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SFI - Q2 2013 iStar Financial Earnings Conference Call

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Michael Kim *CRT Capital Group - Analyst*

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Jonathan Feldman *Nomura Securities - Analyst*

Ian Goltra *Forward Management - Analyst*

PRESENTATION

Operator

Good day, everyone, and welcome to iStar Financials' second quarter 2013 earnings conference call.

(Operator instructions.)

As a reminder, today's conference is being recorded. At this time, for opening remarks and introduction I would like to turn the conference over to Mr. Jason Fooks, vice president of investor relations and marketing. Please go ahead, sir.

Jason Fooks - *iStar Financial - VP of IR and Marketing*

Thank you, John, and good morning, everyone. Thank you for joining us today to review iStar Financial's second quarter 2013 earnings report. With me today are Jay Sugarman, Chairman and Chief Executive Officer, and David DiStaso, our Chief Financial Officer. This morning's call is being webcast on our website at istarfinancial.com in the investor relations section. There will be a replay beginning at 12.30 PM Eastern Time today. The dial-in for the replay is 1-800-475-6701, with a confirmation code of 298455.

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 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 - Chairman and CEO*

Thanks, Jason and thanks to all of you for joining us this morning. We worked hard in the second quarter to begin ramping our investment activity and to set the table to resolve several of the existing NPL assets. Both will be important to continue the earnings momentum we have begun to develop and to bridge us until our land portfolio can become a meaningful contributor to earnings in 2015.

While results won't likely show up until the second half of the year, we are pleased with the progress we were able to make on both fronts in the quarter. Our pipeline of investments is beginning to grow, and several NPLs are getting closer to resolutions that will free up both unproductive capital and significant management resources. More to report on that as the year progresses.

On the land front we are moving as quickly as possible to bring several assets to a point where our value creation efforts should become more tangible. The single family sector continues to improve and we remain committed to deploying resources to find ways to enhance our returns in all of our projects.

I'll talk about some early success in this area later in the call, but first, let's do a quick review of the business line.

Our real estate finance book saw continued payoffs but also the closing of the first large investment in our pipeline, a $140 million-plus preferred investment in Landmark Apartment Trust. Segment profit was $8.2 million with new investment closings and more NPL resolutions needed to build that number.

The net lease book remains relatively stable, and with cap rates in the sector continuing to fall for large-scale portfolios, our strong yields and long lease terms look quite good. Segment profit was $11.3 million for the quarter. We've been pretty selective so far in new investments, but our net lease team is focused on finding situations where we can add real value.

Much like last quarter, the operating portfolio continues to benefit from very strong performance from the condominium assets in the portfolio. Strong sales in Miami at Ocean House, 1 Rector Park in New York, the Martin in Las Vegas, and at 10 Rittenhouse Square in Philadelphia led the way to a strong quarter. Segment profit was $31.1 million. While this number will be hard to sustain as the condo portfolio sells off, we are starting to see a pickup in leasing at several of our transitional assets.

Over in the land portfolio, our growing team is making progress despite the continued drag on earnings; the segment profit was negative $14.3 million. We are in dialogue with builders on a growing number of our lots and continue to seek ways to participate in the firming market for homes in our core development plays. More on this segment in a minute, but first let me turn it over to Dave to review the numbers for the quarter in more detail. Dave?

David DiStaso - *iStar Financial - CFO*

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

For the quarter our adjusted income was $4 million, compared to a loss of $1 million for the same quarter last year. Results in the current quarter included $12 million of loss on early extinguishing of debt associated with the early refinancing of debt, while results in the 2012 quarter included $25 million of gains associated with the bulk sale of 12 net lease properties. Excluding these items, our adjusted income for the quarter would have been $16 million compared to a loss of $25 million in the same quarter last year.

Contributing to the year-over-year improvement to adjusted income was a $25 million decrease in interest expense as a result of the progress we've made over the past year to reduce our cost of capital and overall indebtedness. In addition, we recorded increased income from continued strong residential sales. This is partially offset by lower earnings from equity method investments following the sale of LNR.

Our net loss allocable to common shareholders for the quarter was $26 million, or $0.31 per diluted common share, compared to a loss of $59 million, or $0.70 per diluted common share for the same period last year. Excluding the aforementioned items, our net loss allocable to common shareholders for the quarter was $15 million versus a loss of $83 million in the same quarter last year.

