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STAR - Q3 2017 iStar Inc Earnings Call

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PRESENTATION

Operator

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

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

Thank you, John, and good morning, everyone. Thank you for joining us today to review iStar's third 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'll be a replay of the call beginning at 12:30 p.m. Eastern Time today. Dial-in for the replay is 1 (800) 475-6701, with the confirmation code of 431154.

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. During the third quarter, we took meaningful steps to strengthen our balance sheet, while continuing to market several large assets for sale, expand our footprint in the ground lease sector. They are also focusing on strategies to increase investment in both our finance and net lease areas over the coming quarters. As Geoff will detail in a minute, we made a series of moves this quarter to extend the term of our debt and lower its overall cost, expand our reach into the capital markets and reduce our annual preferred dividend expense. The ultimate goal was to improve our credit profile, and we're very pleased to receive upgrades from the rating agencies and move closer toward our desired rating levels. While we remain cautious on many parts of the market, this capital markets progress should enable us to be more active on the investment side in 2018 and beyond. We also made further investments in Safety, Income and Growth during the quarter via additional share purchases and continue to believe we have the opportunity to build the company into a clear market leader, delivering an exceptional combination of principal safety, income growth and capital appreciation. As its manager and largest shareholder, we're using all the tools we've developed over the years to redefine the ground lease sector and help owners and developers access what we believe is a highly efficient way to meet their capital needs.

In addition, iStar has recently made 2 leasehold loans in conjunction with newly created ground lease positions, and believe that iStar and SAFE's unique ability to provide custom tailored capital, both the ground leased and financed based, may create attractive and proprietary financing opportunities for iStar in the future.

Lastly, this quarter's earnings and our full-year earnings guidance were impacted by various asset sales pushing out to next year, and some costs related to the capital markets transactions. But we're still projecting strong numbers for full-year 2017. For that and more detail, let me turn it over to Geoff. Geoff?

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

Thanks, Jay, and good morning, everyone. This morning, we reported earnings for the third quarter recognizing a net loss of $35 million or $0.48 per diluted common share, and adjusted loss of $4 million or $0.05 per share. We had anticipated positive earnings this quarter and the difference from our expectation was driven by 2 land asset sales slipping to 2018, as well as one-time charges associated with our comprehensive refinancing. More on that in a moment.

Looking at earnings on the year-to-date basis, net income was $116 million or $1.61 per diluted common share, and adjusted income was $183 million or $2.16 per diluted common share.

The first item I'd like to discuss this morning is the $2 billion of capital markets transactions we executed in mid-September. These transactions in whole reduced annual interest and preferred dividend expenses by approximately $0.55 per basic share or $0.43 per diluted common share and catalyzed upgrades from all 3 major rating agencies. These upgrades should further reduce our marginal cost of capital and make us more competitive on the investment front. As part of these transactions, we issued $1.1 billion of unsecured notes, comprised of $400 million of 3-year notes, $400 million of 5-year notes and $288 million of convertible 5-year notes. As part of our convertible offering, we also repurchased 4 million shares of iStar. Not only where these transactions a win from an economic standpoint, but also they demonstrated a value of our outreach efforts to the investment community, as evidenced by well over 100 accounts placing orders for our offerings, 50 of which were new accounts for iStar. Jason Fooks and the IR team have lead our efforts to reestablish our public debt and equity market presence and this certainly represents the fruits of their labor.

Subsequent to quarter end, we used the $1.1 billion of offering proceeds, together with cash on hand, to prepay $1.15 billion of unsecured debt, due to mature in November '17, February '18 and July '18, and to redeem $240 million of our Series E and F preferred stock, which had a weighted average cost to capital over 7.8%. During the third quarter, we also repriced, extended and downsized our secured term loan and upsized our revolving credit facility from $250 million to $325 million, an additional $50 million commitment from Barclays, and a new $25 million commitment from Morgan Stanley. Our revolver serves as an important cash management tool and source of liquidity. As we continue to build relationships with additional banks, we will seek to continue to grow our revolver. It's important to note that because we closed the transactions prior to the end of the third quarter, but utilized the proceeds to redeem debt and preferred stock after the end of the quarter, our balance sheet at September 30 shows $1.9 billion of cash and liabilities of $4.9 billion. Pro forma, after the repayments and redemptions, cash stands at $531 million and liabilities were $3.5 billion.

