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STAR - Q3 2014 iStar Financial Inc Earnings Call

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## CORPORATE PARTICIPANTS

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

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

**David DiStaso** *iStar Financial Inc. - CFO*

## CONFERENCE CALL PARTICIPANTS

**Michael Kim** *CRT Capital Group - Analyst*

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

## PRESENTATION

**Operator**

Ladies and gentlemen, good day and welcome to iStar Financial's third quarter 2014 earnings conference call.

(Operator Instructions)

As a reminder, today's conference is being recorded. At this time for opening remarks and introductions I would like to turn the conference over to Mr. Jason Fooks, Vice President of Investor Relations and Marketing. Please go ahead.

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

Thanks John, and good morning, everyone. Thank you for joining us today to review iStar Financial's third quarter 2014 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 istarfinancial.com in the Investor Relations section. There will be a replay of the call beginning at 12:30 PM Eastern time today. The dial-in for the replay is 1-800-475-6701 with a confirmation code of 339184.

Before I turn the call over to Jay I'd like to remind everyone that statements in his earnings call which are not historical facts will be forward looking. iStar Financial's actual results may differ materially from these forward-looking statements and the risk factors that could cause these differences are detailed in our SEC report.

In addition, as stated more fully 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?

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

Thanks, Jason. Thanks to all of you for joining us this morning.

Our third quarter was marked by a steady investment flow and good momentum in the portfolio with the added benefit of strong profits on several deals that we had expected to close later in the year. That combination boosted adjusted income to $58 million and enabled us to continue being selective in pricing new investments.

While our pipeline is quite full, we are comparing multiple deals to try to find the most attractive risk-adjusted returns available and identify real estate and real estate collateral we are most comfortable being invested in during this period of potential volatility. While holding over $650 million in cash will dampen earnings until that cash is fully deployed, we are happy to be in a highly liquid position going into the end of the year and well-positioned to execute on time-sensitive opportunities.

Let me do a brief interview of our major business lines. In real estate finance segment, profit was approximately $14 million after interest in G&A allocations.

Repayments of almost $300 million during the quarter and a selective attitude toward investment will temper results in the finance business but we expect that to be a short-term phenomenon. Market volatility should be a net positive for this business.

In net lease, we closed on the $200 million investment that supported the acquisition of Brunswick's Bowling business and placed the investment in our joint venture with our sovereign wealth fund partner. As we mentioned last quarter, this 20-year master lease on over 2.2 million square feet of real estate comes with very strong financial metrics and we believe will deliver long-term value to our JV partner and to our shareholders.

Our team continues to seek out interesting net lease opportunities that fit within our JV mandate. Net lease segment profit for the third quarter was $12 million compared to $10.3 million last quarter.

Segment profit in the operating portfolio was $21.6 million, well above the second quarter. Accelerating sales at a condo project in Miami together with the sale of a recently leased-up industrial complex in Hawaii helped generate these favorable numbers. While the timing of our realizations on these assets can be difficult to predict, we do expect to have additional projects kicking in some time in the near future and look forward to their contributions to this segment.

In our land portfolio, segment loss was $16.1 million, similar to last quarter. And we are excited to be launching the first phases of our Naples Reserve project in Naples, FL, and Spring Mountain Ranch JV with KB Homes in Riverside, CA. As these projects ramp up and others come online, we will be able to start discussing the results in more detail.

And with that let me turn it over to Dave to review the numbers. Dave?

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**David DiStaso** - *iStar Financial Inc. - CFO*

Thanks Jay, and good morning, everyone. Let me begin by discussing our financial results for the third quarter before moving on to investments and the performance of our business segments, then finishing up with an update on our balance sheet.

For the quarter our adjusted income allocable to common shareholders increased to $58 million, or $0.48 per diluted common share, from a loss of $7 million, or $0.09 per common share for the same quarter last year. There were several factors that contributed to the improvement in adjusted income from the third quarter of last year.

First, our revenues increased by $18 million primarily due to the investments we've made over the past year and positive results from our legacy portfolio. At the same time, reducing our overall indebtedness and cost of capital has decreased our interest expense by $8 million over the past year.

We also generated significant additional earnings from gains on property sales and carried interest earned through the equity method investments that totaled $42 million. Our net income allocable to common shareholders for the quarter was $22 million or $0.21 per diluted common share, compared to a loss of $31 million, or $0.36 per diluted common share for the same period last year.

In addition to the reasons described earlier for the year-over-year improvement, net income was also impacted by an increase of $9 million of impairment charges which were associated with investments we have in Mammoth Lakes, California. Poor snowfall over the past few seasons has resulted in reduced visitors to the area and lower demand for residential product. In addition, during the prior period, our recovery of loan loss provisions was $9 million higher.

