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Starwood Property Trust – 2Q19 Update
Maintain BUY

We are maintaining our BUY recommendation on STWD and this was another solid quarter. If anything, the level of safety is improving here on a number of fronts. We will highlight some of those in a brief update:

- STWD is one of the few investments that sees rising EPS if LIBOR rises or declines. The company has 94% of its loan investments as floating rate tied to LIBOR. However, on the downside, there are also interest rate floors. STWD did a stress test in December when the volatility was wild and found that it could survive marking all investments down based on an instant 20% drop in property values and a 250bp wider spread on all loan valuations. It would not need to raise capital and would have plenty of liquidity to take advantage of the bargains in that situation

- STWD has improved its situation further. LIBOR moving up or down makes it more money now as a result of diversifying away from bank warehouse lines for funding along with the floors on loans. Here is what the change in LIBOR meant in 4Q18 and after 2Q19:

STWD EPS	Libor -200bp	Libor -100bp	Libor +100bp	Libor +200bp
4Q18	-$0.01	-$0.04	$0.07	$0.15
2Q19	$0.12	$0.03	$0.05	$0.11

In our view, this is a nice situation to have amid some of the recent volatility in the market on a stock paying over 8% cash dividend yield.

- The company has actively diversified its funding sources away from heavy reliance on bank warehouse lines that can be off-balance sheet. This includes a CLO financing that was priced very attractively and boosted returns over bank lending without the risk of recourse or credit marks. A-Notes also remove some of those risks and as well as helping on term matching the investment to the borrowing. As Barry Sternlicht noted, banks have a nasty habit of calling short loans in tough times.

- STWD is diversifying more internationally. The book is 16% International now vs 8% in 2018. LTV remains low. We listened to a call from Brookfield Infrastructure Partners on Real Estate last week too and they highlighted several areas of real estate based on its historic valuation range and where it sits now – numerous areas of cheaper real estate were overseas from their analysis. Specifically, Brookfield cited many tech companies wanting a larger Asian physical presence but not in China or Hong Kong as something helping Asian real estate. Also, Europe e-commerce is a big laggard vs. the US at less than 8% of retail sales vs. more than 15% in the US. Yet, the real estate to serve e-commerce is about 1/3rd the supply per capita in Europe vs. the US.

- Both STWD and Brookfield cited slower economic growth helps real estate values by restricting new supply and allowing rents to rise, pushing down cap rates and boosting real estate values. STWD still believes the confluence of macro-events regarding interest rates and trade pose greater volatility risks and has thus taken down its risk profile as described above.

- It should also be noted that STWD continues to out-earn its dividend with core EPS of 52-cents and the dividend of 48-cents. Much of the dilution we talked about in prior updates due to convertible securities is now past. So, lower risk profile overall and greater safety on the dividend that exceeds 8%.

- Book value is penalized by $1.24 per share for depreciation. It also does not reflect an estimated $2.50 per share in unrealized gains on property investments where cash rents just rose another 6%. It was noted that as these are affordable housing units, when the rent increases, it represents the new floor for income on these properties. The company may refinance at a lower rate and further drive the return and pull out some cash to invest elsewhere and also help income. Book value is listed at $16.49, but realistically could be $20.23 given this background.

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 Concerns"	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 may 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 the next quarter. 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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