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Q2 2022 iStar Inc Earnings Call

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CONFERENCE CALL PARTICIPANTS

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

PRESENTATION

Operator

Good morning, and welcome to iStar Second Quarter 2022 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, Senior Vice President of Investor Relations and Marketing. Please go ahead, sir.

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

Thank you, and good morning, everyone. Thank you for joining us today to review iStar's second quarter 2022 earnings. With me today are Jay Sugarman, Chairman and Chief Executive Officer; Marcos Alvarado, President and Chief Investment Officer; and Brett Asnas, our Chief Financial Officer.

This morning, we published an earnings presentation highlighting our results. And our call will refer to these slides, which can be found on our website at istar.com, in the Investors section. There'll be a replay of the call beginning at 2:30 p.m. Eastern Time today. The replay is accessible on our website or by dialing 1 (866) 207-1041, with the confirmation code of 6846235.

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

Lastly, I wanted to highlight that iStar recently filed an amended 13D, disclosing that a special committee of the Board of Directors of iStar and a special committee of the Board of Directors of Safehold are in advanced discussions with respect to a potential strategic corporate transaction and that they are proceeding to negotiate definitive agreements. However, because no definitive agreements have yet been executed, and there can be no assurance that a definitive agreement will be executed, we won't be able to discuss the potential transaction on this call.

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

Jay S. Sugarman *iStar Inc. - Executive Chairman & CEO*

Thanks, Jason, and thank you all for joining today. During the second quarter, we continued to execute on our stated strategies of simplifying iStar, strengthening the balance sheet and scaling Safehold. With the net lease sale behind us, ground lease ecosystem assets make up over 80% of our portfolio, and we continue to monetize non-ground lease-related assets and recycle the proceeds into ground lease adjacent business lines or to pay off debt.

Partially retiring our convertible notes due in September was also a big part of the quarter. And the conversion into shares had a material impact on our P&L, share count and equity balances. Brett will walk you through that in a moment.

Safehold had a strong quarter, with earnings per share up over 30%, and the portfolio nearing \$6 billion. The level of engagement with building owners has been very good, but we expect market volatility is likely going to make go-forward transactions somewhat more difficult in the second half of the year. UCA was also up strongly, adding over \$0.5 billion in mark-to-market value to the portfolio and is now nearing \$10 billion.

Lastly, as Jason mentioned, conversations between iStar and Safehold regarding the future progressed significantly. As you saw in our recent 13D, we're in advanced discussions with Safehold. So again, we won't be able to share details of those conversations on this call. We do hope to be able to do so in the near future.

Okay. Let's turn it over to Brett and Marcos. Marcos?

Marcos Alvarado iStar Inc. - President & CIO

Thanks, Jay, and good morning, everyone. Let's begin on Slide 3 to discuss this quarter's results. We continue to make meaningful progress on our 3-part strategy. First and foremost, we continue to scale Safehold and expand the ground lease ecosystem, seeing solid investment activity during the quarter and the concurrent growth of the unrealized capital appreciation sitting on top of our land.

Second, we strengthened the balance sheet by exchanging convertible notes for stock to increase our cash balance. And we repurchased some bonds in the open market at a slight discount to par. We continue to maintain a large cash position following the sale of our net lease portfolio at the end of the first quarter. And finally, we saw further monetization of our non-ground lease assets, allowing us to continue to simplify the business as we evolve into a predominantly ground lease-focused company.

Slide 4 details our earnings results. For the quarter, net income was a loss of \$138.5 million or a loss of \$1.70 per diluted common share, and adjusted earnings were a loss of \$34.2 million or a loss of \$0.42 per diluted common share. Of note, our net income this quarter was impacted primarily by the \$194 million convertible note exchange, which resulted in \$118 million, predominantly noncash loss on our income statement. However, that transaction was offset by \$298 million increase in equity for the additional 13.75 million shares, resulting in a net equity increase of \$181 million. In total, this transaction resulted in a \$0.04 per share reduction to common equity per share.

Brett Asnas iStar Inc. - CFO

Slide 5 shows an overview of our business as simplified in our presentation of our balance sheet. At the end of the second quarter, we had \$1.4 billion of cash, a carrying value of just over \$1.5 billion of investments related to the ground lease ecosystem and \$684 million of noncore assets.