During the second quarter we issued at par $265 million of 3.875% secured unsecured notes due July 2016, and $300 million of 4.875% senior unsecured notes due July 2018. We used the proceeds from these transactions to repay the remaining $97 million aggregate principal amount outstanding on our 8.625% senior notes due June 2013; and the remaining $448 million aggregate principal amount outstanding on our 5.95% senior notes due October 2013. We have satisfied all debt maturities for the remainder of the year.

During the second quarter, we also repaid $76 million of our February 2013 secured credit facility, bringing the remaining balance to $1.6 billion at June 30th, 2013. Additionally we paid $52 million on the A-1 tranche of our 2012 A-1/A-2 secured credit facility, bringing the remaining outstanding balance of the A-1 tranche to $8 million. The balance of the A-2 tranche at the end of the quarter remains $470 million.

As we've discussed before, we've spent the past several quarters working in earnest to extend our debt maturity profile and reduce our cost of capital. The result of those efforts is that we have significantly improved our debt maturity profile through the end of 2015, with less than 7% of our debt, or only $300 million maturing during the next 2.5 years. In addition, we have brought our weighted average cost of debt down to 6.0% at the end of the quarter, versus 6.5% at September 30th, 2012.

Our leverage for the second quarter was 2x, a decrease from 2.1x at the end of the prior quarter, and at the low end of our targeted range of 2.0x - 2.5x.

Subsequent to quarter-end, we were pleased with the continued positive ratings momentum, as Moody's Investors Services revised its rating outlook on us from "stable" to "positive." We worked closely with the agencies to highlight the meaningful progress we've achieved and we are committed to demonstrating continued progress towards our stated goals of creating value across each of our four business segments.

Let me turn to investment activity in our real estate and loan portfolios. During the second quarter, we closed on an investment origination in Landmark Apartment Trust of America. We agreed to provide up to $146 million of preferred equity financing, of which we've already funded $66 million. We expect to fund the balance of our commitment as Landmark acquires additional multifamily communities. Separately, we invested $43 million of additional capital during the quarter across our business segments.

At the end of the quarter, we had over $700 million of cash, which provides us plenty of dry powder to pursue attractive investment opportunities. Our pipeline for new investments has continued to grow, giving us the ability to evaluate a fairly wide set of opportunities, and we hope to put a sizable amount of this capital to work over the next 12 months. Over the next year, we expect to make an additional $200 million of investments in existing projects in our net leasing, operating, and land segments.

Also in the second quarter, we generated $538 million of proceeds from our portfolio, which included $155 million from repayments and sales of loans in our real estate finance portfolio, $117 million from sales of operating properties, and $16 million from sales of net lease assets; $25 million from sales of land; and $225 million of other investments, which consist primarily of proceeds from the previously announced sale of LNR property.

At June 30, 2013, our total portfolio had a carrying value of $5.4 billion, gross of $422 million of accumulated depreciation, and $32 million of general loan loss reserves.

Let me discuss each of our four business segments. Our real estate finance portfolio totaled $1.5 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 $684 million of first mortgages or senior loans and $492 million of mezzanine or subordinated debt. The performing loans generated a weighted average effective yield for the quarter of 7%. Included in the performing loans, we had $42 million on loans on watch list.

At the end of the quarter, we had $370 million of non-performing loans, or NPLs, which are carried net of $426 million of specific reserves. Our NPLs were mainly comprised of 34% land, 23% hotel, 20% entertainment, and 14% retail.

For the quarter we recorded a $5 million provision for loan loss, bringing our total reserves for loan losses to $480 million, consisting of $448 million of asset-specific reserves and $32 million of general reserves. While we saw the levels of provisions decrease this quarter, the rate at which they may continue to do so is uncertain and we could see quarterly fluctuations.

Next, I'll discuss our net lease portfolio. At the end of the quarter, we had $1.7 billion of net lease assets, gross of $326 million of accumulated depreciation. Our net lease portfolio totaled 20 million square feet across 34 states. During the quarter, we invested $15 million in our net lease portfolio. These fundings include the development of a 185,000 square-foot, build-to-suit campus just outside of Chicago which is leased to Universal Technical Institute for 18 years. Additionally, we generated $16 million of proceeds, recognizing a $3 million gain.

Our net lease portfolio was 94% leased at the end of the quarter, with a weighted average remaining lease term of 12 years. For the quarter, our occupied net lease assets generated an unleveraged weighted average effective yield of 7.8%, while our total net lease portfolio generated an unleveraged weighted average effective yield of 7.2%.

Let me now turn to our operating properties portfolio. Our operating properties totaled $1.1 billion, gross of $93 million of accumulated depreciation. The portfolio was comprised of $825 million of commercial and $302 million of residential real estate properties. We invested $10 million in these operating properties during the quarter.

