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SFI - Q3 2013 iStar Financial Earnings Conference Call

EVENT DATE/TIME: OCTOBER 29, 2013 / 2:00PM GMT

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Michael Kim *CRT Capital Group - Analyst*

Jonathan Feldman *Nomura Securities Intl - Analyst*

Jade Rahmani *Keefe, Bruyette & Woods - Analyst*

PRESENTATION

Operator

Good day and welcome to iStar Financial's third quarter 2013 earnings 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 Financial Inc - VP of IR*

Thank you, Art, and good morning everyone. Thank you for joining us to do today to review iStar Financial's third quarter financial 2013 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 our 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 305829.

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 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 would like to turn the call over to iStar's Chairman and CEO, Jay Sugarman. Jay?

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

Thanks, Jason, and I thank all of you for joining us this morning. During the third quarter our main focus was on ramping up investment activity, and we saw good results with over $400 million in new transactions put under letter of intent and over $100 million of funding on investments made in prior quarters. We still have some $700 million of cash sitting idly on the balance sheet, so these new fundings in potential investments should improve the profitability of the company once fully deployed. We also continue to whittle away at the remaining asset issues in the portfolio, and while there will be both good and not so good surprises, on the whole we are making progress. On the land front, the story is still moving forward with our teams on the east and west Coast beginning to see the light at the end of the tunnel on a number of arduous re-entitlement processes. Nothing is done until it is done, but we are hopeful that 2014 will be the beginning of a significantly more active period in the land book. We continue to add personnel as we prepare for a larger number of projects getting underway in the coming quarters.

Here is a quick overview of our various businesses. Our real estate finance book continued to see repayments outpace new fundings in the quarter, but that relationship should start leveling out and begin going the other way. The good news is we have almost fully funded our $146 million preferred investment in Landmark Apartment Trust, which helped boost the yield on the performing loan portfolio to 8% from 7% last quarter, and we hope to have a good portion of the letters of intent close in the fourth quarter as well to help boost overall revenue in the segment as we head into 2014. Segment profit was $6 million for the quarter.

The net lease book remained stable with strong occupancy and long lease terms still in place. Segment profit was $9 million for the quarter. We are still out competing for new deals and it seems some interest from outside capital to join with us, so we look forward to being able to push that business a little bit faster going forward. Profit in the operating portfolio saw a step down in contribution from the condominium assets which should remain at a solid level for coming quarters. Fewer units remaining in our higher-priced projects in Miami and New York will cap profits, but we should see good sales in other projects as we move to maximize the value of the remaining portfolio. Segment profit was $18 million as our project managers continue to push on the transitional commercial asset portfolio, creating net absorption of approximately 100,000 square feet this quarter and driving yields on the transitional portfolio up from 2.9% to 3.7%.

The land portfolio team remains optimistic about market conditions in many of our key markets where results will remain negative until we bring more projects online, with segment profit this quarter negative $19 million. While we are keeping an eye on the interest rates and affordability, the next few quarters should see increased activity and more engagement with national builders. Once we have completed and signed deals, we will begin discussing those relationships in more detail.

Let me turn it over now to Dave to review the numbers for the quarter. Dave?

David DiStaso - *iStar Financial Inc - CFO*

Thanks, Jay, and good morning everyone. Let me begin by discussing our financial results for the third quarter of 2013 and capital markets activities, before moving on to discuss investments and the performance of our business segments.

For the quarter, our adjusted income was a loss of $7 million, or $0.09 per common share, compared to a loss of $26 million, or $0.31 for the same quarter last year. Contributing to the year-over-year improvement to adjusted income was a $28 million decrease in interest expense as a result of paydowns on our secured facilities and debt refinancings at lower rates, which has allowed us to meaningfully reduce overall interest expense. At the same time, revenues year-over-year have remained flat as the reduction in interest income, which stems from our smaller real estate finance portfolio, was offset by an increase in operating lease income due to the increased size of our operating properties portfolio, and the leasing progress we have been achieving in that segment. We recognized gains from the sale of one of our operating properties, which I will discuss further, while earning less from equity method investments as a result of the sale of our stake in LNR in the second quarter of this year.

Our net loss allocable to common shareholders for the quarter was $31 million, or $0.36 per diluted common share, compared to a loss of $72 million, or $0.86 per diluted common share for the same period last year. The year-over-year improvement was additionally due to the $10 million net recovery of loan-loss reserves is quarter, versus a $17 million provision in the third quarter of 2012.

