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Starwood Property Trust (STWD) 3Q Update

We continue to recommend Starwood Property Trust (STWD). The company continues to diversify its operations while maintaining assets that benefit from rising interest rates. We recommend that clients read our May 24 report as a primer for why we see value here, potential for capital appreciation, and a stable 8.9% dividend.

In this report, we want to update some of the prior notes and address some changes that should be positive as well:

- STWD continues to focus on floating rate investments with fixed funding costs so rising rates help earnings. Core earnings continue to outpace dividend.
- Value of the actual real estate investments is rising via higher cash flow and actual transaction gains – book value at STWD remains understated.
- New GE Infrastructure deal adds diversity but maintains a model of investing STWD is very familiar with.
- Change in accounting for convertible debt retained capital to deploy has not hurt book value per share even with a higher share count.
- Loan provision taken in 2Q18 may result in no loss at all.

STWD Remains Positively Positioned for Rising Interest Rates

STWD buys a number of assets such as commercial mortgage debt, real estate properties, and infrastructure debt all play a role. Each of these has either floating interest rates or have rent increases tied in. 93% of commercial loans and 97% of infrastructure loans are

tied to LIBOR. The result is cash flows to STWD increase as interest rates rise. It enhances this further by using fixed cost of capital when possible. If anything, this has become slightly better in the last 6 months:

LIBOR Increase	Annual EPS Change
100bp	6-cents
200bp	13-cents
300bp	21-cents

Two quarters ago, the 300bp move was 20-cents. There are two things to keep in mind with this, the first is STWD has issued shares to acquire some of its real estate and it issued shares in connection with some convertible debt in 2018. The share count rose about 5% from 1Q18 and yet the forecasted LIBOR change to EPS is gaining strength for shareholders. Second, this is a company that for years reported core EPS in the high 40-cent range against a dividend of 48-cents. The payout was above 100%. Now core EPS is consistently higher than the dividend:

	3Q18	2Q18	1Q18	4Q17	3Q17
Core EPS	$0.53	$0.54	$0.58	$0.55	$0.65
Dividend	$0.48	$0.48	$0.48	$0.48	$0.48
Payout	91%	89%	83%	87%	74%

In 3Q18, the $0.53 was negatively impacted by 2-cents for retiring debt and transaction costs for the GE acquisition. In 1Q18, there was 4-cents of positive impact from retiring debt. In 3Q17, there was a 13-cent gain. Without these items, core EPS has essentially been $0.55 for several quarters now (even with a higher share count) with a 90% payout for the dividend, which is normal for a REIT.

Compare that to the LIBOR sensitivity, and EPS could see 3%-6% growth just from interest rates rising. On top of that, rising rates makes it easier to keep money at work – it doesn't prepay or refinance as quickly. So, the commercial portfolio has grown 17% since 1Q18 with a high level of first mortgage loans and a higher unleveraged return:

$ in millions	3Q18	2Q18	1Q18	4Q17	3Q17
Portfolio Size	$7,505	$7,039	$6,889	$6,966	$6,767
% First Mortgage	87%	90%	85%	83%	82%
Unlevered Return	7.3%	7.3%	7.4%	7.2%	7.2%

Value of Real Estate Continues to Be Seen

Since STWD started to buy physical real estate it has highlighted several things:

- The timing on when a sale occurs is up to STWD unlike investing in mortgages, which can prepay at any time.
- Depreciation penalizes GAAP earnings, which allows STWD to retain more capital to reinvest rather than paying it out as dividends under REIT guidelines.
- The value of these assets is actually rising and will be reflected upon actual sales that recover cost of acquisition, recoups depreciation, and a return on top of that.

The company has focused on unique situations where they see long-term demand growth for the real estate that will boost rents, property values, and keep occupancies high. We would like to highlight three examples where the values are likely understated on the balance sheet and represent some hidden value for STWD:

The Woodstar portfolio of affordable housing apartments in Florida. STWD owns 15,000 units spread over 59 communities. We previously noted that rents were rising at 4% vs. the company's initial forecast of 2%. The units are 98% occupied. The government recently changed tax laws on affordable housing that will save STWD $6.9 million in annual property taxes. The cash on cash yield is now 11.4% vs. 10.9% and these properties are financed at a fixed 3.8% for 12-years.

The Dublin property recently saw a 37% rent increase and occupancy is 99.7%.

The Bass Sporting Goods Stores they purchased came with 23 locations and $294 million of equity was invested. They have now sold 3 locations and expect to sell 4 more in the near future. All 3 were sold at substantial gains and they expect to be at 16 units with only $130 million of equity still invested. The return has exceeded forecasts by 300bp on the IRR.

All three have produced gains in cash flow, and with Bass, have started to unlock gains that are realized into book value. The total depreciation impact from real estate on book value is $0.98 right now. Barry Sternlicht believes real-world book value here is above $20 per share rather than high $16's adjusting for market value of these investments.

The Infrastructure Unit

STWD bought this for $2.1 billion from GE in the quarter. It was a drag on 3Q18 EPS because it was only owed for 12-days in the period. It posted a loss of $6.0 million in the quarter as they recognized $6.9 million of transaction costs. This should be a unit that is accretive to earnings going forward.

This is a smaller part of STWD but keeps many of the same characteristics it looks at when investing:

- Long-term contracts with investment grade counterparties back these projects – looks very much like real estate deals
- 97% floating rate notes
- An area seeing increasing demand over many years, helps asset values
- 10%-13% IRRs forecasted by STWD
- Money stays invested – an average of 5-year loan terms
- Adds diversity – non-correlated to primary business allows flexibility to invest in better areas at all times.

