magnitude of the gains exceeded those same expectations. Furthermore, our efforts to repurchase stock opportunistically over the past few years, loaded the spring as Jay likes to say, allowing us to concentrate these gains on a smaller shareholder base.

In short, we believe that Q2 represents a watershed moment for iStar. As we move forward, we will continue to refocus our -- the energies of our unique platform on the whitespace all around us. With that, I will turn it back to Jay.

Jay S. Sugarman - *iStar Inc. - Chairman of the Board and CEO*

Thanks Geoff. Let's just summarize quickly what we're focused on. One, continue to work off legacy assets that aren't part of the long-term strategy. Two, redeploy those proceeds to grow core finance in Net Lease and Ground Net Lease portfolios, depending on what looks most attractive. Three, continue to plant future whitespace investments seeds and Four, make progress on our credit ratings.

Okay, operator, let's open it up the questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And we'll first go to Jade Rahmani with KBW.

Jade J. Rahmani - *Keefe, Bruyette, & Woods, Inc., Research Division - Director*

I was wondering if you could, just looking at the full-year guidance, and the pro forma book value, give a range for full-year pro forma adjusted book value?

Geoffrey G. Jervis - *iStar Inc. - CFO and COO*

The adjusted book value per share at the end of the year, if you just take the guidance, should be $0.25 to $0.50 above the $13 number. So, I would say somewhere in the $13.25 to $13.50 range.

Jade J. Rahmani - *Keefe, Bruyette, & Woods, Inc., Research Division - Director*

That's helpful. Liquidity, of course, has sharply increased, and yet looking at your performing loan and net lease portfolios, the main sources of current recurring earnings, both are down over last year and -- sequentially. So I was wondering if you could give your thoughts on capital deployment opportunities, what's most interesting? Do you expect new investments, primarily in the lending and net lease space? And how do you view M&A, in either the REIT or Specialty finance space?

Jay S. Sugarman - *iStar Inc. - Chairman of the Board and CEO*

Jade, look, I would say, we think the finance business has some pockets that are of interest, we've build a pipeline around those, we haven't seen much of it actually close yet, but there is that opportunity there that we think will be able to grow those assets. Unfortunately, a lot of the good loans we made in the past aren't paying off, so we've got some work to do there. On the net lease side, would love to do more. I think the triple-net lease business is quite competitive. We do think there's some opportunities in the ground net lease business that fit us particularly well, so we'll be looking to expand in that area, both in terms of what we're doing at iStar, but as you know, this new vehicle we think gives us a new opportunity to expand it even more. So, it's hard to say exactly where the capital will be to redeployed, it will be risk-adjusted return focused. And right now, we see a couple of pockets that look most interesting to us, but we've got to get some more deals done in those sectors to really believe we can put out a lot of capital there.

Jade J. Rahmani - *Keefe, Bruyette, & Woods, Inc., Research Division - Director*

And is there an opportunity to pursue mergers and acquisitions and the recheck there or Specialty Finance space, perhaps some businesses in the Finance space that could be complementary to your existing platform, and also add a new recurring earnings stream?

Jay S. Sugarman - *iStar Inc. - Chairman of the Board and CEO*

Yes, we're always looking for pockets and gaps in the market, whether we can fill them or somebody's already figured out how to fill them. Again, it's very much just objective, risk adjust to return, can we scale it? Do we have particular strengths in competitive barriers? So, if you have any really good ones, let us know.

Jade J. Rahmani - *Keefe, Bruyette, & Woods, Inc., Research Division - Director*

Okay. And turning to the capital structure. Is there an opportunity to repurchase any of the securities, such as Preferreds or Converts?

Jay S. Sugarman - *iStar Inc. - Chairman of the Board and CEO*

Again, I think it comes down to where is the best place to deploy the capital on a risk adjusted return basis. We have had this debate over many years here, in terms of the preferred element of our capital structure, and to the extent that represents the most attractive way to deploy capital, it's certainly an alternative. But again, I think we've seen some opportunities to make even better risk-adjusted returns elsewhere. As we are seeing our legacy assets come off, that's certainly something we will be considering.

Jade J. Rahmani - *Keefe, Bruyette, & Woods, Inc., Research Division - Director*

And on the commercial property and Land portfolios. Are there any specific assets you could identify that have critical milestones in 2017? For optimization or some kind of further progress on development work?

Jay S. Sugarman - *iStar Inc. - Chairman of the Board and CEO*

Yes, I mean this is, as Geoff said, our timeframes haven't always worked out the way we would've hoped. Some of those milestones that we have thought we would've achieved, seem to just get pushed out a little bit longer than we would hope. But progress is being made across the board on a lot of projects. Just, I will caution you that, trying to tell you exactly when things are going to happen is proven a fool's game. So, all I can tell you is we are making progress. There are some fairly substantial assets that are getting towards the -- the end game, whether that's third quarter, fourth quarter or early next year, we just don't know yet.

Jade J. Rahmani - *Keefe, Bruyette, & Woods, Inc., Research Division - Director*

And on Retail exposure. Could you address that and also comment on whether you view changes happening in the retail space as a potential opportunity to redevelop that -- to acquire assets and redevelop them with new business models?

