BEHIND THE NUMBERS
Quality of Earnings Analysis

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Starwood Property Trust (STWD) Earnings Quality Update
March Investor Day

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

We are maintaining 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.

Summary

After the 4Q20 earnings, STWD announced that it would soon have a virtual call and presentation describing its business in more detail. That happened in March and delved into the company's rationale behind getting into some of its diverse portfolio of businesses, how they view risk, and operate each as well as in tandem with other units. Some of this has been discussed in our other updates. This includes having floating-rate loans with floors so that the impact of falling rates is limited, but STWD still enjoys higher earnings as rates increase. Also, the company owns property directly, which effectively adds duration to the portfolio at the same time it enjoys rising rental income. But there was some additional information discussed that we believe illustrates the lower risks at STWD than other mortgage REITs and makes us continue believing that this company should do well and reward shareholders over various credit and interest rate cycles.

What is strong?

- **Lending standards on commercial mortgages have improved considerably since 2009, which are what go into securitizations.**

- Prior to the GFC, a typical securitization had 70% Loan to Value mortgages, it included industries like senior living, casinos, and subordinated loans, the minimum debt service was 1.05-1.35x. Also, rents were assumed to rise over time and vacancies assumed to be filled as well.

- Since 2009, a securitization is only 60% Loan to Value and does not include troubled asset classes. **Only in-place rents are looked at and those are marked down to market in the event of a sublease. Tenant credit is considered as well** as the timing of lease renewal. Minimum debt service is 1.35-1.87x.

- Prior to the GFC, securitizations had little if any cash reserves and lower average debt coupons.

- Since 2009, securitizations have cash reserves and a guarantee from the sponsor.

- STWD goes a couple of steps further on its securitizations by hedging the interest rate risk and locking in the credit spread as well as stress testing each loan to determine what helps or hurts the situation.

- As the securitizer, STWD is required to own a B-piece of 5% of the pool for a minimum of 5-years. The securitization allows STWD to recycle its capital to make more loans and it views the investment in the B-piece as an attractive deal. As the builder of the portfolio, STWD can kick out loans from the pool, split loans between pools, require credit enhancement on specific loans all in the name of producing lower risk.

- **Starwood's close watch of each of these loans and their subsequent performance plays to its business of special servicing too – LNR.** Special servicing is a counter-cyclical business that deals with loans and securitizations that run into problems. Often, STWD is willing to opportunistically buy B-pieces of other securitizations which will also lock in LNR as the special servicer.

  - Each loan in the portfolio can be reassessed and weak performing loans underwritten again on better terms where needed.

  - LNR typically invests in workouts and almost always negotiates a higher equity commitment from the borrower.

- It can also get paid by completing a workout or liquidating the property – a lagging payment compared to trust fees or borrower fees.

- Another unit at STWD also invests in deals provided by the Special Servicer for turnaround plays in real estate. Having LNR see many situations, allows STWD to be selective and knowledgeable about what may be coming.

- These types of situations may add some long-term growth potential and future gains for STWD after Covid.

- **Liquidity remains very strong at STWD and it does not have nearly the same risks of traditional mortgage REITs that rely heavily on warehouse lending to finance their investments.** There are two downsides to warehouse lending: the duration doesn't necessarily match and the loans can often be called if the collateral is marked down. STWD counters this with a more diverse source of debt with longer terms.

  - Normally, STWD holds $250 million in cash on hand. This is a drag on earnings but helps liquidity. Cash was over $700 million at the end of 4Q, so putting that back to work is worth about 3-cents in EPS per quarter.

  - Half its total capital is off-balance sheet financing and equity.

  - 45% of debt is either unsecured or off-balance sheet.

  - 62% of debt has no margin calls and 75% has no margin calls or only calls based on credit issues.

  - The life of liabilities of secured liabilities is 50 months vs. 41 months for the mortgage assets tied to them. That reduces refinancing risk as the mortgage rolls over. This also highlights STWD's use of A-Notes as financing over warehouse lines. For a typical commercial mortgage, it is 75% borrowed with 25% equity. STWD splits the 75% loan into an A-tranche of 56% and a B-tranche of 19%. It will then borrow against the A-tranche with A-Notes.

  - STWD has $7 billion in liquidity now plus $3 billion in unencumbered assets. The goal going forward is to continue to boost unencumbered assets with more issuances of unsecured debt and securitizations to move debt off the balance sheet.

- We believe all of this activity continues to point to STWD's dividend being safe.

What to watch

- The securitizations allow STWD to recycle capital and generate/buy more commercial mortgages and non-qualified residential loans. This also effectively removes the loans and borrowing off the balance sheet and it can avoid mark-to-market issues on those portfolios. However, STWD has to consolidate the securitizations with GAAP, which effectively makes the debt and asset totals look higher with the VIEs included.
  - The CMBS – by owning the B-share STWD has to consolidate the deal.
  - The non-QM residential – by having kick-out rights on loans in the securitization, STWD has to consolidate.
  - STWD's on-balance sheet leverage is 2.18x Debt/Equity. Adding in the securitizations, it rises to 3.49x. However, the securitizations are non-recourse to STWD.
  - The consolidation is required by GAAP, but the real leverage is lower. Also, by using securitization and its own underwriting and monitoring prowess – STWD can effectively control more loans and diversify away from risk even more.
  - Also, holding a portion of the B-share tier can provide STWD with a double-digit return and with its servicing business involved, it can react quickly to preserve the credit for the full securitization.

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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