During the third quarter, we paid off the remaining balance on the A-1 tranche of our 2012 secured credit facility, and repaid $30 million on the A-2 tranche, bringing the remaining outstanding balance to $440 million. Also during the quarter, we repaid $121 million on our 2013 secured credit facility, bringing the remaining balance to $1.5 billion at the end of the quarter. We have continued to make progress on lowering our cost of capital. Our weighted average cost of debt for the third quarter was 5.7%, an improvement from 6% for the second quarter and 6.5% for the third quarter of last year. Our leverage for the third quarter was 1.9x, a decrease from 2.0x at the end of the second quarter and slightly below our targeted range of 2.0x-2.5x.

In addition, during the quarter we repurchased an interest rate cap in order to reduce our veritable weight exposure. This $500 million notional hedge is effective should LIBOR rise above 1%, and has a term beginning in July 2014 and lasting three years.

Let me turn now to investment activity in our real estate and loan portfolios. As Jay discussed, we completed letters of intent for over $400 million of new investments recently, which if closed, would begin funding during the fourth quarter. During the third quarter, we funded $116 million of investments primarily within our real estate finance portfolio. We generated $346 million of proceeds from our portfolio during this quarter, which included $239 million from repayments and sales of loans in our real estate finance portfolio, $98 million from sales of operating properties, and $9 million from sales of assets across other segments.

At the end of the quarter, we had over $700 million of cash. This balance will allow us to finance new investments in our real estate finance and net lease portfolios and fund capital expenditures in our operating and land segments. As of September 30, 2013, our total portfolio had a carrying value of $5.2 billion, gross of $439 million of accumulated depreciation and $28 million of general loan-loss reserves. Let me discuss the activity in each of our four business segments.

Our real estate finance portfolio totaled $1.4 billion at the end of the quarter. This includes $1.2 billion of performing loans that had a weighted average LTV of 73% and a weighted average maturity of just under three years. They were comprised of $630 million of first mortgages or senior loans and $526 million of mezzanine or subordinated debt. The performing loans generated a weighted average effective yield for the quarter of 8%.

At the end of the quarter we had $235 million of nonperforming loans, or NPLs, down from $370 million at the end of the second quarter. Our remaining NPLs are mainly comprised of 41% land, 33% entertainment, and 11% retail.

For the quarter, the provision for loan losses was a net recovery of $10 million, compared to a $5 million provision for loan losses last quarter. Our total reserve for loan losses is $380 million, consisting of $352 million of asset specific reserves and $28 million of general reserves. We expect that the rate of provisions and the level of NPLs will continue to fluctuate.

Next, I will discuss our net lease portfolio. At the end of the quarter, we had $1.7 billion of net lease assets, gross of $335 million of accumulated depreciation. Our net lease portfolio totaled 20 million square feet across 34 states. Our net lease portfolio was 95% leased at the end of the quarter, with a weighted average remaining lease term of 12 years. During the quarter, we signed two net leases covering approximately 150,000 square feet. For the quarter, our occupied net lease assets generated an unleveraged weighted average effective yield of 7.9%, while our total net lease portfolio generated an unleveraged weighted effective yield of 7.4%.

Let me now turn to our operating properties portfolio. Our operating properties totaled $1.1 billion, gross of $100 million of accumulated depreciation. The portfolio was comprised of $802 million of commercial and $255 million of residential real estate properties. We invested $17 million in these operating properties during the quarter.

The commercial properties represent a diverse pool of 29 real estate assets across a broad range of geographies and property types such as office, retail, and hotel. They generated $31 million of revenue, offset by $20 million of expenses during the quarter. At the end of the quarter, we had $158 million of stabilized commercial operating properties. The stabilized properties were 85% leased resulting in a 9.6% unleveraged weighted average effective yield for the quarter.

During the quarter, we generated $37 million of proceeds from the sale of stabilized commercial operating properties, which resulted in a $9 million gain. The remaining $644 million of commercial operating properties are transitional real estate properties that were 58% leased and generated a 3.7% unleveraged weighted average effective yield for the quarter. We are actively seeking to lease up these properties to maximize their value. During the quarter, we executed approximately 35 commercial operating property leases covering approximately 200,000 square feet.

The residential operating properties were comprised of 702 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 109 condos for $61 million in proceeds, resulting in $15 million of income offset by $5 million of expenses and $6 million of impairments.

That brings me to our land portfolio. At the end of the quarter, our land portfolio totaled $976 million, and included 11 master-planned communities, 9 infill land parcels and 6 waterfront land parcels. Master-planned communities generally represent large-scale residential projects that we plan to entitle, plan, and develop. We currently have entitlements at these projects for more than 25,000 lots. Our infill and waterfront parcels are currently entitled for 6,000 residential units, and select projects include commercial retail and office space. The projects in the portfolio are well diversified, with our largest exposures in California, the New York metro area, Florida, and several markets in the Mid-Atlantic and Southwest regions.

During the quarter, we invested $11 million into our land portfolio through capital expenditures. At the end of the quarter, 6 of these land projects were in production with sales activity having begun, 12 were in development and actively seeking entitlements, and 8 were in the pre-development phase.