The commercial properties represent a diverse pool of real estate assets across a broad range of geographies and collateral types, such as office, retail and hotel properties. They generated $29 million of revenue, offset by $20 million of expenses during the quarter. Our strategy within this portfolio is to reposition or redevelop these assets with the objective of maximizing their values through the infusion of capital or intensive asset management efforts.

At the end of the quarter, we had $182 million of stabilized commercial operating properties. The stabilized properties were 88% leased, resulting in a 9.5% unleveraged weighted average effective yield for the quarter. During the quarter we sold $24 million of operating properties, which resulted in a $5 million gain.

The remaining $643 million of commercial operating properties are transitional real estate properties that were 56% leased and generated a 2.9% unleveraged weighted average effective yield for the quarter. We are actively seeking to release these properties to maximize their value. During the quarter, we executed approximately 50 commercial operating leases covering 300,000 square feet.

The residential operating properties were comprised of 805 condominium units remaining in inventory at the end of the quarter. These units are generally located in projects characterized by luxury buildings in major cities throughout the United States. During the quarter, we sold 118 condos for $92 million in proceeds, resulting in $36 million in income, offset by $5 million of expenses.

This brings me to our land portfolio. At the end of the quarter our land portfolio totaled $962 million and included 11 master-planned communities, seven infill land parcel and six waterfront land parcels. Master-planned communities generally represent large-scale residential projects that we 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 which include commercial, retail and office. 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 $8 million into our land portfolio through capital expenditures.

During the quarter, we contributed a land parcel into a joint venture in exchange for $21 million in proceeds, for which we recorded a $3 million gain and received both a preferred partnership interest and a 47.5% equity interest in the development joint venture. The joint venture will develop the project, called Marina Palms, in Miami, Florida, which will be a 468-unit luxury condominium with a 112-slip full-service marina. After the first few months of pre-sales, 85% of the first tower is under contract or reservation.

At the end of the quarter, five of these land projects were in production, with sales activity having begun; nine were in development and actively seeking entitlements; and 10 were in the pre-development phase.

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

Jay Sugarman - *iStar Financial - Chairman and CEO*

Thanks, Dave. I mentioned last quarter we tried to offer a few markers of value throughout the year as the early stages of certain land assets began to crystallize value. Obviously we cautioned that land is never a good business to try to generalize around and we're certainly are not yet in a position to project larger outcomes. But we have seen some success in a few projects possibly worth noting.

In Miami we took several steps to unlock value in a parcel of land we took back several years ago. Beginning last year, our in-house team and a third-party developer began the process of designing a sales center and preparing the site for the construction of two 234-unit towers and a high-end marina. As Dave mentioned, during the second quarter we completed the contribution of this land into a joint venture in return for cash and interest in the JV. And once units were released for sale, we saw contracts and reservations quickly written on almost the whole first tower. This strong demand should enable construction of the first tower to begin later this year, and if this strong demand continues, would generate sizable returns on our basis upon completion of the second tower.

One other project with growing momentum is our waterfront redevelopment along a mile-long stretch of beach in Asbury Park. With a growing and increasingly successful downtown core of restaurants, art house cinemas, and local shops, our Asbury Park waterfront redevelopment is kicking into high gear. We've been investing continuously over the past several years to upgrade and prepare the waterfront to follow on the success of the downtown, and we recently brought our first project, a 28-unit townhome community called Vibe, to market. While only representing 28 units out of a likely 2,000-plus total waterfront unit, the sellout of the second phase of units in less than a day has confirmed the strong demand we see developing in the market and should enable us to accelerate our conversations with other homebuilders going forward. The project team on this one has put their heart and soul into it and we look forward to being able to build something really special in a market that seems poised to finally live up to its potential.

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

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator instructions.)

And first is the line of Michael Kim of CRT Capital Group. Please go ahead.

Michael Kim - *CRT Capital Group - Analyst*

Hi and good morning. Nice quarter and I really appreciate the effort in disclosing more information on asset level detail for investors.

Jay, for my first question I know you talked about the pipeline for new investments is growing. You know, a lot of talk in the market, just the impact of the recent uptick in rates, how should we think about where you deploy capital into new investments? You know, what sort of investment type and asset classes would you favor in a higher interest rate environment?

Jay Sugarman - *iStar Financial - Chairman and CEO*

Thanks, Mike. I guess our focus certainly has been on some of the higher-yielding opportunities that we think we have a well-positioned company for. So we're not really in the commodity business where I think small changes in rates have had a pretty meaningful impact. I think most of our borrowers are looking to make very significant returns on their capital, and so small changes in rates probably don't change their business plans too much, and that has allowed us to continue to plow that area pretty successfully.

