BEHIND
THE NUMBERS
Quality of Earnings Analysis

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Starwood Property Trust, Inc. (STWD)
Earnings Quality Update- 12/21 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are maintaining our earnings quality coverage of STWD at 5+ (Strong) and putting it back to our Top Buy list.

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

STWD's 4Q21 Distributable Earnings (non-GAAP) of $1.10 beat by a wide margin due to a transaction with its apartment portfolio. This amounted to $191 million or $0.67 per share. STWD sold a 20.6% interest in the property and realized a gain on that stake of $191 million. That is unlikely to recur unless it sells more of the property, which STWD does not plan to do.

We think investors should be aware of some accounting issues at STWD going forward that could lead to the company paying special dividends in addition to its current $0.48 quarterly dividend. There are enough moving parts here that special dividends may be lumpy and difficult to model, but we do believe it should be a positive for investors. Don't forget – STWD is a REIT and tax laws require it to distribute at least 90% of its taxable income to avoid paying income taxes. What is changing here:

- STWD has exhausted its loss carryovers that allowed it to offset some of its taxable income in recent quarters. That shielded the company from some of the 90% rule on

dividends. However, the large gain taken with the sale of the 20.6% Woodstar stake used up the last of the carryovers. Management said several times on the call that any future gains would likely create a special dividend payment to inventors.

- With the Woodstar portfolio now set up as an investment company security, STWD will carry the property at fair market value. Before this, STWD carried the property at cost and recognized rent collections as income with depreciation and interest expense shielding some of that income. In the 4Q, STWD recognized a $1.2 billion increase in book value for the property, with book value for STWD now $20.67. Going forward, changes in fair value will be marked and flow through the income statement and recognized as GAAP earnings.

- There are several reasons to expect the value of that property to rise. Rent levels are set by the federal government based on both the inflation rate and the median wage in the area. The rents cannot decline. They can stay flat or increase. The rent increases are set by using data three years in arrears - so the levels today are based on 2019 figures. STWD noted the property has about $90 million in rent and it is looking at several years of $10 million increases. That could result in the value of the property increasing and higher fair market value would flow through GAAP earnings.

- The remaining property – medical offices and master leases will still be accounted for under the old method. STWD will carry them at cost and recognize rent income less depreciation and interest expense. That should result in much lower GAAP earnings than what Woodstar may produce. However, STWD could have some potential gains on that property should it decide to sell some of it and without a carryover loss shield anymore, that could lead to a special dividend too. Occupancy is 94% on medical and 100% of leases.

- Keep in mind, STWD reports Distributable Earnings which are not GAAP. They approximate cash earnings and remove unrealized gains/losses, stock compensation, and depreciation. Distributable Earnings are often higher than GAAP earnings, and investors need to remember that its GAAP earnings that are used for the 90% dividend rule for a REIT. In 4Q21, GAAP EPS was 31 cents and non-GAAP was $1.10 with 67 cents coming from the Woodstar gain. For the year, GAAP EPS was $1.52 vs non-GAAP of $2.63 Currently STWD pays 48 cents as its normal quarterly dividend, so it is already paying out over 100% of GAAP earnings. The new Woodstar accounting of marking the investment to fair value could become a large source of GAAP earnings that will be non-cash. If the rent is rising from $90 million to $100 million to $110 million – that could add

$150-$200 million to the value of the investment each year and STWD owns 79.4% of that. That would add about 40-50 cents to GAAP EPS and could quickly push GAAP earnings over $2.00. At $2.13 in GAAP EPS, the current divided is 90% of that total at $1.92 so this is why there may be more reasons to expect dividends at STWD to increase.

- There are other reasons to expect higher GAAP earnings beyond Woodstar. STWD still deals almost exclusively in variable-rate assets and with some interest rate increases, that should boost earnings too. Much of its financing is fixed and even more is off-balance sheet. During Covid, STWD was carrying excess cash that it is now deploying. There is likely about 8-12 cents of GAAP EPS just from that. The special servicing business is also aging so deals are being completed and turning more of those assets into income generators and STWD gets paid on completion. Some deals are still on nonaccrual from Covid and those should eventually bring in higher cash flows. STWD also said it is seeing lower prepayments which should reduce lost income between the time cash comes back early and when it is redeployed. It's difficult to fully quantify all of these buckets, and as always there will be some lumpiness to them. Without any income shields left, it looks to us that almost anything STWD does going forward may lead to special dividends.

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 Concern)- 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 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 upcoming quarters. 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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