BEHIND
THE NUMBERS
Quality of Earnings Analysis

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Starwood Property Trust (STWD) Earnings Quality Review

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

We are initiating earnings quality coverage of STWD with a 5+ (Strong) rating.

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

We discontinue our BUY rating on STWD and initiate earnings quality coverage with a 5+ (Strong) rating. We are moving all our buy/sell ratings to earnings quality coverage and will use our quarterly Focus List to communicate top long ideas and sell recommendations.

Summary

STWD beat forecasts for 4Q20 by 2-cents with Distributable EPS of 50-cents. EPS was hurt by the company carrying excess cash of about $500 million. Every $100 million is worth about 3-cents in annualized EPS so $400 million is worth about 3-cent per quarter. STWD also announced a large Investor Day in March so we will focus this update on Earnings Quality issues. We believe STWD will discuss several areas of their normal continuation of blocking and tackling designed to realize higher asset valuations, boost ROIs, and limit risk including:

- Unlocking value in owned real estate where values have appreciated, but depreciation has lowered book value.

- Taking advantage of markets operating outside norms to sell weaker assets into a strong residential housing market or acquire strong assets in weak European, hotel, or office markets.

- Using its strong credit rating to refinance deals to lower cost of funds and boost ROI.

- Having its special servicing department find and lead the way on restructuring troubled loans in the market, earning fees, and perhaps buying or repackaging the assets.

What is strong?

- Unlike many mortgage REITs, STWD actually owns property. This does two things for it. It extends the duration of the portfolio because it cannot be called away or refinanced away like a loan. Plus, the depreciation rather than being a tax shield is a non-cash expense that reduces GAAP earnings. A REIT is required to pay out most of its income as dividends. With the income reduced, it would allow STWD to retain more of its internally generated capital to invest with.

- Commercial mortgage loans are primarily floating rate and at STWD it is 95%. With interest rates having been low, STWD has added LIBOR floors to a high percentage of its loans. Those loans are now on average about 150bp in the money. This protects income with low interest rates and if they fall, it still allows STWD to benefit from the upside to earnings if rates increase.

- Adjusted EPS vs GAAP EPS remains high-quality earnings. It approximates cash flow better and primarily adds back non-cash marks to the portfolio of unrealized gains and losses. Our biggest issues would be that the company adds back the management incentive fees, which do occur regularly and while depreciation on property is clearly a non-cash item, there probably should be a reduction from some maintenance capital spending. These two items were about 11-cents and 3-cents of adjusted EPS in 2020 of $1.98. Both should be completely offset post-COVID as STWD reduces its idle cash that cost it about 15-cents in EPS.

What to watch

- The biggest issue with STWD for investors is there is a considerable amount of “noise” in the structure. We say that because on the surface, investors see many things such as Variable Interest Entities, a changing share-count based on contingent events, and the long list of adjustments to GAAP earnings.

- A small amount of convertible debt and convertible equity issued in deal create tables that see GAAP earnings adding back the interest expense and a higher share count one year and then keeping the interest expense and a lower share count the next depending on thresholds in the price of STWD stock. For all this noise and investors seeing the effective share count change at times, the net impact of accounting for full conversion or not is actually immaterial to reported EPS. Running the figures under both scenarios does not change the EPS.

- The variable interest entities are primarily securitizations and CLOs which give STWD more diversification for funding and can recycle capital to generate more earnings. The fear is always that STWD will need to support these deals in the event of a crisis. We've now had a crisis in 2020 and a nuclear situation did not happen. The company cannot pool the cash flow from those structures into other deals – it must remain to support those trusts. But the amount STWD can lose is limited to its subordinated interests. In the case of deals where it is not the primary beneficiary, it is less than 1% of book value. In deals where it is the primary beneficiary and consolidates the VIE, the equity portion of those trusts provides a sizeable cushion of often more than 30%.