We've illustrated these pro forma adjustments in more detail in our earnings release and supplemental. The net impact of all the aforementioned transactions was the extension of our average debt maturities by 1.5 years to 4 years, and a reduction of our weighted average cost of debt by 35 basis points.

Lastly, the transactions eliminated all of our corporate debt maturing for the next 20 months. Brett Asnas and the entire capital markets team deserve a tremendous amount of credit for both formulating and executing this plan.

Next, let me return to our portfolio and core businesses. Our overall portfolio of loans, net leases, operating properties, land and cash available for investment stood at $4.6 billion on a gross basis. This includes our $1.1 billion real estate finance portfolio, and our $1.4 billion net lease portfolio. But both of these businesses continue to perform very well, the market is competitive, and to be successful we're hard at work to identify niches that play into iStar's competitive strengths.

From a net leases asset management standpoint, Barclay Jones and his team successfully renegotiated the lease on our largest triple net lease asset, extending the lease term on this $220 million book value asset by 8 years to 2032, giving us a fresh 15-year lease term.

Turning to our ground lease business. We continue to be very excited about the opportunity in ground leases, which we pursue through our investment in Safety, Income and Growth, separately traded public company with a ticker symbol SAFE on the New York Stock Exchange. We're the largest shareholder and the manager of SAFE, and during the quarter we purchased an additional 1.3 million shares of SAFE for $24.5 million, bringing our total ownership up to 6.3 million shares or just under 35% of outstanding shares. Based on the price of SAFE at September 30, our investment has a market value of $117 million. These shares, however, are carried in conformity with GAAP at $75 million on our balance sheet. Under new GAAP rules that take effect in 2018, we will be required to recognize an additional $55 million gain associated with the April 2017 sale. This gain will not initially show up in our 2017 financial statements filed in 2017. However, the gain will be included when we present those same 2017 financials in 2018 and beyond.

Translation, we have a retroactive $55 million gain and commensurate increase in book equity that will show up once we file our first quarter results in 2018. On the ground lease origination front, we took advantage of 1 of the synergies of running both SAFE and iStar, as we partnered with SAFE to provide a complete capital solution to 2 customers in the form of ground lease financing from iStar, and a ground lease from SAFE. First transaction is LifeHope Medical Center where iStar and SAFE provided a one-stop capital solution to a repeat customer in the form of a $16 million SAFE ground lease and a $24 million iStar leasehold loan. The other, which closed subsequent to quarter end, and was on a portion of our Great Oaks land development in San Jose, California. iStar provided both an $81 million leasehold financing and a $24 million ground lease to a developer as part of a $105 million construction financing solution for a 301-unit multifamily project. In 3 years, when we expect the project to be completed, SAFE will purchase the ground lease from iStar. While we do not anticipate this to be a major driver of new business for iStar, we do expect it to be an attractive one-stop shop solution for some customers. Of course, it is our policy for any joint transactions to be approved by both sets of independent directors from iStar and SAFE.

Back to income and earnings. This morning, we updated our guidance to incorporate our latest expectations. Our prior guidance for net income was in the range of $2.15 to $2.65 and adjusted income was in the range of $3 to $3.50. The successful and highly accretive capital market transaction we closed in the third quarter, will result in one-time charges of approximately $25 million to net income and $9 million to adjusted income. In addition, as I mentioned before, certain land asset sales that we had originally forecasted to generate approximately $0.65 per share of gains in 2017, are now expected to be sold next quarter or even next year. The net effect of these items brings our 2017 net income guidance to a range between $1.21 and $1.71 per fully diluted share, and adjusted income guidance to a range of $2.25 to $2.75 per fully diluted share.