Let me now turn to investment activity in our real estate and loan portfolios. We invested $206 million during the third quarter including $139 million of new originations and $67 million associated with ongoing developments and prior financing commitments. We generated $513 million of proceeds from our portfolio this quarter which included $308 million from repayments and sales of loans in our real estate finance segment, $105 million from sales of operating properties and $100 million in proceeds across other segments.

We ended the quarter with $653 million of available cash. At the end of the third quarter, our portfolio totaled $5 billion, which is gross of $455 million of accumulated depreciation and $31 million of general loan loss reserves.

Let me discuss each of our four business segments. Our real estate finance portfolio totaled $1.2 billion at the end of the quarter. The portfolio includes approximately $1.1 billion of performing loans, comprised of $463 million of first mortgages or senior loans and $665 million of mezzanine or subordinated debt.

The performing loans generated yield for the quarter of 9.4%, which includes 60 basis points related to an increased rate and exit fee for a loan that repaid during the quarter. At the end of the quarter, we had $93 million of NPLs essentially flat from last quarter.

For the quarter, we recorded a $1 million reversal of our loan-loss provision compared to a $10 million reversal in the third quarter of 2013. Our total reserve for loan losses at September 30 was $120 million comprised of $89 million of asset specific reserves and $31 million of general reserves.

Now let me provide a brief update on certain key metrics relating to our net lease portfolio. At the end of the quarter, we had $1.7 billion of net lease assets gross of $361 million of accumulated depreciation.

Our net lease portfolio totaled 19 million square feet across 33 states. This portfolio was 94% leased at the end of the quarter with a weighted average remaining lease term of over 11 years.

For the quarter, our total net lease portfolio generated an unleveraged yield of 7.8%. Our net lease venture has grown steadily since formed at the beginning of the year.

As Jay mentioned, this quarter the venture entered into a $200 million net lease transaction with Bowlmor AMF. At the end of the quarter, the venture had a total of $331 million of assets.

Next, I will turn to our operating properties portfolio. Our operating properties totaled $128 million, gross of $90 million of accumulated depreciation. The portfolio was comprised of $737 million of commercial and $191 million of residential real estate properties.

The commercial properties represent a diverse pool of real estate assets across a broad range of geographies and property types such as office, retail and hotel properties. They generated $31 million of revenue offset by $22 million of expenses during the quarter.

At the end of the quarter, we had $107 million of stabilized commercial operating properties. These properties were 85% leased, resulting in an 8.9% unleveraged yield for the quarter. The decrease in the balance of stabilized properties was due to the sale of a $34.2 million property which resulted in $4.6 million of income.

The remaining $629 million of commercial operating properties are transitional real estate properties that were 64% leased and generated a 2.9% unleveraged yield for the quarter. We are continuing to actively lease these properties in order to maximize their value. During the quarter we executed leases covering approximately 120,000 square feet, net of rolloffs.

The residential operating properties were comprised of 459 condominium units remaining in inventory at the end of the quarter. These units are generally located in projects characterized as luxury buildings in major cities throughout the United States. During the quarter, we sold 124 condos and a parking garage located within one of our condo buildings for a total of $71 million in proceeds and recorded $28 million of income, offset by $7 million of expenses.

That brings me to our land portfolio. At the end of the quarter, our land portfolio totaled $1 billion and included 11 master planned communities, 12 infill land parcels and six waterfront land parcels.

Master planned communities generally represent large-scale residential projects that we may entitle, plan and develop. We currently have entitlements at these projects for approximately 25,000 lots. Our infill and waterfront parcels are currently entitled for 6,000 residential lots and select projects include commercial, retail and office. The projects in the portfolio are well diversified, in locations such as California, the New York Metro area, Florida and several markets in the Mid-Atlantic and Southwest regions.

At the end of the quarter we had 6 land projects in production, 10 in development and 13 in the pre-development phase.

This quarter, we began lot sales at two additional master planned communities, Naples Reserve and Spring Mountain Ranch, which in addition to Magnolia Green and Tetherow, brings the total number of projects selling lots to four. We had a total of 69 lot sales this quarter which includes equity method investments like our joint venture for the first phase of Spring Mountain Ranch. Associated with these lot sales, we generated $5.71 million from land sales offset by $5.05 million of cost of land sales. We also invested $39 million in our overall land portfolio during the quarter.

