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Conference Call Transcript

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CORPORATE PARTICIPANTS

Jason Fooks
iStar Financial – Investor Relations & Marketing

Jay Sugarman
iStar Financial - Chairman and CEO

David DiStaso
iStar Financial - CFO

CONFERENCE CALL PARTICIPANTS

Michael Kim
CRT Capital Group - Analyst

Joshua Barber
Stifel Nicolaus - Analyst

PRESENTATION

Operator

Ladies and gentlemen, good day and welcome to iStar Financial's fourth quarter and fiscal year 2010 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 of iStar Financial Investor Relations and Marketing. Please go ahead, sir.

Jason Fooks - ***iStar Financial – Investor Relations & Marketing***

Thank you, John, and good morning, everyone. Thank you for joining us today to review iStar Financial's fourth quarter and fiscal year 2010 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 www.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 192269.

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 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 reports.

In addition, as more fully stated in our SEC reports, 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 Sugarman - ***iStar Financial - Chairman and CEO***

Thanks, Jason. Overall, the fourth quarter finished up the year in which iStar made good progress toward its goal of simplifying its capital structure, streamlining its portfolio and moving past many of the challenges in the real estate downturn. By retiring large amounts of debt while protecting shareholder equity, we brought leverage down to a relatively comfortable level, enhanced our balance sheet strength and set ourselves up to refinance our 2011 and 2012 debt maturities prior to the end of the first quarter. That process is now underway, and Dave and I will give an update later in this call.

First, let me recap where the fourth quarter and full-year results came in. The fourth-quarter adjusted earnings were negative $0.42 per share, primarily due to provisions and the large number of assets that have no GAAP income associated with them yet. We continue to work hard to try to get those investments back in a position where they can contribute positively to earnings and have begun to see some success in this area, though much more work remains to be done. Full-year earnings, including gains and losses, were positive but adjusted earnings per share excluding the gains remained negative, at a $2.33 per share loss. We expect the impact of gains and loss provisions to decline throughout 2011 relative to prior years but to remain a part of the story for the next several quarters.

On the liquidity front, principal and proceeds inflows were steady and added to the significant repayment and monetizations completed earlier in the year. For the full year we generated just under $5 billion in capital from the portfolio and used the bulk of the capital for debt reduction and the smaller amount to fund new and existing investments. This capped a 3.5-year period in which iStar paid off almost $22 billion in obligations and demonstrated the strength and flexibility inherent in its diversified portfolio during the worst of the downturn. The $22 billion in obligations retired included some $6 billion related to the Fremont transaction, $8 billion in other secured and unsecured debt and over $8 billion in funding obligations related to the portfolio.

On the credit front, we saw positive movements in the commercial real estate market reflected in a better trend in our risk ratings, with the numbers modestly improving after an extended period of generally worsening metrics. We also saw a number of watch list loans become safer and exit the watch list. One important note is that this quarter we will be giving risk ratings on both a gross basis and a net basis for those loans where we have taken a specific reserve. In many cases, net of the specific reserves already charged to the balance sheet, and these loans represent attractive investments at significant discounts to their initial value and should enjoy increasing values as the market recovers.

And with that update, let me turn it over to Dave for more of the details. Dave?

David DiStaso - ***iStar Financial - CFO***

Thanks Jay, and good morning, everyone. I will begin by discussing our financial results for the fourth quarter and fiscal year before moving to investment activity and credit quality, and I will end with an update on liquidity.

For the quarter, we reported a net loss of $67 million or $0.73 per common share compared to a loss of $159 million or $1.65 per common share for the fourth quarter 2009. Adjusted earnings were a loss of $38 million for the quarter or $0.42 per common share compared to a loss of $142 million or $1.47 per common share for the fourth quarter of 2009. Results included a significantly lower provision for loan losses and impairment of assets during the fourth quarter of $58 million versus $281 million for the same period last year. We also recorded a $9 million net loss on early extinguishment of debt this quarter versus a $100 million gain for the same period last year.

The current quarter's activity included a $5 million gain from the repurchase of our bonds offset by a $14 million loss due to the acceleration of deferred financing fees related to the prepayment of our $1 billion First Priority Credit Facility.

Net investment income for the fourth quarter was $66 million compared to $79 million for the same period last year. The year-over-year decrease is primarily due to lower interest income from a smaller asset base resulting from loan repayments in sales and also due to performing loans moving to nonperforming status. This was partially offset by lower interest expense resulting from significant debt reductions during the year.