Of course, as I mentioned before, we'll be required under GAAP to recognize an additional $55 million gain or $0.64 per diluted common share associated with the second quarter sale of our ground lease business to SAFE. Again, this gain will not initially appear in our 2017 financial results, but will be retrospectively recognized in our 2017 financial results once new accounting standards become effective in January 2018.

Under those new accounting standards, we would expect 2017 net income to be in a range of $1.85 to $2.35, and adjusted income to be in a range of $2.89 to $3.39.

In terms of our legacy assets, I'd like to highlight a few items. We're very pleased to have started construction on the centerpiece of our redevelopment project in Asbury Park, New Jersey. Our 17-story oceanfront tower, appropriately named 1101 Ocean, is now 4 stories out of the ground and making steady progress every day. We expect this iconic mixed-use tower to be completed in 2019, with residential sales starting this spring. This quarter, we hired Kate Doerge to be our new Head of Marketing. Kate will spearhead our marketing efforts in Asbury Park as well as coordinate all of SAFE's and iStar's marketing activities. While Kate has only been here 3 weeks, she's already made a notable impact. On the operating property front, we did not sell any operating properties this period. We have, however, successfully stabilized the retail and entertainment components at our Westgate property in Phoenix. As a result, we migrated this portion of the asset to the book value of $57 million from transitional to stabilized this quarter. Stabilized properties now represent 72% of the overall operating portfolio. As we are all too aware, several hurricanes hit the United States this season, consistent with our prior statements, damage to our portfolio was minimal. As the dust is settling, we can now put more meat on the bone. Damage was confined to 3 properties, residential development in Naples Florida, and 2 Marina's, 1 in Key West and 1 in Tampa. In total, we have booked $1 million this quarter for expected hurricane related damage expense, while we're unable to estimate the exact amount of this expense, our expectation is that these expenses will not exceed $3 million.

Lastly, let me provide a quick update with respect to Bevard. As we previously discussed, the multi-year lawsuit with Lennar was decided in our favor earlier this year, and we were awarded and received $234 million of proceeds related to specific performance, default interest and real estate taxes. We were also awarded reimbursement of our legal fees, the amounts to be determined through further proceedings before the district court.

During the quarter, Lennar petitioned the U.S. Supreme Court to review 2 specific issues previously decided in our favor by the lower courts. There can be no assurances as to the outcome of Lennar's petition or if the U.S. Supreme Court would accept the case. As a result, the timing of when we receive reimbursements is uncertain. We, however, expect to prevail in this matter as well. And with that, I'll turn it back to Jay.

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

Thanks, Geoff. So to sum up, good work on the right side of balance sheet, more work needed on the investment front and on legacy asset sales, and a number of things in progress to help get those moving. Okay, operator, let's open it up for questions.

QUESTIONS AND ANSWERS

Operator

[Operator Instructions] And that will go to the line of Jade Rahmani with KBW.

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

Just a high-level question. Over what time period do you think you can get to profitability on a core recurring basis? I mean, maybe you could give some color on outsize legacy assets and the timeline to converting those into investment capital that could produce recurring earnings?

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

Yes, sure Jade. I think its 2 things, it's the cash on the balance sheet and the liquidity that we can deploy. It's also recycling some of the legacy asset capital that, in many cases, is not contributing to earnings, is actually hurting earnings. As you know, we're pounding away on it. We do see some near-term progress, we're going to be able to make there. But as you've seen over the quarters, it's hard to predict quarter-by-quarter, I will say. We have, internally, made it a core focus of 2018 to really start pushing out some of the assets that we think have reached maturity. But we're not willing to take big discounts to do things at once. We -- particularly in the land sales, we've had a long journey, I think we've created some very valuable pieces of real estate and we are interested in monetizing them, but we also think we have the capability to make sure we're extracting full value there.

