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STAR - Q2 2015 iStar Financial Inc Earnings Call

EVENT DATE/TIME: AUGUST 04, 2015 / 2:00PM GMT

CORPORATE PARTICIPANTS

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Jay Sugarman *iStar - Chairman & CEO*

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Jade Rahmani *Keefe, Bruyette & Woods - Analyst*

Sean Monaghan *Penn Capital - Analyst*

PRESENTATION

Operator

Good day and welcome to iStar's second quarter 2015 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 - VP, IR & Marketing*

Thank you, John and good morning, everyone. Thank you for joining us today to review iStar's second quarter 2015 earnings report. With me today are Jay Sugarman, Chairman and Chief Executive Officer and David DiStaso, our Chief Financial Officer. This morning's call is being webcast on our website at istar.com in the Investors 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 the confirmation code of 365176.

Before I turn the call over to Jay, I would like to remind everyone that statements in this earnings call, which are not historical facts, will be forward-looking. iStar's actual results may differ materially from these forward-looking statements and the risk factors that could cause these differences are detailed in our SEC reports. iStar disclaims any intent or obligation to update these forward-looking statements except as expressly required by law.

In addition, we refer you to our June 10, 2015 investor presentation, which can be found in the Investors section of our website for the reconciliation and assumptions underlying forward-looking non-GAAP metrics. Now let's turn the call over to iStar's Chairman and CEO, Jay Sugarman.

Jay Sugarman - *iStar - Chairman & CEO*

Thanks, Jason and appreciate everyone joining us today. During the second quarter, we took a conservative approach to the market while laying out the foundations of the strategy we think will differentiate our Company and help us find attractive investments in the coming years. With global risk factors escalating, we retain large cash balances while assessing new possible areas of interest. Our adaptive investment platform is built upon interesting opportunities and we expect to make certain smaller investments in the coming quarters to give us a toehold in sectors we think have the potential for larger scale investing.

Our cautious stance is reflected in the quarter's investment activity with the successful layoff of two large participation interests and several assets being put on the market for potential monetization in the latter half of the year. We also took additional reserves against an asset in litigation that has likely seen its value diminish while the courts sort through conflicting claims between our borrowers.

In addition, we moved to simplify our balance sheet and enhanced our earnings profile by tendering for all outstanding high-performance units or HPUs. These units were issued over a decade ago and have economics that closely mirror the economics of our shares, but are illiquid. The tender offer offers holders cash and/or iStar shares and based on binding tender agreements received to date, we expect a substantial majority of the units will be tendered and we won't know the cash share split until the tender closes on August 12.

Moving over to earnings for the quarter, our adjusted income came in at $0.11 per share impacted by the still sizable portion of noncontributing assets and cash on the balance sheet. We think this is an issue that will shrink over time and should see a corresponding bump in earnings as more noncontributing assets get in position to provide positive earnings.

Despite the high cash balances, we are still maintaining an internal adjusted income goal of $0.75 per share for the full calendar year. Breaking it down further, the finance, net lease and operating property segments all remain solidly profitable with segment profits $17 million, $19 million and $10 million respectively versus $34 million, $10 million and $7 million for the prior year.

The land and corporate segments remained a drag on earnings, but we are getting closer to having land become a contributor to segment earnings as sales of portions of our holdings become more visible. We should have some additional news on that front in the upcoming quarters. Segment profits for land were a loss of $11 million and a loss of $12 million for the corporate segment versus a loss of $17 million and a profit of $8 million last year. So we still have a lot of work to do in these areas. With that quick summary, let me turn it over to Dave for the numbers. Dave.

David DiStaso - *iStar - CFO*

Thanks, Jay and good morning, everyone. Let me begin by discussing our financial results for the second quarter of 2015 before moving on to investment activity and the performance of our business segments. Finally, I will finish with an update on recent capital markets activity.