For the full year 2010, we reported net income of $36 million or $0.39 per common share compared to a loss of $789 million or $7.88 per common share in 2009. Adjusted earnings were a loss of $217 million or $2.33 per common share compared to a loss of $689 million or $6.88 per common share in 2009. The main driver of the year-over-year difference in our results was a significantly lower provision for loan losses and impairment of assets of $354 million for the year versus $1.4 billion in the prior year. This year's results also included a $250 million gain associated with the sale of a portfolio of 32 corporate tenant leases, or CTL assets, completed during the second quarter of 2010. As you know, gains associated with the sale of CTL assets are not included in adjusted earnings.

Additionally, we had fewer gains on early extinguishment of debt in 2010, totaling $109 million versus $547 million last year. Net investment income for the year was $255 million compared to $311 million the prior year. The year-over-year decrease is primarily due to lower interest income from a smaller asset base resulting from loan repayments in sales and also due to performing loans moving to nonperforming status. This was partially offset by lower interest expense resulting from significant debt reductions during the year.

During the fourth quarter, we generated $688 million of proceeds from our portfolio comprised of $316 million of principal repayments, $286 million of loan sales and $85 million of other real estate owned, or OREO sales. This brings our total proceeds for the year to $4.9 billion comprised of $2.3 billion of principal repayments, $708 million of loan sales, $460 million of owned asset sales and $1.5 billion of CTL sales. These proceeds were used in part to reduce the Company's debt obligations by $3.5 billion and also to retire the remaining $473 million A-participation associated with the Fremont portfolio. In addition, we funded $75 million and $630 million in new and pre-existing investments for the quarter and year, respectively.

Let me turn to the portfolio and credit quality. At the end of the fourth quarter, our total portfolio had a carrying value of $9 billion, gross of depreciation and general reserves. This was comprised of approximately $4.7 billion of loans and other lending investments, $2.2 billion of corporate tenant lease assets, $841 million of real estate held for investment, $746 million of OREO assets of $516 million of other investments. 70% of our portfolio is comprised of first mortgages, senior loans and corporate tenant lease assets. Our total apartment residential exposure, comprised primarily of condos, was $2.1 billion at the end of the quarter versus $2.2 billion last quarter. Our total land exposure at the end of the quarter was $1.5 billion, unchanged from the end of the prior quarter. The land exposure was comprised of $648 million of loans and $811 million of owned real estate.

Our remaining unfunded commitments for the total portfolio were $358 million at the end of the fourth quarter, of which we expect to fund approximately $111 million. At the end of the fourth quarter, our nonperforming loans, or NPLs, had a carrying value of $1.4 billion, net of $668 million of specific reserves, or 29.6% of the total carrying value of loans. This compares to $1.9 billion net of $864 million of specific reserves, or 35.5% last quarter. The drop in NPLs during the fourth quarter was in part due to improving real estate fundamentals as well as increased interest in real estate investment from both traditional and nontraditional sources of capital. Our remaining NPLs are primarily made of 44% condo, 19% land and 16% retail assets.

At the end of the quarter, the performing loan watchlist had a carrying value of $191 million, or 4.2% of total carrying value of loans. This compares to $696 million, or 13% last quarter.

Let me now turn to our OREOs and real estate held for investment. During the quarter, we took title to properties which had a carrying value of $166 million. These assets had a gross book value of $385 million prior to foreclosure, including $219 million of previously provisioned loan loss reserves which we charged off this quarter. At the end of the quarter, our OREO and real estate held for investment assets totaled $1.6 billion versus $1.5 billion in the prior quarter. Of these assets, $746 million were classified as OREO and considered held for sale based on our current intention to market the assets and sell them in the near-term. The remaining $841 million of assets are considered investment properties and classified as real estate held for investment, based on our current intention and ability to hold them for longer periods of time.

Let me move onto reserves. As I mentioned earlier, we recorded $54 million of additional provisions for the fourth quarter versus $78 million last quarter. We have continued to see provisions trend lower from the levels reported last year. For the fiscal year 2010, we recorded $331 million of provisions, substantially lower than last year, when we recorded $1.3 billion. As a reminder, while we believe provisions will continue to trend lower, the rate at which they may continue to do so is uncertain and we could see quarterly fluctuations.

At the end of the quarter our reserves totaled $814 million, consisting of $694 million of asset-specific reserves and $120 million of general reserves. Our reserves represent 15% of total gross book value of loans.

Okay, let me review our covenants. For our secured bank credit facilities, our tangible net worth was approximately $1.7 billion at the end of the fourth quarter, above our $1.5 billion requirements. Our fixed charge coverage, calculated on a trailing 12-month basis, was 1.6x at quarter end, which is above the 1.0x requirement, and our unencumbered assets to unsecured debt, or UA/UD ratio, was approximately 1.4x at quarter end, exceeding our 1.2x requirement. For our bonds, our fixed charge coverage ratio was 1.9x, and our UA/UD ratio was approximately 1.4x.