Let me finish by providing an update on the right side of our balance sheet. After refinancing our $1.3 billion secured credit facility last quarter and unencumbering $2 billion of assets, our only remaining secured credit facility is our 2012 secured credit facility, which we paid down by $10 million during the quarter, bringing the remaining balance to $382 million.

Our weighted average cost of debt for the third quarter was 5.5%, in line with the cost of debt for the second quarter and down from 5.7% for the third quarter of last year. Our leverage was 1.9x, a decrease from 2.1x at the end of the second quarter this year and below our targeted range of 2.0x - 2.5x.

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

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

Thanks, Dave. I've been asked about our investment strategy a couple of times recently so I will just take a moment to let you know how we are thinking about this market.

You saw in our earlier comments that we have tried to be pretty selective in our new investment strategy this year with a focus on markets that we feel a little more comfortable with. On single asset deals this meant focusing on top tier cities and staying out of secondary and tertiary markets. New York City, Chicago, San Francisco, DC and Miami are all markets where we've been investing where we think a good loan basis or solid net lease property can withstand some headwinds.

On portfolio deals we've been gravitating to larger deals involving highly granular portfolios with strong financial metrics. And as we have talked about before with rates remaining low we continue to believe investing in our existing portfolio makes a lot of sense with marginal returns often higher and more certain than what we are seeing in the broader market.

The combination of single asset deals and top markets, large portfolio transactions and ongoing investment in existing positions should create a solid pipeline of investment opportunities and enable us to invest efficiently under a wide range of market conditions.

So with that quick summary let's open it up for questions. Operator?

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## QUESTIONS AND ANSWERS

**Operator**

Thank you. (Operator Instructions) Michael Kim, CRT Capital.

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**Michael Kim** - *CRT Capital Group - Analyst*

Hi. Good morning guys, nice quarter.

Jay, you talked about being liquid at the year end and I guess with almost $650 million of cash on hand, you talked a little bit about the pipeline, the potential investments. Can you talk about the size of opportunities and maybe the timing of putting new capital to work?

And also kind of thinking about how much money, what portion of cash on hand would be allocated towards new investments versus reinvesting in the existing portfolio given rates are low, or even the trade-off of buying back stock in the open market? I think you've got about $16 million left under the current share repurchase authorization and I think given the underperformance in the stock it doesn't make sense to exhaust authorization or even seek a larger authorization from the Board. Thank you.

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

Thanks, Michael. Couple of questions in there. I think in terms of the cash balance, as you know for 20 years we have kind of had a strategy of being very liquid going into the fourth quarter.

We tend to see a lot of anomalies then. Of course the one year we weren't liquid was a very bad year. So we feel quite good about having liquidity on hand. I can't really predict exactly when we will spend it. I will tell you we have got a pipeline that could spend it all pretty quickly if we desired.

I think we are being a little more selective and trying to really find the best risk-adjusted returns in those key core markets that I mentioned, so it will get spent. I am hesitant to predict exactly when but there's plenty of pipeline to take care of redeployment of that money. What was your second question?

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**Michael Kim** - *CRT Capital Group - Analyst*

Just talking about how much money would be kind of redeployed back into the existing portfolio but kind of the trade-off also with buying back stock in the open market just given the underperformance the past couple of weeks and the large liquidity position you have right now.

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

Let me just touch on the existing portfolio. We are very confident a lot of the deals that we are investing in, in the internal portfolio, are double-digit unlevered return opportunities so we still think those are really good places to deploy capital.

About half of that money is going into what I will call vertical development and about half is going into horizontal development of some of the land we have. For the most part, I would tell you we are going to continue on the pace we have been. I would say $40-$50 million a quarter is kind of a good run rate.

We think those are good solid investment and will likely continue throughout next year. But everything competes for capital here.

So new deals, our own capital structure, investments in legacy assets. So I would tell you we are constantly looking at where do we think the best way to get from here to where we think fair value is and the stock is. And if it turns out to be a change in our capital structure we're going to do that. If it turns out to be new investments that we think are highly attractive and accretive we are going to do that. I wouldn't be surprised if we look at all three and have the capital to do a piece of each but everything is fighting for capital here. So all I can tell you is we are looking at that decision pretty constantly.

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**Michael Kim** - *CRT Capital Group - Analyst*

Okay. I appreciate that. And then just more -- a recurring question that I have gotten over the past few quarters but have you guys thought about thinking or considering some sort of spinoff of some business lines, just similar to like Newcastle or NorthStar, just some recurring questions that I've gotten but kind of curious if you guys have taken a look at some of those options on your end? Thank you.