Jay S. Sugarman - *iStar Inc. - Chairman of the Board and CEO*

Yes. Retail's never really been part of our core strategy. I don't think we'd tell you we have any particular expertise there, we've done some things there. I mean, you could call them Retail Auto Dealerships, things like that we have played in. We have a couple of assets on the balance sheet that probably make up 2% to 3% on our asset-base. So, they're not a material portion that we have -- some very smart people helping us, try to improve the cash flows, I think Geoff mentioned one of the largest ones. So, it's not a business that we spend a ton of time focused on, so I can't tell you we have any insights into how to create lots of value there, I think others are probably better positioned for that. But, look, stuff comes across our desk that looks interesting we tend to dig in and try to see if there's something there. So, as that market becomes more and more out-of-favor, maybe something will come out of that.

Operator

(Operator Instructions) And we'll go to Steve Delaney with JMP Securities.

Steven Cole Delaney - *JMP Securities LLC, Research Division - MD, Director of Specialty Finance Research and Senior Research Analyst*

I want to talk a little bit about Real Estate -- the Real Estate debt side of the business. And Jay I appreciate your comments about the tightness and the low cap rates -- in net lease business today. But I wanted to raise, if we flip to the other side -- to the finance side, we had 3 sort of pure-play bridge lenders this quarter, have earnings misses. Two of the CEOs were, specifically, quoted as saying, they saw "the market was increasingly competitive." And the misses, it seems like, was due to heavy prepayments. And while there are a lot of -- there's good pipeline, they're really fighting the challenge of being -- of staying fully invested, just given the short-term nature. So, I guess, what I'm trying to say is you've got a foot in both camps. And if you look at it today, you still believe the opportunities are better on the shorter term floating-rate bridge loans or construction loans versus the more stable long-term triple-net lease?

Jay S. Sugarman - *iStar Inc. - Chairman of the Board and CEO*

Okay, I think the question you're asking is the relative value between the 2...

Steven Cole Delaney - *JMP Securities LLC, Research Division - MD, Director of Specialty Finance Research and Senior Research Analyst*

Absolutely, that's it, precisely.

Jay S. Sugarman - *iStar Inc. - Chairman of the Board and CEO*

Look, we've always been big fans of duration. When you find an excess return opportunity or a situation where you can really help a customer create value, you want to lock that relationship in for as long as you can. And net lease for us, over a long period of time, has been very good at that. I will tell you, trying to scale into today's market is difficult. There is lots of capital. I think everybody who plays in that business is going to find a couple of really good deals and a lot of other deals that are just, on the margin, okay. We call that the commodification of returns. So, if we're in the business to find excess returns for shareholders, it certainly has gotten harder in both worlds. And it means we just have to dig deeper and find places where that situation, we can bring unique strength to it. I think if you ask anybody, if you're just one of 10 bidders right now, you're going to get very commodity-like returns. So if you're not bringing something special to the table -- both business are still fine. I'm not telling you they're bad businesses, I'm just telling you, if you're trying to create excess returns, above and beyond what sort of normal risk reward is in either market, you really got to dig deep right now, you really have to bring something special to the table. We are doing that in some really good situations, it's just not creating enough volume to really drive our business. So, we're going to continue to look for places where we do have competitive advantage and deploy more and more capital there, and sit on the sidelines, frankly, on some of the other places.

Steven Cole Delaney - *JMP Securities LLC, Research Division - MD, Director of Specialty Finance Research and Senior Research Analyst*

I appreciate that. Because, that's -- the way you describe that is, sort of, how we see the market as well, that it's not a market where you can throw a ton of capital at, whether you're talking about net lease or the likely transactional bridge market. And of course, we've got 2 new IPOs, that are one in the market and one coming. Fresh capital, probably is going to make that tougher. Going back to Jade's comment about M&A. You went down market before with Fremont. And I'm just curious, as you guys are sitting around trying to focus where can we put capital. Do you ever find yourself talking about the small balance commercial market, which seems to be extremely fragmented? And I'd just be curious if you see any opportunities down market?

Jay S. Sugarman - *iStar Inc. - Chairman of the Board and CEO*

Let me put it this way, what we're set up to do, doesn't fit well with that strategy. We have looked at platforms that have focused on that strategy, to date we've not really seen any of that fit us. Or we've felt could scale and maintain their competitive advantage. Again, not to say that there aren't great companies doing it, it's just hasn't fit us. If they were set up the way we use our human resources, it's been a difficult match. So, not something that we're particularly, attuned to right now.

Operator

And Mr. Fooks we have no further questions.

Jason Fooks - *iStar Inc. - VP of IR & Marketing and Head of Marketing*

Okay, 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 give the conference call replay instructions once again.

Operator

Certainly, and yes, ladies and gentlemen this conference is available for replay. It begins at 12:30 p.m. Eastern Time today, and will last until May 21 at midnight. You can access the replay by dialing 1 (800) 475-6701, with the confirmation code of 423394. That does conclude your conference for today. Thank you, for your participation. You may now disconnect.