For the quarter, our adjusted income allocable to common shareholders was $10 million or $0.11 per diluted common share compared to $29 million or $0.26 per diluted common share for the same quarter last year. There were several factors that drove the year-over-year change. Other income decreased by $17 million primarily due to gains on the sale of two NPLs in the second quarter of last year. In addition, earnings from equity method investments decreased by $15 million as the prior year quarter included a significant gain associated with the sale of properties within one of our strategic investments. Lastly, general and administrative expense decreased $6 million as the prior-year quarter included incremental performance-based compensation expense.

Our net income allocable to common shareholders for the quarter was a loss of $31 million compared to a loss of $16 million for the same period last year. In addition to the year-over-year changes just discussed, the prior-year quarter included a $24 million loss on the early extinguishment of our 2012 secured credit facility largely offset by a $19 million provision for loan losses recognized this quarter.

Let me now turn to investment activity in our real estate and loan portfolios. During the quarter, we committed to $255 million of new investments and funded a total of $126 million associated with new investments, as well as prior financing commitments and ongoing development activity. We generated $249 million of proceeds from our portfolio this quarter, which included $178 million from repayments and sales of loans in our real estate finance segment, $40 million from sales of operating properties, $21 million from the sale of several net lease properties and $10 million in proceeds from land and other investments. At the end of the second quarter, our portfolio totaled $5.2 billion, which is gross of $473 million of accumulated depreciation and $27 million of general loan loss reserves.

Let me discuss each of our four business segments. Our real estate finance portfolio totaled $1.6 billion at the end of the quarter. The portfolio includes approximately $1.5 billion of performing loans comprised of $785 million first mortgages or senior loans and $726 million of mezzanine debt. Our performing loans generated a yield of 8.7% for the quarter and had a weighted average last dollar loan to value of 67%.

During the quarter, we transferred to a third party a $100 million junior loan participation and a $250 million mezzanine loan commitment that we had previously originated. We had funded $39 million of the junior loan prior to transfer and received proceeds of $39 million at closing. The junior loan participation bears interest at a rate of 5.9% and the buyer is responsible for funding the remaining $61 million under the funding commitment. The benefit of this transaction is that we were able to significantly reduce our last dollar exposure without reducing our yield.

In a separate transaction, we transferred to a third party a $100 million senior loan participation and a $220 million senior loan commitment that we had previously originated. The senior loan participation was fully funded at the time of the transfer and we received $99.2 million of net proceeds at closing. The buyer's note bears interest at a rate of LIBOR plus 350 with a LIBOR floor of 25 basis points. By selling the most senior portion in the capital stock at a lower interest rate, we were able to manufacture a risk return profile better than we have seen available in the market. Our ability to take down an entire envelope is an important competitive advantage that our borrowers value, which has enabled us to win several transactions.

We had one new NPL this quarter bringing the balance of NPLs to $84 million from $65 million at the end of the first quarter of this year. We recorded a $19 million net provision for loan losses this quarter, which was primarily associated with the new NPL. This brought our total reserve for loan losses at the end of the quarter to $122 million, including $27 million of general reserves and $95 million of specific reserves.

Now let me provide a brief update on key metrics pertaining to our net lease portfolio. At the end of the quarter, we had $1.6 billion of net lease assets, gross of $379 million of accumulated depreciation. This portfolio was 96% leased at the end of the quarter with a weighted average remaining lease term of approximately 14 years.

For the quarter, our total net lease portfolio generated an unleveraged yield of 7.9%. During the quarter, we sold several net lease assets for $21 million in total proceeds and recorded a $5 million gain. We also closed the new build-to-suit net lease investment for our net lease fund whereby the fund will make an initial $10 million preferred equity method investment and retain the option to purchase the property upon its completion by the developer.