I think longer-term, if you see rates move up I think that opens the door, frankly, for more on the net leasing side. That business has seen lots of activity and lower rates have driven cap rates pretty materially. So a backup in rates there probably would be a little bit good for us. But we're still seeing plenty of economic activity in the underlying properties, and I think 50, 75 basis points probably doesn't unhinge that.

Michael Kim - *CRT Capital Group - Analyst*

Got you. I appreciate that.

And nice to see the monetization of some of the stabilized commercial properties during the quarter. And just looking at the yield profile, it would almost assume that the unleveraged weighted average effective yield for the assets that were sold during the quarter were closer to 10% for these assets. I'm just curious if you can provide some color on these transactions maybe in the type of assets, implied cap rates, and the rationale for monetizing?

Jay Sugarman - *iStar Financial - Chairman and CEO*

Yeah. I guess it's a mixed bag, and again, hard to generalize. Those cap rates, as you mentioned, sound a little high. There's seasonality in the stabilized portfolio, so it's a little bit difficult to go quarter to quarter.

But I would say we sold a commercial property adjacent to one of our condominium properties; I think that cap rate was more in the 6.5% zone. We sold a piece of commercial property on the West Coast that didn't really have a cap rate but certainly was a minor piece of a larger portfolio out there and just was taking up more time than we wanted to spend on it.

So you'll see us continue to peel off stuff that either from a time management perspective or valuation perspective makes more sense for somebody else to own. But again, I think trying to unwind the cap rates, we'll try to do a better job of giving you a little more detail. The largest trade this time was, again, the commercial piece down in Philadelphia, and I think that went off at 6.5%? It was in the sixes.

Michael Kim - *CRT Capital Group - Analyst*

Okay. No, I appreciate that.

And in the press release and in the prepared remarks you talked about executing about 50 commercial operating property leases for about 300,000 square feet. When you say "executed," does this mean this is already reflected in the second quarter or is this more of a timing issue and when can we expect this to flow through the income statement and what does that do for the effective yield, if anything?

Jay Sugarman - *iStar Financial - Chairman and CEO*

As you know, Mike, typically we're signing the leases, but either through free rents or actually when the rent begins to kick in, there's probably a little bit of a lag. So you probably didn't see much if any effect in the second quarter from those leases.

Michael Kim - *CRT Capital Group - Analyst*

Mm-hmm. And most of those leases, are those kicking in in the third quarter, or is more two or three quarters out where that might be the typical lag?

Jay Sugarman - *iStar Financial - Chairman and CEO*

Yeah. I can't give you a weighted average, but most of those have a little bit of downtime before the rent starts to come in. So by year-end I would say they're all going to start, but giving you an exact date between now and then I'm not sure.

Michael Kim - *CRT Capital Group - Analyst*

I understand. Okay, great. Nice quarter. Thank you.

Operator

And next we go to Amanda Lynam with Goldman Sachs. Please go ahead.

Amanda Lynam - *Goldman Sachs - Analyst*

Thanks so much for taking my question. I know that your upcoming debt maturities over the next two and a half years are very, very modest. But could you just update us on your plans for the capital structure longer-term? How are you feeling about the mix of secured versus unsecured debt? To the extent you can talk about any opportunistic things you might be looking to do, we'd appreciate the color. Thanks.

Jay Sugarman - *iStar Financial - Chairman and CEO*

Yeah. I think given the limited maturities coming up, we're focused a little bit more at this point on trying to match-fund the assets of the pipeline that we think is coming down the pike. So that'll probably drive its tenor and it'll drive whether we go fixed or floating.

Longer-term, obviously we've said we want to be primarily an unsecured borrower with a rating in kind of the BB/BA2 range, so we've got some work to do there. But those two things are probably driving our vision right now more than any specific transaction.

Amanda Lynam - *Goldman Sachs - Analyst*

Great. Thank you.

David DiStaso - *iStar Financial - CFO*

Are there any more questions?

Operator

One moment.

And we'll go to Jonathan Feldman with Nomura Securities. Please go ahead.

Jonathan Feldman - *Nomura Securities - Analyst*

Good morning. Just wondering if you guys could provide an estimate in terms of your expectations around spend, both operating and CapEx, on the land portfolio this year.

David DiStaso - *iStar Financial - CFO*

Yeah. I think, Jonathan, looking forward we talked about spending approximately $200 million over the next 12 months on all of the different portfolios. I think on land you're probably talking about that being approximately half that we would be spending over the next 12 months in development.