Finally, let me conclude with a discussion on our liquidity. During the quarter, we fully prepaid our $1 billion First Priority Credit Facility due June 2012. Repayment of this facility allows us to repurchase additional debt and equity securities subject to limitations under the terms of our remaining credit facilities. As we previously announced, subsequent to year-end we redeemed the remaining $312 million of our 10% senior secured notes due 2014. In connection with this redemption, we expect to recognize deferred gains of approximately $109 million as a gain on early extinguishment of debt during the first quarter of 2011.

During the quarter, we also repaid the remaining $111 million on our 6% unsecured notes that matured in December and repurchased $51 million par value of unsecured notes at a discount, resulting in a gain on early extinguishment of debt of $5 million. Having retired a total of $3.5 billion of debt, including $2.5 billion of secured debt over the past year, we believe that we are well-positioned to put in place up to $3 billion of new senior secured credit facilities that we have engaged J.P. Morgan to arrange. The facilities will be divided into a $1.5 billion A-1 tranche due in 2013 and a $1.5 billion A-2 tranche due in 2014 with different interest rates. Amortization payments would be applied first to the A-1 tranche and then to the A-2 tranche. The new facilities will be secured by a first lien on $3.75 billion of diversified collateral, comprised primarily of performing loans and CTLs. The proceeds from the facilities will be used to refinance our existing secured bank facilities that are due to mature in June 2011 and 2012, as well as repay a portion of the unsecured debt we have maturing in 2011.

Let me remind you that we are still in the syndication process and we have not yet received commitments for the new facilities, so there can be no assurance that the preliminary terms I just discussed will not change materially or that we will be successful in our efforts to complete the new facilities. Of course, we will report the result of our efforts to complete this transaction or alternative financing after the process has concluded.

We ended the year with $500 million of unrestricted cash versus $1.1 billion at the end of the prior quarter. Our non-discretionary cash usage prior to our bank facilities maturities in June of this year include approximately $200 million associated with our March and April unsecured bond maturities.

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

Jay Sugarman - ***iStar Financial - Chairman and CEO***

Thanks, Dave. Let me do a couple of follow-up comments here.

One, the pro forma balance sheet is going to be a lot simpler, assuming the new senior credit facility is completed. We will have $3 billion in new senior secured that will mature in June 2013 and June 2014. We will have $200 million scattered in a number of individual mortgage debt. We will have $3.7 billion in unsecured debt maturing between 2011 and 2017. We'll have $600 million of trust preferred and preferred equity, and we will have over $1.2 billion in common equity including the $100 million plus gain triggered by our repayment of the 2014 senior lien notes in early January that Dave mentioned.

That pro forma tangible common equity number equates to around $13.50 per share and over $14.50 when general reserves are added back in. This is a strong cushion for our creditors and one of the markers of value that we are very focused on relative to our common stock.

One other thing I alluded to before is the potential contribution to earnings embedded in our nonperforming loan and assets we have previously taken ownership of. In our overall portfolio, the $3.0 billion in performing loans generate very solid earnings. The $2.2 billion sale/leasebacks also generate solid earnings, but the $2.9 billion of NPLs and REO portfolio segment are still mostly in turnaround mode and are generating sizable losses as we reposition and upgrade this part of the portfolio. In 2010, we saw a number of these deals complete their turnaround and generate solid returns, but the majority of these will take a more extended time frame to do the same. As we move through 2011, we will be working on getting these assets repositioned and providing some specific examples to highlight why we think there is upside in this segment of the portfolio, assuming the markets continue to recover.

And with that, let's open it up for questions. Operator?

QUESTION AND ANSWER

Operator

(Operator instructions) Michael Kim, CRT.

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

Assuming you are able to consummate the proposed $3 billion refinancing transaction, could you prioritize for us the allocation of capital by business line going forward? And would the proposed amort schedule on the proposed A-1 tranche with securability to originate new loans? And if you could maybe address anticipated REHI development spend, over what time period, and some of the more opportunities and timing of loan origination?

Jay Sugarman - ***iStar Financial - Chairman and CEO***

A couple things in your question -- I think, to start with, in terms of priorities we are going to continue to simplify the balance sheet and continue to pay down some debt and continue to reduce leverage. Where we have found the best opportunities and the most interesting things are still within our own portfolio. That $9 billion portfolio covers about 350 assets. There are lots of situations inside there where we see very attractive opportunities, where obviously we have 100% perfect knowledge and a very high win rate, where we see an opportunity to provide capital.

