BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

November 14, 2019 | www.btnresearch.com

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

Starwood Property Trust (STWD)– 3Q19 Update
Maintain BUY

We are maintaining our BUY recommendation on STWD. In our view, it remains more diversified with lower risk than many similar types of mortgage REITs. There continue to be some sizeable unrealized gains in the portfolio, and it still sees a seasonally strong 4Q for new volumes. The core EPS continues to outpace the dividend at $0.52 vs. $0.48. The dilution from convertible securities had its last tough comp in 3Q19 as a drag of 3-cents on core EPS. 4Q the drag should be 1-cent and then neutral thereafter. There remain several other sources for EPS growth going forward:

- Sensitivity to LIBOR continues to positively expand if rates decline in the near future.

STWD EPS	Libor -200bp	Libor -100bp	Libor +100bp	Libor +200bp
4Q18	-$0.01	-$0.04	$0.07	$0.15
2Q19	$0.12	$0.03	$0.05	$0.11
3Q19	$0.17	$0.05	$0.03	$0.08

This is a combination of interest rate floors on floating-rate securities helping on the downside and fixing some of their borrowing costs at longer terms. The company noted that 84% of its loans have LIBOR floors and 25% of those floors are in the money now.

- In our view, should the company believe higher rates are more likely at some point in the future, it could move more of its financing back to take advantage of that situation. The turnover of loans in the portfolio and its efforts to match maturities should always allow for the portfolio to adapt to changing forward views. Where we think they deserve some credit now is pushing out maturities and reducing reliance on the repo market and short-term credit lines. As the CEO said last quarter, when ugly things are happening, banks have a habit of reducing short-term credit lines.

- STWD writes for credit quality not for spread. When spreads tighten, they maintain a lower cost of funds than competitors and can still earn higher returns. They can also be a seller into tight spread markets. When spreads widen, they have the liquidity and permanent capital to take advantage of others not being able to finance deals at when cheap. They have also focused on trophy or one-of-a-kind properties. In the past, they would do construction loans of 50-60 cents on the dollar, meaning worst case, they take a building worth much more than the mortgage. They have taken some grief for lending to refurbish the Lord & Tailor building on Fifth Ave. However, they are paid in full if the value of the construction falls to only 50-cents on the dollar. There is strong demand for the space in the building and STWD has had offers to sell its loan.

- STWD's president, Jeff DiModica, does not see credit quality deteriorating on new loans. *"The good news is that volumes (of new loan activity) are fairly high, and we are seeing a decent amount of loan activity for everybody to choose from, and we're going to pick and choose where we want to be within that. The non-banks, people think that they're being more aggressive. I do we're getting pushed to tighter spreads today. Fortunately, we have tighter liabilities, so we're able to earn similar spreads…So, it's hard to say that standards are getting worse and that loans are deteriorating when everybody in our space seems to write more every year."* He also noted that many competitors specialize in particular areas and with high loan volume, they don't have to modify their approach.

- Barry Sternlicht, the CEO noted that they continue to see strong property markets in both the US and Europe with accelerating rent growth in their portfolio. He views office, industrial, and multifamily as being strong and challenges are retail and hotels. The hotel problem he characterized as overbuilding more than lack of demand. STWD has only 3% of its lending book in retail with half of that to The American Dream Theme Park/Retail Center which has strong leasing demand. Hotels are 23%. International is an area where the company continues to pursue more opportunities to expand and diversify the portfolio further.

- The Energy Infrastructure unit may now be ready to grow. Since the acquisition of this portfolio, STWD has been selling off lower margin loans and repaying/refinancing debt so loan maturities match the debt maturities. This has caused this unit to lag during 2019 as the portfolio shrunk nearly 50% and they prepaid debt. The unit has been profitable at 1-cent of core EPS in 3Q19 and 3-cents YTD. But by STWD's estimates, they have probably endured $0.10 lower EPS YTD via the restructuring.

STWD has completed much of this and will start originating new loans in this unit. It may be more of a 2020 story, but if they have been restrained by 2-3 cents per quarter during 2019 in this area, that should drive EPS growth going forward.

- Settling some convertible securities in 2018 has diluted the share count of late. That was a 3-cent drag in 3Q19.

Share Count	3Q19	2Q19	1Q19	4Q18	3Q18
Basic Avg Shares	280.0	279.2	277.5	273.9	265.4
Unvested Stock Awards	2.3	2.3	2.4	2.5	2.4
Dilutive Woodstar II Op units	11.0	11.6	11.9	11.0	9.9
Other Dilutive items	-	-	-	0.5	0.1
Dilutive Avg Shares	293.3	293.1	291.9	288.0	277.8

By our calculation, this 3-cent drag on Core EPS will fall to 1-cent in 4Q19 and should have a minimal impact after that in 2020. There are $500 million in convertible notes due in February 2021 and another $700 million due in December 2021. Historically, STWD has settled its convertible notes in cash. In 2018-2019, it wanted to keep its liquidity and settled some with shares which accounts for the rise in basic average shares in the table above.

Disclosure

BTN Research is a research publication structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. Information included in this report is derived from many sources believed to be reliable (including SEC filings and other public records), but no representation is made that it is accurate or complete, or that errors, if discovered, will be corrected.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.