Supporting Detail

STWD Reports GAAP and Distributable Earnings

As STWD has several portfolios of property, mortgages, and other investment securities – its GAAP earnings have a number of mark-to-market items reflecting unrealized gains and losses in valuations. Those are among the largest parts of the adjusted EPS along with non-cash equity compensation and incentive fees due to the manager. Here are the differences between GAAP and Distributable Earnings:

	2020	2019	2018
GAAP Income	$331.7	$509.7	$385.8
Depreciation/Amortization	$92.8	$113.2	$132.4
Reversed GAAP unrealized G/L	-$59.3	-$66.3	-$108.6
Reversed recognized G/L	$77.0	-$121.5	$50.8
Credit Loss Provision	$42.1	$7.1	$34.8
Noncontroll Int. in Woodstar	$20.4	$21.6	$17.6
Equity Compensation	$31.2	$36.2	$22.9
Mgt Incentive Pay	$30.8	$20.2	$41.4
Interest Income Adjustment	$14.2	$15.3	$16.0
Miscellaneous	$4.3	-$6.6	$14.9
Distributable Earnings	$585.3	$528.9	$608.0

- Distributable EPS was $1.98 in 2020 and the number of shares was 295.94 million. This compares to GAAP EPS of $1.16 with shares of 282.48 million.

- Depreciation is on real estate investments. We do not have a problem adding back this non-cash expense. Most of this is for the property segment. Adding it back makes earnings more focused on cash figures. To make this even more conservative, we would like to see the maintenance capital spending figure removed. Comparing net PP&E for the last two years and depreciation, we estimate that STWD contributed $16 million in new investment toward the properties. Some of that would be improvements more than maintenance in our view. Perhaps maintenance is $8-$12 million. Thus, depreciation is about 31-cents of D/EPS and maintenance may cost it 3-4 cents.

- Adding back marks to Fair Market Value and recognized gains/losses takes estimates and lumpy results out of the distributable EPS. We do not have an issue pulling these out of distributable earnings which are compared to the dividend payment.

- Bad debt expense is something STWD has been very good at avoiding. Over time, it has been practically non-existent. The new CECL rules have increased bad debt reserved based on required third-party models. STWD found that its own internal work was tougher than CECL on estimates and valuations. That is not to say that STWD does not book bad debt expense. It simply adjusts CECL back to its own standards. We do not have a problem with STWD adding back the CECL accrual. Per the 10K:

  "During the year ended December 31, 2020, we recorded a $42.1 million increase in the current expected credit loss, or CECL, reserve, which has been excluded from Distributable Earnings consistent with other unrealized gains (losses) pursuant to our existing policy for reporting Distributable Earnings. ***We expect to only recognize such potential credit losses in Distributable Earnings if and when such amounts are deemed nonrecoverable upon a realization event. This is generally at the time a loan is repaid, or in the case of foreclosure, when the underlying asset is sold, but***

non-recoverability may also be determined if, in our determination, it is nearly certain that all amounts due will not be collected. *The realized loss amount reflected in Distributable Earnings will equal the difference between the cash received, or expected to be received, and the book value of the asset, and is reflective of our economic experience as it relates to the ultimate realization of the loan."*

- We will discuss the non-controlling interests of Woodstar – which are two apartment communities in Florida – below. A quick summary is GAAP removes the non-controlling interest and Distributable earnings adds it back. However, the latter also assumes a greater number of shares as a result.

- Stock compensation and management incentive pay- In both cases these are lumpy. However, in both cases they are recurring. We are firm believers that recurring costs such as these should not be added back. We don't mind if a company quantifies them, they just shouldn't be operating on the assumption that these are discretionary and could be canceled at any time. In 2020, these were 11-cents and 10-cents of distributable EPS respectively.

- Interest income adjustments can arise from loans receiving interest expense deferrals for a few months, amortization of premiums/discounts, a non-accrual loan is moving back to current, and as a servicer of securitizations – STWD can be called on to forward payments of underlying securities for a few days. This appears to be the difference between contracted cash flows to be received and what actually is received at period end. It's a short term adjustment often measured in days. We do not see an issue here.

Our conclusions are that the Core or Distributable EPS of $1.98 essentially may be 3-4 cents inflated by not factoring in some maintenance capital spending on property investments. Another 10-cents are incentive fees paid to management and 11-cents are paid in stock. STWD is paying $1.92 in dividends.