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Jonathan Feldman - *Nomura Securities - Analyst*

And on a going forward basis, do you expect that spend to moderate next year and the out years, or how should we think about that?

David DiStaso - *iStar Financial - CFO*

Yeah. I think as more projects come on line, I think you'll probably see that increasing over a period of time. And then as sales gain momentum, you'll see obviously cash come back into the company more so than going out.

Jonathan Feldman - *Nomura Securities - Analyst*

And then just lastly, I believe in past calls you've talked about expectations around profitability being centered, I think, around 2015. You guys, just with there having been some series of time since you guys have talked about that and changes in your cost of capital, I just wondered if you had any -- without giving guidance, any current thoughts in terms of when you think you might be able to report a net income positive quarter.

Jay Sugarman - *iStar Financial - Chairman and CEO*

I guess I'd say, Jonathan, two things. One, given the very significant proportion of the assets we now own and depreciate on our own balance sheet, we think NOI is probably not a metric we're going to track too much. We think adjusted income is the right metric, adding back certainly depreciation and some of the other factors that we think will bleed off over time.

But I do think we're looking at 2015 as a kind of jump-step year when some fairly large land projects go into production and we should begin to see some meaningful sales. It doesn't mean we're not looking to make progress before then. It doesn't mean certainly on an adjusted basis we've already perhaps broken through. But I don't think you'll see us talking about net income very much. You will see us talking about the segment profits and overall adjusted income.

And yes, lowering the cost of funds, pulling some of the NPLs into an earnings position, pulling some of the transitional assets into higher-lease states, those are all good things that will continue to move earnings up. But we think the next big step for us is to get the $700 million of cash sitting on the balance sheet to work. If we do that successfully, if we redeploy some of the capital that will continue to come in, we'll set the stage nicely for the land portfolio to kind of turbo-boost that.

Jonathan Feldman - *Nomura Securities - Analyst*

Totally understood.

And just towards your comment on profitability not being the best metric to track the progress of the company, have you given any more thought, or do you have any suggestions for investors newer to the story in terms of value in the company, and in particular, on an NAV basis? Is there any additional assistance you guys think you'll be able to provide in terms of tackling that challenge?

Jay Sugarman - *iStar Financial - Chairman and CEO*

Yeah. You know, I think we've done what we can on finance and the net lease and the operating properties. I've given you the statistics; I think people can make their own judgment on what cap rates are and how fast leasing can occur. We see certainly markers of value and each of those being relatively transparent.

I think land is the one place people are still trying to get a hand around it. As I said, we're going to give you things as they come through the system that we think are meaningful. But it's hard to predict the large scale sort of shift we know we're building towards. That will only kick in when some pretty meaningful projects come online and we can provide sales statistics, structures in which we've even ventured or in which we own a very significant economic interest.

So I think that's a little ways off. I think what we've consistently said is that we think our book basis would be impossible to replicate on those assets today. So we feel quite good with that. But the upside potential and the optionality embedded in it is harder to pin down or has been to do that until we have some real strong of value from the end users.

David DiStaso - *iStar Financial - CFO*

Thanks, Jonathan.

Operator

And we'll go to Ian Goltra with Forward Management. Please go ahead.

Ian Goltra - *Forward Management - Analyst*

Good morning, Jay. Just a quick question regarding Michael Kim's earlier question surrounding seasonality. I just wanted to confirm which of the assets are seasonal and what's the source of that seasonality?

Jay Sugarman - *iStar Financial - Chairman and CEO*

Yeah. One of the biggest is hospitality in Waikiki, which does have a pretty pronounced seasonality. We also get, on one of our large net lease projects, a little bit of participation payments that come in. So there's a couple things that are going to show up that'll make those numbers move around a little bit.

Ian Goltra - *Forward Management - Analyst*

Okay. Good. Thank you.

Jay Sugarman - *iStar Financial - Chairman and CEO*

Thank you.

Operator

And Mr. Fooks, I'll turn it back to you.

Jason Fooks - *iStar Financial - VP of IR and Marketing*

Great. Thank you for joining us today. If you have any additional questions on today's earnings release, please feel free to reach out to me directly. John, would you please give the conference call replay instructions once again?

Operator

Certainly. And ladies and gentlemen, the replay starts today at 12.30 PM Eastern, will last until August 9th at midnight. You may access the replay at any time by dialing 800-475-6701 or 320-365-3844. The access code is 298455. Those numbers again, 800-475-6701 or 320-365-3844; the access code, 298455.

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