Next, I will turn to our operating properties portfolio. Our operating properties totaled $745 million, gross of $85 million of accumulated depreciation. The portfolio was comprised of $611 million of commercial and $134 million of residential real estate properties. The commercial properties generated $26 million of revenue, offset by $20 million of expenses during the quarter. At quarter-end, we had $109 million of stabilized commercial operating properties. These properties were 88% leased resulting in a 9.1% unleveraged yield for the quarter. The remaining $502 million of commercial operating properties are transitional real estate properties that were 57% leased and generated 2.2% unlevered yield for the quarter. We are continuing to actively lease these properties in order to maximize their value.

Within our 5 million square feet of commercial operating space, we executed leases, including lease extensions covering approximately 300,000 square feet during the quarter. The residential operating properties were comprised of 213 luxury condominium units remaining in inventory at the end of the quarter. During the quarter, we sold 56 condos for a total of $40 million in proceeds and recorded $16 million of income offset by $4 million of expenses.

That brings me to our land portfolio. At the end of the quarter, our land portfolio totaled $1.1 billion and included 11 master plan communities, 14 infill land parcels and 6 waterfront land parcels. At quarter-end, we had seven land projects in production, 12 in development and 12 in the predevelopment phase. We invested 23 million into our land portfolio this quarter. Our land portfolio generated gross margin and earnings from equity method investments totaling $6 million this quarter compared to approximately $700,000 for the same period last year.

Let me finish by providing an update on our capital markets activities. We have launched a tender offer for all of our outstanding high-performance units or HPUs. Under the current terms, HPU holders can elect to receive $9.30 in cash, 7/10 of a share of iStar common stock or a combination thereof for each common stock equivalent underlying their HPUs. The Company has binding commitments from holders representing approximately 61% of the HPUs to tender and not withdraw their units and an additional 25% of the HPUs have been tendered as of July 30, 2015, but remain subject to withdrawal. The offer is scheduled to expire on August 12, 2015. The offer will enable us to repurchase a meaningful portion of our equity at a discount to the value of our listed common stock.

In addition, our authorization for share repurchases remains at $28 million. Our weighted average cost of debt for the second quarter was 5.4%, down from 5.5% for the second quarter of last year. Our leverage was 2.0x at the end of the quarter and remains at the low end of our targeted range of 2.0x 2.5x. With that, let me turn it back to Jay.

Jay Sugarman - *iStar - Chairman & CEO*

Thanks, Dave. Just touching on that tender once more, that represents about 2% to 3% of our outstanding shares that we should be able to bring in at a discount. We don't know the breakdown yet between how many people take cash or shares, but certainly we have the opportunity to bring back a number of shares in-house and that's something we think is quite attractive at the prices offered. So let's turn it over to the operator. Operator.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Jade Rahmani, KBW.

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

I was wondering if you could give some color around the potential new investment areas that you cited.

Jay Sugarman - *iStar - Chairman & CEO*

Sure, a couple things we are focused on -- demographics, the whole aging longevity issue inside the demographic trends. We'd like to get out ahead of that and some new areas we see were real estate and so the operating businesses are crossing over. We see a couple niches in there that could be quite interesting. We will start small. If they perform, we will likely try to take them bigger, but still toehold kind of thought processes, but definitely some long-term macro trends we want to be involved in.

Clearly, home ownership versus household formation is creating some interesting dynamics. We see that in our land book. We may have a chance to do some stuff on the commercial side on land we own, but we are watching those trends. We will make some small investments in that sector to try to figure out some of the new stuff that's trying to be responsive to those trends.

We're just seeing a lot of things that suggest to us if we can get our foot in the door at the right basis and the right places there's a lot more to do, but we want to test those waters first in a relatively small size.

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

Are these going to be owned equity investments, owned real estate where you are taking control over the development process or are these debt investments?

Jay Sugarman - *iStar - Chairman & CEO*

You know us; it's going to be where the best risk returns are. We think we'll probably end up playing a debt role and an equity role. If we like the businesses, we are going to want to own some of the equity. But certainly the capability of doing it all in-house, building those capital structures ourselves gives us a speed and a responsiveness, particularly with operating partners who are looking for that kind of capital partner. I wouldn't be surprised if we are across the capital structures of these opportunities.