Let me turn it back to Jay. Jay?

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

Thanks, Dave. You know, Dave mentioned some interest rate protection we put on this quarter. With rates low and favorable conditions in the real estate markets, we took the opportunity to protect somewhat against the rise in rates beginning later next year. As long as rates stay low, we are likely to find a lot of good spread opportunities in the market. So this was a way the stretch that low-rate environment out on about $5 million, so we can work part of the new investment book with more interest rate certainty. I look forward to closing some more deals, in our pipeline and using that protection to our advantage in the coming quarters.

With that, let's go ahead and open it up for questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator instructions).

And our first question comes from the line of Michael Kim with CRT Capital.

Michael Kim - *CRT Capital Group - Analyst*

Hi. Good morning. Thank you for taking my question and a nice quarter. Jay, in your prepared remarks, you talked about your team's light at the end of the tunnel for some of the land projects, and I know your team has made a lot of progress with the waterfront land active. But, just kind of curious, what are you seeing for the master-planned communities, or what sort of project milestones have you hit that's giving you but better visibility for the first time on these projects?

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

Mike, I would say a couple things. One, on the East Coast we have been able to push some of the projects forward. We're feeling pretty good that 2014 will have some material milestones that we can share with you. I think in terms of just the re-entitlements process, Southern California has always been a tough place and continues to be a tough place. We have got some very valuable land there that we are trying to do some smart things with. One case up zoning and another case down zoning. But those have been long, relatively difficult processes, again, I feel like both of them are in the home stretch, but we definitely do not want to count our chickens before they hatch. So, all we can say it is point is, it feels good, and I think our guys have done a great job kind of getting us to the two yard line. Now we have to push it across.

Michael Kim - *CRT Capital Group - Analyst*

Are you getting more of a function of just local municipalities generally being more willing to work on these projects with you? Or like a sense that any change in terms of at the local level?

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

I wish I could say that. I do not really think there has been a change. I think it has just been a lot of hard work between the locals zoning boards and ourselves in the planning commissions. These are meaningful projects in each of these communities, and a lot of people have a say on them. And so you have to go through the process because everybody has a voice and sometimes that just takes a long time.

Michael Kim - *CRT Capital Group - Analyst*

Fair. I appreciate that. And just on the new originations and investments, it's great to see the pipeline so large. I was just wondering if you could provide some detail on sort of the types of investments that are part of the pipeline. Should we expect the return profiles to be somewhat similar in nature to the Landmark preferred investments? Just, give us a sense of kind of what is in the pipeline right now.

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

Yes. I do not want to go into too much detail, but as we said in the past, they tend to be larger deals, they're going to be in major metro markets, these are primarily in the, I am going to call it the L+700, L+800 range. A lot request 800s, a lot request 700s. So not quite the yield on the Landmark deal, but, we think, on a risk-adjusted base, is quite attractive. Some good floating-rate exposure. We continue to poke around in the net lease world. Those kind of deals are still in the 7 cap range. It is a tougher market these days, but the leverage is pretty attractive in that sector as well, so you can push the return on equities up into the double digits. With bumps on those, that can be a nice place to put capital.

So right now we are trying to pick and choose among the things we have historically played in. We have done a lot with the existing book as you saw this quarter. We had some nice resolutions on a number of deals in the US, tougher on two deals in Europe, that look like they are going to end up with less favorable resolutions. But we may get an interesting financing opportunity out of one of those. So, we have got a large field to pick from and we are going as fast as we can with the kind of prudence you would like to see.

Michael Kim - *CRT Capital Group - Analyst*

Right. And the new investments that you have in the pipeline, I mean, what sort of, weighted average duration can we expect or are you, kind of, looking at with or without maturity extension option?

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

Yes. As you might expect, the floaters are going to be relatively short, call it two to three years on average duration.

Michael Kim - *CRT Capital Group - Analyst*

Okay.

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

Net lease will be longer.

Michael Kim - *CRT Capital Group - Analyst*

Yes. Understood. Okay. Great. And you talk touched on the NPL balance, and obviously you are well ahead of the guidance you provided earlier to your -- just kind of curious, as you look forward, how much opportunity or visibility do you have, in terms of additional resolutions within the next six or nine months? Is that just a work in process, or do you have better visibility on the rest of the NPL book?

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

Yes. I think, as I said, we are going to see some good outcomes, we are probably going to see some not so good outcomes. But overall the number issues are shrinking. We definitely have a hope here that the good surprises will outpace the bad ones, and I think that has been our experience to date. And I will continue to work hard on the remaining ones, but we have never been able to predict exactly when those resolutions will occur. But hopefully we are getting to the end of that part of the curve, and by the end of 2014 we hope most of that list will be cleaned up.