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

Yes, I think at least at this point we still see the near-term opportunities really redeploying inside our own balance sheet, some of the assets that are not yet generating capital or generating earnings, things like the land book. Once we get those things wrapped up I think there will be other opportunities strategically to look at but that's not really on the near-term plate.

We do have this third-party joint venture with a very sophisticated and large sovereign wealth fund. There is certainly opportunity down the road to expand that relationship but for the near term I think we've got to keep our eyes focused on the task at hand, which is to start driving earnings out of a bigger proportion of the portfolio.

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**Michael Kim** - *CRT Capital Group - Analyst*

Understood. And just lastly, a housekeeping item. Dave, you mentioned the $9 million impairment with Mammoth Lakes. Was it $9 million of the $15 million total during the quarter? Or did I mis-hear that?

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**David DiStaso** - *iStar Financial Inc. - CFO*

No Michael, the $9 million was an increase quarter over prior year. The full impairment was $15 million.

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**Michael Kim** - *CRT Capital Group - Analyst*

And the $15 million was solely isolated to that one particular asset in Mammoth Lakes?

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**David DiStaso** - *iStar Financial Inc. - CFO*

Yes, there were two properties in Mammoth Lakes. Both impacted.

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**Michael Kim** - *CRT Capital Group - Analyst*

Okay. Understood. Thank you very much.

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**David DiStaso** - *iStar Financial Inc. - CFO*

Pray for snow.

**Operator**

Jade Rahmani, KBW.

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

Great. Thank you for taking the questions. On the competitive outlook I was wondering if you could comment if you are seeing any spread widening or increase in loan yields just in the past say month or so?

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

Jade, I'm sure you have seen in other markets we have seen a little bit of a pullback in our market. People are taking a second look at things that they might have not done so before.

So we have seen a little bit of softening but still competitive. But I know everybody's kind of looking at year-end and pulling in just a touch so you can feel that in the marketplace.

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

Can you just remind us what target yields are on new loans that you are originating outside of the existing portfolio?

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

I hate to fall back on the old risk-adjusted but we are looking at spreads that are somewhere in the high single digits. But for something that is good and safe and solid we will tighten in and for things that we think have different risk profile we are trying to hit low teens.

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

Great. On the land side the four communities that are actively selling lots, how many total lots are encompassed by those projects?

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

Realistically, you could call it 6,000 but we are not going to develop all of those lots. We will sell out some of the super pads and some of the phases. Right now online we have phases that probably have about 1,000 lots in them.

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

Okay. Is there a number of master planned communities you expect to be actively selling lots next year? Would it be higher than what is currently active?

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

We've got a community in Southern California that we are quite excited about that should come on next year. That is probably the biggest follow-on to Naples Reserve in particular and Spring Mountain, so let's see how those go.

We have other stuff that we are working on. But I think those are the ones we are most focused on and should be able to tell an interesting story by about mid-year next year.

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

Okay. Just on the equity method investments excluding the asset sales that took place in the quarter, that baseline of $17 million roughly, is that a recurring figure, is that a figure you expect to grow? I think it has some of the KB Home joint venture income in it. Just any color you could provide on that line item?

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**David DiStaso** - *iStar Financial Inc. - CFO*

Yes, looking at that line item obviously we had to gain on sale of one of our equity method investments. That was approximately $33 million of the $49 million and then when you look at the land sales for the quarter, there was a piece of equity there.

So that would have an impact. So I think you would see the run rate of our equity method investment significantly lower.

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

Okay. And then just sort of another version of Michael's strategic question, do you think that maintaining sort of a multi-sector diversity or multi-exposure to multi-property types and holding real property, is that really core to the type of company you envision iStar becoming?

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

Again if you are asking a longer-term question I would probably answer differently than the near-term question. In the near term we do think it's a pretty powerful platform to work from to find the next big things.

But longer term I think I think the core of your question, we are very comfortable in sort of the finance net lease world. We are not likely to become a major developer in the marketplace.

But right now we are extracting some pretty sexy returns out of that part of the business. And we are going to prosecute that as long as we see that opportunity but you will see new origination volume really be driven on the finance and net lease sides of the business.

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

Great. Thank you very much for taking the questions.

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**Operator**

And Mr. Fooks, we have no further questions.

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

Great. Thanks John, and 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, please?

**Operator**

Certainly. And once again, ladies and gentlemen, this conference is available for replay.

It starts today at 12:30PM eastern; will last until November 11 at midnight. You may access the replay at any time by dialing 800-475-6701 and entering the access code 339184. That number again, 800-475-6701 and the access code 339184.

That does conclude your conference for today. Thank you for your participation. You may now disconnect.