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

Can you also, on the lending side, discuss the syndication strategy and what the driver for that was? Was that conservatism with respect to concentration risk or is that due to having other areas to deploy capital that are more attractive?

Jay Sugarman - *iStar - Chairman & CEO*

I'd say this quarter it was probably more the former. In one case, we were able to take risk down very materially. In the other case, we were able to boost yields without really taking on any more risk. We laid off about the senior 25% of a capital structure, so we don't think we changed the risk profile at all of the piece we retained, but we've materially changed its earnings profile. So we will use that to do both, increase reward and decrease risk when we think it's appropriate.

Other quarters and other situations might be more the latter, but this quarter was much more about rejiggering the risk reward profile in those deals in a more favorable way.

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

Switching to the land side, can you maybe give a sense of which projects are most likely to go into production next and over what timeframe?

Jay Sugarman - *iStar - Chairman & CEO*

I want to caution you it's not just about going into production. Some of these things have gone through years and years and years of re-entitlement and so they are now at a point where we have to decide what's the highest and best return for us, whether it's pretax, post-tax, sell in bulk, develop internally, develop externally with partners. We just see a number of assets getting to that position and so they may never get to production. They may be assets we can monetize as opposed to have to go into production and take the tax consequences sometimes that creates.

So we do see a number of things in the Northern California market reaching fruition. We are starting to ramp up I think in Southern Florida a project we have high hopes for. So we are seeing some things just get to the point where we are going to see real activity or real choices being made available to us either to monetize in bulk, monetize in phases or go for the full lifecycle with these assets. We haven't had that choice on a whole lot of assets, but I think you're going to see stuff coming through the pipeline that gives us that choice in more abundance going forward.

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

And when we think about the earnings goals that you set forth at the investor meeting specifically for 2016, is land the primary walk to get from the $0.75 in 2015 to $1.75 in 2016 or is it across the board?

Jay Sugarman - *iStar - Chairman & CEO*

Land is a meaningful component, but so is putting $600 million, $700 million of cash to work and turning some of the assets that we've made good leasing progress on into either core assets in the book or monetizations. So yes, we've got a couple drivers that we are expecting to start pushing earnings next year. Hopefully, we will see some part of that happen later half of this year, but those are the things that will turn. You guys know the numbers. It's almost $2 billion of assets that are dragging, not pushing. So hopefully a good portion of those will start pushing next year.

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

And just regarding the overall state of the commercial real estate market, following this earnings season, there's been a mix of views. Some characterizing the environment as still rational, some noting asset bubbles in certain areas. Can you give an update on your view?

Jay Sugarman - *iStar - Chairman & CEO*

I think as you heard from our comments, we are probably on the more cautious side. We are seeing some of the dynamics you don't like to see. We always kind of bracket it as there are good deals at good prices. There's good deals at prices you don't love and then there's not good deals at not good prices. I think we are seeing more of the middle and starting to get a little worried that things are moving towards the latter bucket.

But there's still plenty of stuff to do in the market. We think there are ways to play that kind of market. Certainly, we are going to try to monetize some assets where we think the prices have reached points where it makes sense to, but we are also going to try to find places where we think we can [arb] that kind of market. So it's not an easy market to play in, but it's a big market. We play across all parts of the capital structure. There should be things to do, but I would definitely put us on the more cautious side of that camp.

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

Thanks for taking my questions.

Operator

(Operator Instructions). Sean Monaghan, Penn Capital.

Sean Monaghan - *Penn Capital - Analyst*

Can we just talk about -- two questions -- just the land portfolio and what you guys are hearing from builders in terms of taking down developed lots versus undeveloped or overall land? And I guess progression with you guys and how you guys are thinking about entitlement and development of your lots.

