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BTN Research

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Starwood Property Trust (STWD) Update
Maintain BUY

We are maintaining our BUY recommendation on STWD. Given some of the moves in the bond market, we thought clients may want to remember a few key points about STWD:

1. Interest rate movements will not hurt the company. In general, STWD benefits from rising LIBOR because the bulk of its investment portfolio is tied to LIBOR. We have noted many times that STWD picks up about 6-7 cents in EPS from every 100bp increase in LIBOR.

   It is also worth noting that if interest rates are cut, STWD has many investments with LIBOR floors. Thus, if rates decline noticeably, the company's EPS will rise that way also. The sensitivity analysis STWD has done shows it gains 8-cents in EPS from a 200bp decline in LIBOR.

2. The company's LTV (Loan to Value) ratio of 64%-66% depending on the sector is really a collection of 64%-66% LTVs. It is not a barbell approach where some 90% and 95% loans are averaged down with a pool of 50% loans. In the event of stress, a barbell would likely see more problems in the 90%-95% LTV area. Conversely, very little of STWD's book will have issues with underwater investments.

   In 4Q18, the company stress tested its full portfolio for a 20% drop in real estate values across the board and spreads on loans widening by 250bp both within a single day. They looked for impacts on liquidity, book value, and debt/bank lines. STWD found it could not only endure that type of an event – it would still have liquidity to take advantage of bargains caused by other players being in trouble and could be a buyer.

3. In times when the market is looking at falling interest rates instead of rising rates, being in the ETF funds with residential mortgage REITs may be beneficial. When

we first wrote about STWD, we noted that it is being misclassified and grouped into ETFs where the bulk of other players deal solely with buying residential agency fixed-rate mortgage bonds financed at 5:1 – 9:1 leverage with a large difference in funding maturities vs. those of assets. STWD instead has floating rate loans and funding and focuses much more on commercial property. It can own property directly and has diversified in several areas. It also carries considerably less leverage.

When investors believe interest rates are unlikely to rise and may in fact decline, the traditional mortgage REITs like Annaly Capital (NLY) and AGNC Investment (AGNC) which make up 20%-27% of the two largest ETFs for the group look more attractive. STWD at 6%-8% of those ETFs could benefit from more investors eyeing the ETF portfolios yielding over 8%.

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