BEHIND THE NUMBERS
Quality of Earnings Analysis

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Starwood Property Trust (STWD)

Update after 3/22 Quarter Results and 10-Q Review

We are maintaining our earnings quality rating of STWD at 5+ (Strong).

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

Summary

STWD's 1Q22 non-GAAP EPS of 76 cents beat estimates by 25 cents. The key parts of this beat are:

- CECL bad debt reserves declined by $3.6 million adding 1.2 cents
- It realized a gain of $84.7 million on the sale of a previously-acquired property through foreclosure which added 26.7 cents.

As we noted after 4Q21, STWD does not have much in the way of loss shields left to avoid paying special dividends on GAAP earnings. In 1Q, STWD's GAAP earnings were $1.02 which recognized the 27-cent gain on the sale of the foreclosed property and:

- $173.3 million from marking the apartment property to Fair Market Value or 55 cents.
- It lost much of its depreciation shield on GAAP earnings on this deal and recognizes investment income on the investment. Depreciation was down $9.8 million and replaced by higher investment income.

When asked about payments of special dividends, STWD noted that will be determined at the end of 2022 and if necessary would likely be paid quarterly in 2023. Per the CFO Rina Paniry:

> *"So, the special dividend related -- as it relates to the Orlando gain, which was really the outsized performance for the quarter, we look to a full year because the dividend is based on full year taxable income and we look to pay that out over four quarters. And so, we wouldn't be making a determination today as to a special dividend related to that gain. We will see how the year plays out and ultimately*

make that determination as we approach the end of the year to see whether or not we've covered. So, it's not a decision that we would make today."

Higher Interest Rates Help Income

STWD notes that a 200bp increase in LIBOR adds about 11 cents to annual EPS (both GAAP and non-GAAP). This is due to:

- The loan book is 98% floating rate and is up 33% y/y
- STWD has LIBOR floors with a weighted average of 57bp, which is down from 77bp in 4Q.
- LIBOR is now breaking past many of those floors (some are still over 200bp) so more of the portfolio will capture rising interest rates at this point.

STWD Has Line Of Sight to Higher Income and Higher FMV Marks on Woodstar Property

- The property is seeing rent increases of over 9% based on incomes in the area and inflation figures looking backwards. Much of the recent inflation is NOT in the increases the government agencies are authorizing now.
- Of the $218 million gross increase (remember STWD owns a net 79.4% which is how that became $173 million above) – the bulk of the FMV gain is coming from rising income on the properties via higher rental rates. That was $137 million of the mark.
- The debt on the property has a blended rate below the market rate so that also added to the higher valuation by $65 million.
- And there is a 100bp LIBOR cap on the floating rate portion of the debt, the value of that cap rose another $16 million.
- This FMV mark could likely be even higher – except STWD is not reducing its cap rate in doing the valuation. It sees the cap rate it is using as about 25%-30% higher than the market.

- It marks to FMV quarterly, so with rent increases, this should continue to produce GAAP income from a higher mark.

The key thing to remember about the apartments is once rent is raised it cannot fall again as that is the deal with the housing authorities. Also, these are still cheaper rents than other properties without housing authorities involved, so they stay full.

STWD's Balance Sheet Is Built to withstand Volatility

We recommend readers look at our note from April 9, 2021 on how STWD focuses as much on its financing as it does its assets. A few highlights are worth noting here given the current environment:

- STWD does not rely on warehouse lending – so its cost of funds does not rise rapidly with interest rates even though many of its assets benefit from that. Conversely, it uses interest caps, floors, and other derivatives to hedge falling rates.

- STWD matches durations – there are not investments on 4-year loans that stretch out to 8 years when rates rise being financed by 30-day money.

- One of the biggest keys is how much of the financing and assets are off-balance sheet with securitizations and CLOs. This means STWD has little margin call risk and much less mark-to-market risk for assets in a downturn. It has only 2.1x equity in debt on the balance sheet, with another 1.6x off-balance sheet and is basically non-recourse.

- Using fixed corporate debt also leaves STWD with $3.8 billion in unencumbered assets it could borrow against if needed.

- The risk of negative marks is also mitigated by writing loans in the low 60s for loan-to-value.

In 1Q22, STWD saw interest rate spreads widen on some deals but also saw the safety-first practices on the financing side offset much of that. Losses on mortgage loans matched almost perfectly with gains on derivatives and hedges in place. There is not a history here of short-term thinking in this area. There are times, STWD will note it has a larger unrealized gain on a LIBOR floor or cap and it's not recognized in book value. But, they don't sell it if it is still providing the protection it was set up to cover.

STWD Writes/Buys Loans with a View of Being Willing to Own the Property

STWD likes to point out that all the defaulted property they have taken over has resulted in gains. This quarter, that was highlighted by the Orlando distribution center it acquired through a default and resold for an $85 million gain. This process has happened a few times in STWD's history and its history has been a cumulative positive income figure from work-out situations. This led STWD to joke that its $51 million CECL loss reserve required by GAAP should actually be $0 and boost book value more. (They are not doing that)

We think this mindset is driven by many years of focus:

- Buying/writing loans with a low loan-to-value in the beginning. The normal blocking and tackling STWD does is to acquire a portfolio of loans and go them all individually and sell off ones that don't meet their credit standards.

- They own one of the largest special servicers in the industry – which is hired to work out troubled loans and either refinance, restructure or foreclose and resell the property – so they have the infrastructure and experience to deal in this area.

- Having a balance sheet that allows them to wait out market events rather than have fire sales on troubled properties.

There are many conference calls that are primarily reading the news – "our sales were X our income was Y and we think our customers will continue to eat." We always recommend STWD calls very much just for the commentary and rationale behind some deals, where they are seeing risks/opportunities where the competition cannot play. They are much better than college.

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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