Jay Sugarman - *iStar - Chairman & CEO*

Look, builders want to have things they can build on sooner rather than later. We definitely have seen that. The price discounts for long-lived assets where they are going to be sitting on that land for a long time is not favorable. The favorable part of the trade is to deliver them something they can make money on quickly. So we've got that kind of relationship and we are seeing those homebuilders be reasonably aggressive for near-term lots, less aggressive for way-out lots.

I think the household formation numbers still give us comfort that there's a wind at our back, that the builders will want lots. They just don't want to sit on them forever or make long-lived assets. They don't need to right now and so we are not trying to provide them something that's going to be developable five, six, seven years from now. We're trying to provide them more just-in-time stuff that they can see over the next 12, 24 month horizon a profitable execution of their business plan.

We still think homeownership is a drag right now, but longer term we don't see it going a ton lower. So we think the combination of household formation and more stable homeownership rates not even turning around some time out in the next 24 to 36 months will be another leg to the stool that we can take advantage of from our land book.

Sean Monaghan - *Penn Capital - Analyst*

Perfect. And then just talking about -- two questions. Asking about the new NPL that you guys had during the quarter. Can you guys give some disclosure behind that?

Jay Sugarman - *iStar - Chairman & CEO*

Can't go into a ton of details. We talked about it in our presentation. We have some legacy assets in litigation. A couple of them are going well; one of them was not. We just don't see a reverse of that trend, the likelihood of the asset's value being harmed and therefore our position being harmed seems to be going in that direction. So we took an appropriate reserve. We've removed some of the danger of that loan; although I can't tell you we're entirely out of the woods because it's still sitting in a courtroom; it's not in our hands to work with.

But those are some of the legacy issues. We are going to have some good outcomes, we are going to have some not great outcomes, but we are moving past those. Hopefully we can shrink that part of the story relatively soon and get onto the future.

Sean Monaghan - *Penn Capital - Analyst*

Yes, what kind of asset was that? What was it written down to? Can you guys disclose that?

Jay Sugarman - *iStar - Chairman & CEO*

I think in our presentation we call it the hotel credit line. It was a combo loan to an individual borrower and to a corporate holder of hotels and they are in a little bit of a fight.

Sean Monaghan - *Penn Capital - Analyst*

Okay, perfect. And then just talking about the reasoning -- can you guys disclose a little bit more about the decision to buy back the HPUs? I mean given the recent stock performance, don't you guys think cash would be better used elsewhere?

Jay Sugarman - *iStar - Chairman & CEO*

I'm sort of surprised at that characterization. Look, we've said in the past we would like to buy in stock. We think the discounts still reflect an attractive place to deploy some of the cash that we are sitting on. And when we think cash is better deployed in our own capital structure versus the external market, we are going to do that.

As we looked at the opportunity to do that in the past, we've struggled to buy any meaningful amount of shares without impacting the marketplace. We are finding ourselves in a blackout situation. We think HPUs, A, do --

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Sean Monaghan - *Penn Capital - Analyst*

Do the same thing.

Jay Sugarman - *iStar - Chairman & CEO*

People still ask us what is this line item? They have to go back and research 10 years why is it, who is it. The truth is it's a near stock equivalent. It claims about 2% to 3% of our earnings and will claim 2% to 3% of our earnings going forward if we don't retire them.

So relative to share repurchases, the price is lower. It cleans up a lot of the accounting and reporting anomalies that people, new people to our name probably don't need to go back and learn about and we think it's just a more effective way to deploy cash than a share repurchase right now.

Sean Monaghan - *Penn Capital - Analyst*

Thanks, guys.

Operator

And Mr. Fooks, no further questions in queue.

Jason Fooks - *iStar - VP, IR & Marketing*

Great. 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 please?

Operator

Certainly. Ladies and gentlemen, this conference is available for replay. It starts today at 12:30 PM Eastern time and will last until August 18 at midnight. You may access the replay at any time by dialing 800-475-6701 or 320-365-3844. The access code is 365176. Those numbers again 800-475-6701 or 320-365-3844. The access code 365176. That does conclude your conference for today. Thank you for your participation. You may now disconnect.