Turning to the right side of the balance sheet. We had \$2 billion of total liabilities at the end of the quarter, which comprised of \$1.8 billion of net debt obligations, \$48 million of accrued expenses associated with our iPIP plan and \$99 million of accounts payable and other liabilities. We also have \$305 million of preferred equity. When we adjust for marking our SAFE investment to market and estimate for unaccrued iPIP distributions, the result is our common equity at quarter end of approximately \$1.4 billion or \$17.01 per diluted share.

Let's walk through our portfolio's businesses, beginning with Safehold on Slide 6. As announced yesterday, at the end of the second quarter, we owned approximately 40.1 million shares of Safehold with a market value of \$1.6 billion. Although SAFE stock is down considerably from last year, Safehold's underlying business continues to make solid progress, and during the second quarter, closed on 7 new ground leases for \$381 million.

Additionally, during the quarter, SAFE raised \$150 million of fresh 30-year unsecured debt, which left the company with \$930 million of total liquidities to fund its expanding pipeline. Safehold's earnings per share grew 32% compared to the same period last year. Additionally, the estimated value of the UCA pool increased by \$543 million and now stands at approximately \$9.9 billion.

On Slide 7, we detail our investments in the ground lease ecosystem. To capture additional ground lease adjacent opportunities, iStar has 2 dedicated funds focused on investing in the ground lease ecosystem, consisting of the Ground Lease Plus Fund and the leasehold loan fund. iStar holds a 53% interest in each of these funds, and a third-party investor owns the balance. Our net carrying value for these investments totals \$120 million and is comprised of 8 assets with targeted returns between 9% to 12%. Additionally, we have \$154 million of unfunded commitments associated with these ground lease-related investments.

Slide 8 highlights what remains of our non-ground lease assets. At quarter end, the remaining real estate finance portfolio consisted of

approximately \$204 million of outstanding loans, which is down from \$332 million at the end of the first quarter. During the quarter, we had the opportunity to restructure 1 loan in order to receive our proceeds years earlier than what we were expecting. In connection with this agreement, we took a net provision of \$23 million during the quarter.

With regard to our legacy assets and other strategic assets, we reduced the balance by a net \$23 million during the quarter. We have 14 remaining short-term assets totaling \$127 million as well as 2 long-term legacy assets totaling \$287 million comprised of Asbury Park and Magnolia Green.

Slide 9 details the makeup of our portfolio. At the end of the second quarter, the portfolio had \$3.8 billion of total assets, of which 82% is related to the ground lease ecosystem in cash. For the balance of the portfolio, land and development represents 7%; real estate finances, 5%; operating properties, 3%; and 3% is strategic and other investments.

Slide 10 presents an overview of our corporate debt. During the quarter, iStar extinguished a total of \$255 million of debt through convertible exchanges and open market purchases of our bonds. In the exchange transactions, we entered into privately negotiated agreements with certain holders of our convertible senior notes, which mature in September 2022, to exchange \$194 million aggregate principal amount of the notes for 13.75 million of newly issued shares of common stock and \$14 million of cash. The purpose of this exchange was to simplify the balance sheet, deleverage and reduce volatility as we approach maturity with the stock significantly in the money. Importantly, the transaction enables us to preserve cash on hand as well as reduce outstanding debt.

And subsequent to the end of the quarter, we were able to exchange an additional \$48 million of convertible notes for 2 million shares of common stock and \$24 million of cash. Today, we have \$45 million of convertible notes outstanding.

In addition to these convertible exchanges, during the second quarter, we repurchased \$60 million of our other unsecured notes, resulting in a \$2 million gain. At quarter end, we had approximately \$1.86 billion of outstanding debt with a weighted average maturity of 3.3 years.

So in conclusion, consistent progress on all fronts of our strategy, and we hope to provide a larger strategic update as soon as possible. With that, let me turn it back to Jay.

Jay S. Sugarman iStar Inc. - Executive Chairman & CEO

Thanks, Brett. Again, I know many of you will want to ask about the Safehold-iStar conversations, but I hope you understand we can't say anything at this point. But let's go ahead and open up for questions. And operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Jade Rahmani, KBW.

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

As the evolving macro picture has played out this year, is there anything you've seen that has caused you to change any of your views with respect to how you're pursuing the ground lease investment? And also whether there are other investment strategies or opportunities you might pursue, perhaps looking at structures with less duration or more of a variable rate component? Just curious if there's anything that's played out this year that has caused you to revisit any of your prior assumptions or expectations.