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

And looking at the iStar asset base and recognizing you've already consummated major asset sales over the last 2 years, are there additional opportunities to monetize assets and provide construction financing to developers? And maybe on the back end, create ground leases as in the Great Oaks deal? Just thinking about sizing the pipeline or the asset base that could be used to create future revenue opportunities.

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

It's a good thought, one we've been working on in a number of situations as you saw in comments today. We do think ground leases and iStar financing solutions do play a role in monetization of a lot of our assets. And certainly, we're prepared to provide that capital. In many cases, the sellers have not needed it or have different plans that take them in a different direction. So yes, we do think of it as part of our core opportunities set. We will get some amount of capital from that, but I don't think it's the main driver.

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

Okay. And the asset gains that are being pushed out into 2018, is that a function of the lower market demand than you expected, pricing or is it merely a timing issue? And are any of those assets in contract, but closing is scheduled for 2018?

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

Yes, I hate to generalize, but I would say, in almost every case, it is not a function of lack of demand. It's either very specific things in due diligence that we either do not agree with, or it's a case where somebody has come to the conclusion that they want a price discount, which we're not willing to do. But it would tell you that the markets -- the primary markets that the assets that we have targeted for sale all seem very strong right now. So we don't see that as a driver, we don't think there's any impediment to a sale. There are things on the ground, particularly the large land communities that are complicated. They involved outside government agencies that don't move at the same speed as we would like in the private sector. And timing issues are always going to be a concern in terms of trying to predict them, but we still think we've got lots of good assets and we think the market is highly interested in them. In terms of whether they are under contract, we do have LOIs out there. But as we've learned over the years, particularly in the land business, until we have a hard contract with hard money down, we assume that it's just a conversation and a due diligence period, so we're not predicating sales dates based on LOIs.

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

And you mentioned in your comments, you are cautious on many aspects of the market. Do you elaborate on where you think things are getting overheated? And what concerns you exactly? In the leverage of loan space, we've seen a lot of compromise on structure and covenants, but from players I speak to, I haven't really seen the same thing play out in commercial real estate, but maybe they are just not providing a true view. So would you be able to elaborate on that?

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

Yes. Look, I think, endemic to the late cycle, I certainly think we're getting towards the late end of a cycle, risk get a little higher and cautiousness tends to get a little lower. So yes, we have seen some diminution in call protection, we've seen some diminution in the way people are underwriting certain types of assets. Doesn't mean, you can't still make money. It doesn't mean that there isn't still market opportunity, it just feels like we continue to move further down the line and as we all know from past cycles, it's just an inevitability that things get a little looser, people stretch a little more, it doesn't feel like much at the beginning, but you've got to be really cautious and careful about what you're doing. And so we see that, we feel it and we're willing to lose deals that we feel have crossed the line, and are really looking for more proprietary opportunities where it isn't 5 or 6 people bidding and the low price and worst structure wins. You actually feel like you are having a solution-based conversation with a customer, that you both are getting what you want and you both are being reasonable about it. So that continues to be our core thrust. It's our historical strength and I think with Safety, Income and Growth, we actually have a pretty unique tool to bring to the table and say we can build you a more efficient, better capital structure than what the market traditionally has been offering you. And I think that's some place we do see some opportunity.

Operator

Next we'll go to the line of Ben Zucker with JMP securities.

Benjamin Ira Zucker - *JMP Securities LLC, Research Division - Research Analyst*

My first question is pretty high level. We've heard a lot of speculation on tax overhaul. And aside from just the changes to the tax brackets, there've been some things mentioned that could impact the real estate industry more directly, like changes to the 1031 exchange or the ability for like accelerated depreciation recognition. I'm not going to ask you about what do you think the tax bill will say, but I'm curious if this talk has had any notable implications on the real estate industry as a whole? And I figured that as the lenders, owners and operators, and also developers, you guys kind of have a unique perspective on this. Just kind of wondering if people are behaving differently, plans getting pushed forward, pulled forward or back? Or is this just business as usual? Any kind of comments there would be great.

