BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Starwood Property Trust (STWD) 3Q20 Update
Maintain BUY

We are maintaining our BUY recommendation on STWD. It beat forecasts by 3-cents and Core EPS out-earned the dividend too. At a 13% yield, trading at a discount to asset value and even GAAP book value – we still like the future here. We see several points that we have made in recent updates starting to develop that should help earnings growth more:

- **More money is going back to work. Early this year, STWD was holding much more cash than normal to preserve liquidity.** Cash is a drag on earnings as does not generate yield. When STWD was holding $800 million in cash – it noted that was about $600 million too high. It has since put $400 million back to work in 3Q. There is a period when deals haven't closed yet or are not producing yield for the full quarter. However, for STWD, **$400 million fully at work is worth about 3-cents in additional core EPS/quarter.**

- **The Special Servicing unit continues to ramp-up with close to $9 billion in active cases vs. $5 billion at the end of 2019.** This unit fixes problem loans in the market and earns fees. With COVID, there is more business available to restructure loans or repossess property and resell it. The fees are earned on a lagging basis as the work is complete. With a rising backlog – it should be a source of lumpy but rising income for STWD:

	3Q20	2Q20	1Q20	4Q19
Servicing Fees	$13.7	$15.6	$6.4	$12.0
Active Cases	$8,825	$8,038	$5,550	$5,085
REO	$3,245	$3,338	$3,450	$3,335

The Real Estate Owned portion can generate higher fees as there is more work involved but can take longer to realize it. It is part of the $8.8 billion of active cases. STWD comments that fees can take 18-24 months in some cases so this could provide higher income for many quarters to come. $3 million in higher servicing fees adds 1-cent to EPS.

- **Non-QM Residential has the potential to expand returns.** These are loans with high FICO scores over 700 with low LTV ratios in the 60s. STWD has been buying these at a discount and securitizing them at par and booking gains. The market is now over par for these loans, but it is at the stage where the **early securitization trusts are refinancing**. The loans are paid down to even less LTV, and **the trust has financing of 3%. STWD will roll the loans to a new trust at a lower rate with more loans**. They will not have the same gains on sale with new loans, but the lower financing will push up the rate of return. Also, in a trust with some more seasoned loans with even lower LTVs – STWD may hold more of the junior tranche.

- **STWD continues to be well-positioned for rising or falling interest rates**. Of the $9.8 billion in the loan book, $7.1 billion have 145bp Libor floors. That is also helping earnings and they still get upside if rates increase. It should still be in a position to add 1-cent in quarterly EPS from a 100bp move up in rates and close to 3-cents on a 200bp move up. That book is not seeing many loan problems either. They had three interest deferrals in 2Q, all hotels, and all have been repaid. STWD continues to collect about 97%-98% of interest as scheduled. They have only 0.5% exposure to San Francisco and <4% exposure to NYC. They derisked the only NYC hotel loan by selling the mezzanine loan and buying part of the first mortgage.

- **Liquidity is good shape with $8.1 billion available and unencumbered assets of $2.9 billion. STWD has already raised the money to repay its February debt too.** Its property book continues to appreciate and it has boosted the return by refinancing the property multiple times at lower rates. The longer duration there also solidifies the core EPS as well.

Explanation of EQ Rating Scale

6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
1- "Strong Concerns"	Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

In addition to the numerical rating, the EQ Review Rating may also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into the next quarter. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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