On the positive side, the company is sitting on excessive liquidity due to COVID. That is a drag on Distributable EPS too. STWD is likely carrying about $500 million too much cash and based on current rates of return – every $100 million is worth about 3-cents. So, they are light by about 15-cents in the 2020 numbers. That alone covers the maintenance and incentive fees. Then, STWD simply has considerable other liquidity. 1-cent in EPS is $3 million. STWD has $7 billion in liquidity. On top of that, it has $3 billion in unencumbered assets. Plus, another $4-$6 billion of investments recycle on average every year. So there is considerable cash flow to support a few cents of dividend and the Distributable EPS appears understated by 15-cents already.

Changing Share Counts are Due to Convertible Bonds

STWD has a $250 million convertible bond that matures in April 2023. The conversion price is $25.91. The company no longer asserts that these will be settled with cash. That means that when the stock price is less than 110% of the conversion price, STWD's EPS reflects the interest expense on these bonds of $10.94 million but not the 9.65 million shares the bonds could eventually convert into. If the stock price is above 110% of the conversion price, then STWD's EPS removes the interest expense but uses the higher share count.

In 2020, the stock price was below $25.91 and these bonds were not dilutive. If we assume they were dilutive, here is the impact on EPS:

	no dilution	**adj.**	**with dilution**
2020 Diluted Income	$326.5	$10.9 Int Exp	$337.4
Fully diluted share count	282.5	9.6	292.1
EPS	$1.16		$1.15

The net impact on EPS is essentially nothing – the actual difference is less than 0.1 cents, rounding makes it look like a penny.

A Convertible Share Issued with a Property Purchase Also Has Minimal Impact on EPS

Woodstar assets the multi-family apartment villages that STWD bought in Florida. A portion of the purchase price was paid for Class-A shares and there was a contingent issuance of additional shares if milestones were reached and they were. The Class-A shares are convertible into STWD shares.

For the accounting of Distributable EPS – it is the same as the convertible bonds. STWD adds back the income from Woodstar represented by the non-controlling interest which inflates Distributable Income. It then divides Income by a higher number of shares to reflect the potential dilution of the Class-A shares. There is also some minor dilution from unvested stock awards:

GAAP shares	282.4
unvested stock	2.8
Woodstar Class A	10.7
Distributable Shares	295.9

The difference between EPS without the Woodstar non-controlling interests and a smaller share count, versus adding back the non-controlling interests and a larger share count is less than 1-cent in annual EPS.

As redemptions have occurred, STWD has been settling Class-A shares with a combination of common shares and cash. The net result at this point is the number of Class-A shares should decline going forward – all the contingent payments in additional Class-A shares have been paid. Also, as these Class-A shares are redeemed in cash or common shares, the Woodstar adjustment between GAAP and Distributable earnings should become smaller too.

The Variable Interest Entities Are Simpler and More Vanilla than They Appear

STWD uses securitizations or CLOs to remove loans from its balance sheet. These occur primarily with its commercial mortgage loans and residential mortgage loans. There are three primary goals:

1. They can often sell these assets for more than cost as part of a trust portfolio. So it is a source of income in the form of gains.
2. It recycles capital so that STWD can repeat the process or invest in new areas – again with the goal of generating additional income.
3. It diversifies its funding sources and moves a portion off the balance sheet and it also limits risk.

There are VIEs where STWD is considered the primary beneficiary. In those cases, STWD manages the trust and can participate in losses or gains based on its equity interest. These assets and liabilities can be consolidated onto the balance sheets of STWD because of the control aspects. It is important to realize that STWD has no obligation to support any of these deals and its downside is limited to the amount of its actual equity position. The debt is not recourse to STWD.

In the cases where STWD is the primary beneficiary – there is considerable equity as well:

VIE Primary Ben.	Asset	Liability	Equity
CLO	$1,105	$931	$174
Woodstar	$673	$444	$229
CMBS JV	$330	$85	$245
Miscellaneous	$100	$54	$46

On VIEs where STWD is not the primary beneficiary, losses are again limited to the carrying value in the deals. One set has a value of $19.5 million for STWD and the other $25.1 million. We should add that often STWD is a value player and it buys loans at a discount to its view of fair value. It then sells those loans at a premium into a securitization facility. That builds cushion as well. The two values at risk need to be compared to book value of $4.9 billion. The two figures given for maximum loss are under 1% of book value.

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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