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

Thanks for the comment, Ben, on the ratings upgrade. We're really delighted with that and it was a lot of hard work from the team and Geoff. Look, on tax, we have not actually seen people change their decision-making, based on seems to be the ever moving targets of tax reform. I think in most aspects, we do think it is a net positive for a lot of parts of the industry. Specific things like 1031s, there's actually some positive impacts on sale leaseback markets, we think, and our net lease business, but there'll be negative, somewhere else in our world. So net-net, we can't really give you a balance of, "hey, we think this is net positive, net negative." We think there is going to be winners and losers under any tax reform. But it still seems like we're a long way from actually having finality. And I guess, most people like us are not yet changing behaviors based on something that seems so uncertain at this point.

Benjamin Ira Zucker - *JMP Securities LLC, Research Division - Research Analyst*

I guess the nice part is when you are so diversified, like you guys are, may be some of your businesses, you have like a natural hedge in there, where some businesses get a boost, while others may be get a little hit?

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

But certainly one of our -- because we're so flexible, wherever the opportunity pops up, I think we can go after it.

Benjamin Ira Zucker - *JMP Securities LLC, Research Division - Research Analyst*

You guys have done a lot of work this year and specifically in the third quarter to lower your cost of capital. I was wondering if there are any new investments that we might see you make that. You just -- you couldn't have looked at or you -- that wouldn't have worked under your previous cost structure?

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

Yes, I think, look long-term, we have a number of opportunities that we have to pass on in the past because they just didn't make sense from risk/reward standpoint. And we felt like the financing structures we had were not quite flexible enough to give us a comfort that we had all the tools needed to make sure the risk profile was as low as possible on the liquidity and financing front. As we have expanded, as we continue to grow our reach as our liquidity is, at this point, very large, we think some of those constraints will fall away. And it's not been for lack of deal flow. It's really been, if you're trying to earn the kind of ROEs that we would like to earn, there is a certain threshold we need on the ROA and with our cost of funds actually make things work well. Every time we lower our cost of debt financing, a little part of the market opens up to us. So that -- it's just a continuous curve, where we think more and more of the market opportunities just show up on our doorstep because we are in so many places, we can now be the one-stop solution, we can now provide a better solution for our customers, the owners, developers. And I think, again, Safety has been a big part of our ability to offer attractive capital structures. And now that iStar has also the ability to be a little bit more flexible, do a little better match funding, I think that combination should open up parts in the market that we didn't like passing on, but we had to in the past and now, I think we can attack.

Benjamin Ira Zucker - *JMP Securities LLC, Research Division - Research Analyst*

As a follow-up to that, if I may, since you kind of led me there, I saw you guys bought back a little bit of stock at about $11.50 during the third quarter, and the stock still seems to be trading around that same level. But given your lower cost of capital now, would you expect to be less active in buying back your own shares all else being equal? And I know this is a relative value exercise, so to your point, I'm just assuming that with a lower cost of capital now that would raise the bar on choosing to buy back shares over some kind of new investment?

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

Yes, I think, really you're going to hear in 2018 us focus very much on growth and very much on how to invest capital at attractive rates of return. To the extent the markets don't offer us those opportunities, buying our shares continues to be an interesting place. But, and the more opportunity -- the bigger the opportunity is set, the lower cost of capital we expect on the investment front to see real growth and that's where we're going to focus our efforts.

Operator

[Operator Instructions] And allow me few moments, Mr. Fooks, we have no further questions in queue.

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

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

Operator

Certainly. Ladies and gentlemen, this conference is available for replay, it starts today November 2, at 12 p.m. Eastern and last until November 16, at midnight. You may access the replay at any time by dialing 1 (800) 475-6701 entering the access code 431154. That number again (800) 475-6701 and the access code 431154. That does conclude your conference for today. Thank you, for your participation. You may now disconnect.