But it will be the case, at least for the foreseeable future, that money coming in is going to exceed money going out. So we will see debt continue to come down, leverage continue to come down, with new investments made primarily within our own portfolio, within the -- I think you called it the REHI and OREO segments. We have money scheduled and set aside to upgrade a lot of those positions. That number is probably less than $100 million next year. But, again, we look at every investment of capital kind of on a marginal basis and are trying to decide where best to deploy it. Right now, we are seeing those opportunities almost entirely within our own portfolio.

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

Understood, thanks. Just as a follow-up, I noticed the CTL assets showed sequential improvement in occupancy. Could you talk about the trends for the CTL portfolio, I guess how lease spreads trended over the past few quarters? And maybe if you could talk about or quantify the improvement in cap rates for office and industrial CTL assets, in particular, over the past few months or the past year?

Jay Sugarman - ***iStar Financial - Chairman and CEO***

I think that's an interesting dynamic we are seeing. Certain markets are recovering. We are seeing lease velocity picking up in markets that have been relatively dormant for the past couple years. I wouldn't make it a sweeping statement, though; there are still pockets of weakness out there. But certainly, the tone is getting better. Our viewpoint, in terms of how we look at the lease portfolio, it's a little bit idiosyncratic and we were able to sign some nice leases that had good term on them. But again, it's kind of market-by-market, deal-by-deal, property-by-property. So I wouldn't go so far as to say there's a sweeping change in the underlying dynamics.

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

Great, thank you.

Operator

Joshua Barber, Stifel Nicolaus.

Joshua Barber - ***Stifel Nicolaus - Analyst***

Maybe following up on Michael's question a little bit but talking about some opportunities that might exist outside of your portfolio, do you think that there's an opportunity going forward to, at least assuming that you are getting the bank refinancing done, to raise new capital either in the high-yield market combined with something in equity to sort of complement your strategy of fixing whatever is on the balance sheet going forward?

Jay Sugarman - ***iStar Financial - Chairman and CEO***

Again, we think and have, I think, pretty consistently said we have sufficient assets on this balance sheet to do whatever financing we needed when we thought the pricing was appropriate, and in the structure we thought was best suited for the profile of the assets and for the preservation of value for our shareholders.

Right now, we think this secured facility meets our needs for an extended time frame. Right now, we have plenty of capital for the things we envision doing over the next four, five, six quarters. Just thinking about the quality of the secured portfolio, it is a very high-quality, collateral-rich secured facility. It's got great credit metrics. Many of the assets in there you couldn't replicate today if you tried. So we are quite confident that this will be a period of time in which the market will begin to see the quality of these portfolios. And until we get the kind of recognition we think the portfolio deserves, you won't see us reaching for capital that we have no current need for.

Joshua Barber - ***Stifel Nicolaus - Analyst***

Okay. You touched before on some amortization on the potential secured line. I know that -- I guess details are sort of murky at this point. But would that be a fully amortizing line, just based on the credit portfolio, or would there be some amortization targets that were built in?

Jay Sugarman - ***iStar Financial - Chairman and CEO***

We have structured it to try to match the profile of the assets that are being contributed. The weighted average maturity of the loan portfolio that will be part of the secured facility is less than three years, so there's a lot of natural amortization and natural repayments in there. The way we have structured it, the A-1 gets those repayments first, so it will have a relatively short duration. And then there will be some amortization targets that will shorten the creation of both pieces of paper shorter than their final maturities.

Joshua Barber - ***Stifel Nicolaus - Analyst***

Okay, you touched before also on the potential from the real estate held for investment/OREO portfolio. Is that portfolio actually generating any cash today, or is that still cash flow negative?

Jay Sugarman - ***iStar Financial - Chairman and CEO***

It's cash flow negative. Individual assets are, as I mentioned, turning the corner. We have seen some nice turnaround stories with pretty eye-popping returns. But that's still a small minority of the total portfolio. We are going to continue to commit capital. We think there are upsides as the market recovers in that segment, and that's one of the places we are devoting a lot of our asset management resources.

Joshua Barber - ***Stifel Nicolaus - Analyst***

Great, thanks very much.

Operator

With no further questions, I'll turn it back to you, Mr. Sugarman.

Jason Fooks - ***iStar Financial - IR***

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

Operator

Certainly. Ladies and gentlemen, again, this conference is available today starting at 12.30 PM Eastern and will last until March 10 at midnight. You may access the replay at any time by dialing 800-475-6701 and entering the access code 192269. That does conclude your conference for today. Thank you for your participation. You may now disconnect.