STWD has experience within the company looking at these types of energy infrastructure deals and adds experience with GE employees coming over.

We will wait for some actual results like the real estate segment to emerge before fully judging this deal. On the surface, we are comfortable with it. Our knowledge of energy assets like pipelines, fractionators, power plants is they are seeing rising values in the private equity world.

Convertible Notes Accounting Change

Until June 2018, STWD's policy was that it would settle all convertible notes in cash. As a result, it did not have to account for share dilution, but it did need to record potential and paid premiums it would need to pay. For example, if the bond is convertible at $20 per share and the stock price is $21 – the bondholder has an incentive to covert the debt into stock and make a 5% return on capital. STWD would need to pay that value to avoid conversion. Thus, it would add the incremental cash payment to interest expense, which in turn would reduce book value. We noted in our May 24 issue that this lowered earnings and book value but kept share-count flat:

	1Q18	4Q17	3Q17	2Q17	1Q17
EPS Convert Impact	$0.08	$0.13	$0.15	$0.21	$0.21
Diluted Units	267.7	262.5	261.9	261.6	260.1

*The 1Q18 share bump was due to shares issued to buy the Woodstar assets

After June 30, 2018, STWD changed to a policy where it no longer asserts that it will settle all convertible notes with cash. The result is the convertible premium is no longer expensed as part of interest expense. In fact, in computing fully diluted share figures, interest expense on the convertible notes is added back to earnings but the share count reflects 100% conversion if they are dilutive.

	3Q18	4Q17
2018 Converts	$0.0	$370.0
2019 Converts	$105.9	$341.4
2023 Converts	$250.0	$250.0
	$355.9	$961.4

In March of 2018, all the 2018 convertible notes were settled in cash.

The company settled $235.5 million of the outstanding 2019 notes last quarter with 11.2 million shares and $20.8 million in cash. After the quarter, another $27.9 million was settled with 1.2 million shares and $4.7 million in cash. What remains is $78.0 million and the conversion price is $19.33 per share so they are in the money. This issue is largely resolved. What remains would be a maximum of 4.0 million shares and roughly $10-11 million in cash if they are settled with shares.

The 2023 issue converts at $25.91 and does not represent an immediate dilution issue. If they become one, the stock will have appreciated 18% - which would not be a bad thing for investors.

The share count definitely increased as a result of doing these recent settlements.

	3Q18	2Q18	1Q18	4Q17	3Q17
Shares O/S	274.1	262.4	262.0	261.4	260.8
Core Fully Diluted Shares	277.8	273.4	267.7	262.5	261.9
Adj. Book Value/Core	$17.84	$17.85	$17.74	$17.71	$17.73

But, book value per share is still rising even with the higher share count. This adds back the depreciation on real estate that should be worth more than what STWD paid.

So, why the change in policy? STWD is finding more deals to do is the easy answer and this preserves their cash for those. President Jeff DiModica noted this on the 3Q call and pointing out that STWD has $1.35 billion in available capital to deploy and a total of $4.5 billion adding in over $3 billion available on the balance sheet,

> *"After settling the bulk of our January 19th maturity convertible bonds with shares in the open window this quarter, we have capacity to execute our business plan. We also have ample unencumbered assets, allowing us the ability to opportunistically create cash, either by issuing more debt or by selling equity assets and thereby taking some of our larger embedded gains increasing our book value and earnings power going forward."*

During the quarter, the company also bought the GE Infrastructure portfolio with $2.5 billion in assets and unfunded commitments that are accretive to earnings. STWD's view would be the convertible bonds had a 5.7% effective interest rate for a few years rather than paying over 10% for a common dividend had they raised equity initially. Now, they convert to equity paying essentially 10%. However, it also becomes equity that can be leveraged against. In the words of the Chairman, "give us a dollar, and we are earning 11%-12% on it." Leverage that a little and they can make 15% against paying 10%.

Issuing 10% capital is expensive. However, the money is being put to work at a higher rate, book value is rising, and the company does have a $250 million stock repurchase plan in place – where it bought $12.1 million back last quarter.

Bad Construction Loan from 2Q May Not Result in a Loss

During the 2Q 18, STWD took a loss reserve of $22 million for a residential building in NYC. The value of the reserve involves discounting expected cash flow at the rate of the loan. The company noted that $15 million of the $22 million was the effect of discounting.

The reason for the reserve was that the developer was not selling units as quickly as forecast and would have trouble paying the loan on time. That appears to be resolving itself now:

> *Jeff DiModica on 3Q18 call:*
> *"We continue to make positive progress on our Upper West Side New York City condo loan that we discussed last quarter. As part of our recent modification to extend the loan, we were able to negotiate a recourse agreement with the borrower which should ensure we are fully filled out in 2019. Since the modification six units have already closed or are under contract."*
>
> *Barry Sternlicht added:*
> *"So, our breakeven on our loan is significantly below what they are selling, more than 50. It's 40% below what they are selling the units at right now. So, we feel very comfortable we will recover all our capital on that deal plus."*

This appears to be a situation where cash flow slowed temporarily. The value of the asset where transactions are occurring far exceeds what STWD has lent against it.

It is worth noting that there was a liquidation of a retailer tenet in Chicago that resulted in an $8.3 million impairment on subordinated mortgage loans. The unpaid balance is $12 million. Jeff DiModica added on the call, "As for credit, the LTV of our book remain consistent at 62.5% this quarter. Please note that the retail exposure in our loan book is only 2% of our portfolio and will be less than 1% in 2019"

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