Jay S. Sugarman iStar Inc. - Executive Chairman & CEO

Jade, no, look, I think the core product, what we call the Safehold modern ground lease, is continuing to gain traction. If you listened in on the Safehold call, we're now covering all 30 top cities in the country, multiple product types, high-end institutional customers, local sharpshooters. We've got over, I think, at this point, 50 leasehold lenders that we've worked with.

So I think the core product is very powerful and has been proving that every quarter. So I don't see us changing or varying that too much.

And we haven't really seen a need to do that. We do think there are other opportunities in this whole ground lease ecosystem that we can pursue. But our focus right now is really on the core product, really making it a mainstream part of the capitalization in the real estate markets. So that piece is pretty well set.

I will say, what we've seen from a macro perspective is transactions, people buying and selling assets, has gotten more difficult. We kind of are part of a capital solution, but transactions need to happen for us to play the role we want to play. So we have seen buyers and sellers struggle to figure out what's the right price for things. We've seen this before. It takes a little bit of time for markets to adjust to sharp changes. And we, clearly, in the first half of the year, saw some pretty high volatility on interest rates, cap rates, et cetera. So we're starting to see green shoots of stability. People are starting to figure out where the new price levels are. But we still expect, in the second half of the year, a slowdown in commercial real estate transactions, which means, for Safehold, it will probably be a little longer to get deals done.

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

And as you look at the scope of this cycle, this correction that seems to be playing out, how do you assess the magnitude of potential change? In the '07 to '09 era, what we had was a very over-leveraged system, a lot of floating rate debt, a lot of securitized debt, which cause waves of defaults that seems to be missing this cycle. On the other hand, we do have high inflation, which has somewhat been a positive to real estate because you get higher rents. How are you looking at the dynamics of the cycle and magnitude of potential downtime?

Jay S. Sugarman iStar Inc. - Executive Chairman & CEO

Yes, it's always dangerous to make sweeping generalizations. We continue to see multifamily and other parts of the ground -- the commercial real estate world very strong, despite some of the challenges and the headwinds. Other parts are struggling a little bit. Obviously, we've talked about office in the past. We do think the market takes time to adapt. We're looking more at long-term trends. And again, inflation historically has been a positive for real estate because it pushes up replacement costs.

We're not anticipating long-term inflation to be outside the norms that we've seen over the past century. There will be a moment in time where it could certainly do what it's doing right now. But when we look back historically, we see inflation between 2% and 3% is pretty consistent over long periods of time. And so I think that's where things will settle in eventually. It's how we model out our business long term.

Interestingly, inflation rates above 2% increase our returns at Safehold on a cash flow basis over long periods of time. I think that's something we need to talk about. It's more tips-like in nature than maybe people give it credit for. But overall, again, Jade, we think the dynamics in the macro environment right now are going through an adjustment process. We see real strength in certain pockets. We see some challenges, certainly from a macro standpoint and geopolitically. So we're not in a business where we have to guess where that's all going tomorrow. If you had to ask us, we think there's some challenges out there. But I think our long-term view remains pretty constant.

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

And just lastly, on the legacy assets, continue to make progress there. Are there any potential bulk portfolio sales that the company is thinking about, either on the loan side or on the legacy asset side? Granted, you may need to take a haircut to carrying value, however, there has been book value growth over the period. There's a lot of unrealized value growth in the Safehold position, and the company's cash and liquidity position is very strong. So wondering if you're contemplating such transactions.

Jay S. Sugarman iStar Inc. - Executive Chairman & CEO

We're looking to position the balance sheet to have the most flexibility possible. So we have made decisions when we think it makes the most sense or where we see a long-term uncertainty that we can get rid of. We did that on an asset this quarter.

I think in terms of the 2 biggest ones, Asbury Park and Magnolia, that will be sort of a segmented approach. There are opportunities to move parcels. I don't think there's an opportunity to sell the whole thing in the near term. But as we continue to track towards the successful conclusion of those projects, there may very well be an opportunity to accelerate some sales.

Operator

(Operator Instructions) And at this time, there are no other questions in queue.

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

Okay. Great. Thanks, everyone, for tuning in. Operator, why don't you give the conference call replay instructions once again.

Operator

Thank you. Ladies and gentlemen, this conference will be available for replay after 2:30 p.m. Eastern Time today through August 18, 2022, at midnight. You may access the AT&T replay system at any time by dialing (866) 207-1041 and entering the access code, 6846235. International participants, dial (402) 970-0847.

That concludes our conference today. Thank you for your participation and for using AT&T conferencing service. You may now disconnect.

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