Michael Kim - *CRT Capital Group - Analyst*

Understood. Great. Thank you very much.

Operator

(Operator instructions).

And our next question comes from the line of Jonathan Feldman with Nomura Securities.

Jonathan Feldman - *Nomura Securities Intl - Analyst*

Good morning. I was wondering, Jay, if you could just talk about deployment of the cash on the balance sheet and how you see that proceeding and moving it closer to earnings break even or even profitability, what you're current thoughts are on that subject?

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

Well, you hit the nail on the head. I mean you cannot have $700 million of unproductive capital sitting around and make progress. So we are looking to get that money deployed. The run-up to some of the deals has been longer than we expected, as you can imagine. We like complexity on the one hand, it allows us to generate excess returns. On the other hand it often means longer lead times in getting back capital deployed.

Usually what happens is that people get a little bit of pressure to close by year-end, so we would expect to get most of that stuff under contract today closed by the end of next quarter. But we have still got work to do, Jonathan, we have got money coming in every day. So, as you can see from Dave's comments, we are de-leveraging, probably even beyond where we would like to be, putting the cash back to work will help that issue. So, it is on us to get back capital deployed in places that are attractive. And we do think even at the kind of high single-digit, low double-digit numbers we are thinking, $700 million deployed is $70 million of earnings. That is a big step towards profitability for us. So a combination of knocking down the NPLs and deploying that capital are the two biggest levers to getting us over the hump.

Jonathan Feldman - *Nomura Securities Intl - Analyst*

Got it. Thanks. That is very helpful. And just one follow-up question which goes along with that and that is, just was wondering, when -- where a dividend lies in terms of your list of priorities and if that is a near-medium term goal? And I guess finally, do your various debt securities prohibit that at this time?

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

I think it is two-fold. As you know, we have a fairly large NOL to utilize, which we think is a pretty attractive way to retain capital, it is probably our cheapest form of retained capital. So we do think as earnings start to kick in, we are not going to immediately go to dividend, even if our debt would allow it. There are some restrictions in the debt, but I think the overarching theme here is to rebuild the equity capital base, begin growing the investment side of the business, and then look to reinstate that dividend once we effectively utilize the NOL to the greatest extent possible.

Jonathan Feldman - *Nomura Securities Intl - Analyst*

Got it. Thank you for your time this morning.

Operator

And our next question is from the line of Jade Rahmani, with KBW.

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

Yes. Hi. Thanks for taking the question. I wanted to find out if you could give any color on what drove the loan-loss reversal and also the asset impairment? And if you could say whether those two items were related at all?

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

They are not related. As I said, we had a couple of nice resolutions in the US and a couple that looked not so good in Europe, and the net of that was a reversal for us. So that was a good thing. The impairment was unfortunate. We had a piece of collateral under contract, thought the deal was done, just could not get the final deal closed. Which means we are back to the drawing board, which pushes out the resolution date, which has to be discounted at a market rate. So, we will probably get the same amount of dollars at the end of the day, but it will be out in the future, and we had the mark back given the time value of money.

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

Great. Thanks. That is helpful. Just regarding your pipeline, can you say, you mentioned refinance opportunities as well as new opportunities. Can you say what percentage of your pipeline is coming from existing borrower relationships? And what percentage is directly sourced?

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

Yes. I would say the preponderance of what we have in shop right now is working on deals we have deep familiarity with and actually have a relatively proprietary way to get into those deals. We will have to close a couple of deals with new parties. Which is good. But that is going to be a slower road for us. I think the markets are not uncompetitive, so we are trying to find angles and wages in the deals where we have some relationships or we have some knowledge. Those tend to be better priced and more interesting to us.

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

Thanks. And just a housekeeping item, the sequential increase in G&A expense, can you give any color on that?

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

Yes. As you probably saw last year, we set up a bonus program that is tied to some adjusted EBITDA targets. We are tracking ahead of that targets set at the beginning of the year so there is an incremental bonus accrual that kicked in this quarter. We cannot say for sure whether that is going to play out, but getting close enough that we need to start accruing for it.

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

Thank you very much.

Jason Fooks - *iStar Financial Inc - VP of IR*

Thanks, Jay.

Operator

Mr. Fooks, we have no further questions.

Jason Fooks - *iStar Financial Inc - VP of IR*

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

Operator

Yes I will. Ladies and gentlemen this conference will be available for replay from 12.30 PM today through Tuesday, November 12. To access the replay, dial 1-800-475-6701 and then you will be prompted for an access code. The access code 305829. For international dialers, please dial 320-365-3844 and enter the same access code, 305829.

That does conclude your conference for today. Thank you for your participation and thank you for using the AT&T executive teleconference service. You may now disconnect.
