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February 27, 2020 | www.btnresearch.com

Starwood Property Trust – 4Q19 Update
Maintain BUY

We are maintaining our BUY recommendation on STWD. The company's $0.47 in core EPS was a disappointment by 6-cents. The miss comes primarily from the company writing a retail JV investment from $72 million to zero which impacted core EPS by $0.24. Offsetting that was an $83 million gain on its Ireland property. However, there was a $23 million tax adjustment as part of the deal, reducing the gain to core earnings to $60 million or $0.20 per share. There remain several positives going forward:

- **The retail JV may be restructured and bring back some value that was written off in 4Q.** If nothing positive happens, that potential loss is fully recognized. There isn't other retail exposure beyond the soon to open America Dream Mall loan made at a 50% LTV.

- **Commercial and Residential Lending contributed $0.37 of the $0.47 in core EPS for 4Q. Commercial set a record for $2.2 billion in new lending but 60% didn't close until the final two weeks of 4Q.** That sets STWD up for a bigger impact on EPS for 1Q20. The Residential side doubled the loan portfolio y/y and it rose 10% from 3Q. That also should be a tailwind for EPS growth in 1Q and 2020. Residential is producing a double-digit yield.

- **Infrastructure that STWD acquired from GE was only 2-cents of core EPS for 4Q.** The company has been selling GE loans and letting other lower margin loans run-off in order to match durations for assets and funding. **In 4Q, this unit is now growing again and funded $424 million in loans – with 85% coming in the second half of 4Q.** New loans are coming in with IRRs > 13% and funding is in place to add to this unit. That should create another source of rising EPS in 1Q and going forward.

- **We have talked about STWD setting up its portfolio to profit from both rising and falling Libor rates. A 100bp decline adds about 9-cents and a 200bp decline would add 20-cents at this point.** STWD has 190bp floors on all 2019 originations in CRE and all domestic loans have floors with 32% in the money now. That should also help drive EPS in 2020.

- **STWD sees its property sector continuing to perform well. First, it refinanced its funding on the Medical Office property and first Florida multifamily portfolio. This boosted the cash yield for the property unit to 15%.** Also, the Florida assets can see rents rise based on income growth, but not decline. Finally, cap rates are declining with interest rates and as the cost of new construction is rising – meaning less new supply. The company sees the cash returns rising and accumulated property gains becoming a larger hidden asset for the stock.

- **One mixed item that will hit in 2020 is the adoption of ASU 2016-13 – CECL (Current Expected Credit Loss) model. Under this new accounting treatment, FASB requires firms to evaluate the potential loan losses over the life of the loan rather than booking impairments after a credit issue arises.** The idea is to smooth out potential losses over time and to employ some historical evidence to the model. As a result, STWD has subscribed to third-party databases to incorporate historical losses for Commercial Real Estate Loans and Infrastructure loans. The final outcome is expected to be:

    - **STWD's Loan-to-Value on loans is expected to decline below 60%.** It currently uses a more conservative standard in evaluating its loans and the 64% ration should drop noticeably.
    - STWD has not had a history of loan losses and the prior system worked off losses triggered by specific events. **Therefore, the company estimates that it will set up an allowance of $30-$40 million based on third-party historical data of losses.** That will be in addition to $0 currently reserved at the Infrastructure unit and $3.6 million of specific reserves.
    - **This charge will not impact core EPS. It will be charged against equity when it is established. After that, changes in the reserve allowance will flow through GAAP earnings.**

- **Europe may get more attention from STWD going forward.** Barry Sternlicht highlighted that the **banks are not involved; rents are rising in Germany,**

London, Spain; and the spreads are wider given the low borrowing rates there. Historically, STWD does not gamble - it matches durations on loans, doesn't want to be caught with FX losses, likes a large cushion on what it views as a worst-case scenario for LTV. So, if STWD starts to make more loans in Europe, we believe it will stick with past form and valuing safety and cash on cash returns along with strong credit analysis. This could become an area where returns may rise going forward also.

- **An interesting comment on the call highlighted that the big tech companies are driving both the stock and real estate markets in several cities. This could be a growing risk factor for real estate** – despite several strong tailwinds (low interest rates, low construction rates, high cost of replacement…) Here is the discussion from Barry Sternlicht:

  "There are markets and cities where you shouldn't invest. We have an interesting portfolio because we don't have a lot of exposure other WeWork in New York City (Lord & Taylor building), for example. And we are not particularly bullish on the New York City office market.

  We think expenses might rise faster than the rents and you need to be super careful there. Cap rates are obviously low, but they may change if people get the view that net rents are going to fall. ***And what's driving all these major markets is the same thing that's driving the stock market, five companies. They are expanding into Berlin, into New York, into Toronto and even Nashville.*** *Amazon or what they call you the fangs and you can add three or four other names, Salesforce, these are driving these commercial property markets.*

  And if they get in trouble in the stock market, they will get in trouble in the real estate market. The markets have never been more intertwined. And it's a very -- ***you don't care about banks expanding anymore. In your cities, you have banks. It's not about banks anymore, it's TMC. And same thing in London, like all the incremental space is being driven by what Google wants, what Amazon wants, what Facebook wants. What Netflix wants or Twitter wants and then a dozen other unicorns. So, for them, the cost of space is minuscule on their P&L military and they don't really care what they are paying, kind of like the hedge fund has evolved. And we would just be careful about the exposure of those markets because actually, the thing that will***

stop these companies is regulation. It's the hardest thing to underwrite, *right. If somebody [thinks] that Amazon is destroying the world and we know it and Congress decides to change things, they will change things. So, it's an interesting world. But there are asset classes, I mean the office markets in United States are fairly sound across the board, other than San Francisco or New York. I can't really think of something that I think is in Chicago, there are always more funds. But it's fine, it's stable. But other markets, rents are rising smartly ahead of expenses."*

Explanation of EQ Rating Scale

Rating	Description
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.

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