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Starwood Property Trust (STWD)- 2Q'20 Update
Maintain BUY

We maintain our Buy recommendation after 2Q results that beat forecasts by 2-cents with core EPS of $0.43. Core adds back gains/losses and non-cash items like depreciation and allowances. We again came away with the belief that STWD focuses heavily on safety and liquidity to be able to not only survive turmoil, but to take advantage of it. We believe STWD will maintain the dividend as the company is a REIT, profitable on both a GAAP and Core basis, the dividend at $0.48 or $135 million per quarter is sustainable given current liquidity and reducing it by 5-10 cents would not result in meaningful cash preservation. Also, one of the major negatives of having so much liquidity and reduced leverage is their balance sheet was a drag on EPS. Barry Sternlicht noted this prominently on the call too:

> *"So it's a choppy road, and we have to be careful. We're here for the long haul. We're not here to have a one quarter. I didn't mention, I should have mentioned that I had in my notes, but you're sitting on $800 million of cash you $600 million of excess cash is at 10% yield, which we've obviously done better in all our business lines and that is $60 million. It's $0.20 a share in earnings. So, you can add $0.20 to our earnings for a normal period for us once we put the capital to work. But we can't do that. However, we can cover the dividend because we have all these gains in our books."*

The fortress balance sheet would appear to have STWD in a good position to see earnings rise going forward and we are going to point to a number of areas where STWD's future is being put in place:

- **One reason they are hoarding so much cash is they have a $500 million maturity of senior notes in November and they will leave the FHLB membership in February where they owe $342 million.** STWD plans to refinance the notes with another bond, however, they are holding the cash on hand in case the market tanks again and

closes to reasonable financing deals before they refinance the notes. They already retired two-thirds of the FHLB borrowings and have $1 billion in new bank lines closing in the coming weeks that should be available to cover both debt issues.

- **On balance sheet debt was reduced to only 2.0 times equity in 2Q**. They have unencumbered assets of 1.5x debt as well. The decision was made in the quarter to not only bolster liquidity but also move more debt off-balance sheet largely with securitizations. Total debt with the securitizations and A-notes is 3.2x equity. The goal is to finance about half the business off the balance sheet so there remains meaningful ability to make deals. STWD has $9.5 billion in borrowing capacity available, over $800 million in cash, and still has $2.9 billion in assets it could put liens against if needed. As we have discussed many times, STWD has interest rate floors of 157bp on $6.2 billion of its floating rate loans – those are in the money and help EPS as rates decline. They could sell some of those floors for cash too. The key for them is they have options to take advantage of mispriced opportunities and many competitors do not.

- **STWD also discussed that is rebuilding its pipeline for more deals. STWD noted that the list of deals they are looking at is about as long as pre-COVID times. Normally there is a fair amount of cash being returned in every quarter via principal payments and borrowers refinancing or selling their property and repaying the loan to STWD. They may be going too far on conservatism by forecasting that less than 4% of their loans will be repaid in 2H20** and that very low rate will last in 2021. That is the other reason they are making sure they have the ability to fund new deals without relying on repayments. The goal was also to reduce future funding obligations on existing deals. With the securitizations, they cut the future funding needs to 35% of 1Q's ending figure. President, Jeff DiModica addressed this too, *"For liquidity planning purposes, we conservatively extended management's expected loan repayment dates, and are now modeling that less than 4% of our loan book repaid in the second half of 2020, as well as significantly less in 2021 than we previously forecasted. Given less loans could pay off in the coming 18 months, we actively reduced our future funding requirements in the quarter to be sure we can easily cover those fundings in cash if no loans are repaid, which is a very draconian assumption that I'm sure we will be wrong on."*

- **Looking for evidence that most of these markets have seen recovery, STWD noted that 98% of interest was collected last month. Some of the remaining 2% was**

temporarily delayed due to COVID-related modifications that were being completed. They have seen a few modifications that were very short-term in nature and came with more equity being infused by the sponsors of the deal. On the worst-performing sector – hotels – they have seen $150 million in new equity put into those deals with another $150 million coming in 2020. Also, 20% of its hotel loans are to extended-stay hotels that have had 80% occupancy during COVID. STWD noted that no assets had to be added to non-accruals or justified a specific bad debt reserve. The new CECL accounting rules that use a modeling forecast based on macro factors did add $11 million to total reserves. One of the great stories of 2Q was STWD bought several deals of non-qualified residential mortgages with low LTV and high FICO scores at significant discounts. During 2Q, it securitized a large number of them at par and the mark-to-market hit in that unit in 1Q was essentially reversed back in 2Q. It had two Winn Dixie warehouse properties it had reserves against and leased both to Amazon and Dollar General and they are now valued at a gain to STWD's cost.

- **Areas where future earnings may arrive that were immaterial in 2Q include the balance sheet inefficiency described in the introduction. It also includes the Special Servicing unit** that sees business pick up in distressed times and it gained $2.8 billion in new business in the quarter with $8 billion actively being worked on. They get paid when deals are resolved and STWD believes many of these will take a longer time – so there should eventually be EPS coming from this area. The Energy Infrastructure portfolio is also not operating as efficiently as it could as STWD kept a large staff there and has not made new loans. The ultimate goal is to do a CLO with some of these loans and that will require adding some more deals. They do not want commodity exposure so we doubt they will finance drillers, but midstream and power plants are possible. STWD could see this area drive some EPS growth at some point.

- **While not part of Core Earnings – Mark to Market hits of 53-cents in 1Q become 15-cents in income in 2Q. Also, CECL triggered a 17-cent high in 1Q and another 15-cents in 2Q.** Given that the bulk of the loan book is first mortgages with an LTV of under 61% we see few reasons to expect many losses in the book CECL headwinds may mitigate. STWD also lost 1-cent from core EPS when it refinanced its multi-family property and had a charge for extinguishment of debt.

- **There continue to be many examples of assets on STWD's books that are carried below fair market value.** In the 2Q, STWD refinanced some of its multifamily properties again, they pulled another $100 million out and cut their cash investment from $169 million to $30 million. They bought these at a 6.16% cap rate and occupancy has stayed very high and rents have risen at more than 2x the expected rate at acquisition. The refinancing included an appraisal of the property at a 4.64% cap rate. So, this is throwing off considerable cash flow on a small cash investment that has appreciated. STWD also pointed to huge gun sales helping its Cabela's investment. They sold a North Carolina office property for a gain in 2Q and a $10 million gain selling a minority stake in a real estate advisory firm that was part of a 2016 transaction. Finally, in discussing real estate's valuation Barry Sternlicht made some strong points. One was - in a world starved for yield, people are buying Amazon bonds to earn 30bp – while STWD is first-tier AMZN creditor too getting paid 500bp.

  Book value is $15.79 and the stock trades below that now with a 13% yield. Simply adding back the depreciation on the property that has appreciated in value makes book value $17.03. Management estimates there is another $2.67 per share of unrealized gains at STWD which makes book value $19.70.

Explanation of EQ Rating Scale

Rating	Description
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 Concerns"	Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

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