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STAR - Q4 2017 iStar Inc Earnings Call

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PRESENTATION

Operator

Good day, and welcome to iStar's Fourth Quarter and Full Year 2017 Earnings Conference Call. (Operator Instructions) As a reminder, today's conference is being recorded.

At this time, for opening remarks and introductions, I would like to turn the conference over to Jason Fooks, Vice President of Investor Relations and Marketing. Please go ahead, sir.

Jason Fooks - *iStar Inc. - VP of IR & Marketing*

Thank you, John, and good morning, everyone. Thank you for joining us today to review iStar's Fourth Quarter and Full Year 2017 Earnings Report.

With me today are Jay Sugarman, Chairman and Chief Executive Officer; and Geoff Jervis, our Chief Operating Officer and Chief Financial Officer.

This morning's call is being webcast on our website at istar.com in the Investor section. There'll be a replay of the call, beginning at 12:30 p.m. Eastern Time today. Dial-in for the replay is 1 (800) 475-6701, with the confirmation code of 444427.

Before I turn the call over to Jay, I'd like to remind everyone that statements in this earnings call, which are not historical facts, will be forward-looking. iStar's actual results may differ materially from these forward-looking statements, and the risk factors that could cause these differences are detailed in our SEC reports. iStar disclaims any intent or obligation to update these forward-looking statements except as expressly required by law.

Now I'd like to turn the call over to iStar's Chairman and CEO, Jay Sugarman. Jay?

Jay S. Sugarman - *iStar Inc. - Chairman & CEO*

Thanks, Jason. Overall, 2017 was an excellent year for iStar, with strong earnings and meaningful progress on the right side of the balance sheet. Capped off by a fourth quarter that included a sizable jump in new loan originations and a very profitable realization of a reposition West Coast net lease assets.

All told, adjusted income reached $0.40 per share in the quarter and $2.57 per share for the full year. Importantly, these numbers do not yet include some $76 million of unrecognized gains that will become part of the adjusted income measures in 2018.

Our goal now is to get these positive results reflected in our share price based on a 3-prong strategy: one, continue generating strong earnings; two, increase our annual investment phase; and three, execute near and long-term strategies for our legacy assets.

On the earnings front, our net leased and finance portfolios continue to perform well, but we still have substantial cash balances and a large number of assets that are not yet contributing to earnings or are, in fact, a drag on earnings. The good news is we entered the year with a range of operating and land assets that are ready to be monetized. So we should, again, be in a position to benefit from our diversified portfolio with consistent earnings from core businesses, supplemented with additional earnings generated from the extensive asset improvement work done over the past several years. We expect the combinations to create attractive earnings and substantial liquidity during 2018.

On the investment front, we made a very significant hire that should help accelerate the investment pace going forward, bringing on board Marcos Alvarado and his $25 billion in transaction experiences as our new CIO. We knew Marcos from deals we have done together when he was a Managing Director at Starwood Capital and believe he will immediately impact our ability to deploy capital across our core business lines and help spearhead our growth.

The third key step, we believe will help unlock shareholder value, will be executing a continued monetization strategy on our legacy assets in the near term and developing an optimal strategy for longer-term assets that are still midstream in their business plan or development process. This should help us achieve multiple goals, creating fuel for new investments, simplifying our story and helping streamline our organization, while still realizing significant values from these assets. J.P. Morgan is working with us to explore the full range of options for this part of the portfolio.

I should mention one other important piece of the puzzle; Safety, Income & Growth. As you know, we launched a new company last year to completely reinvent the ground lease industry and turn it into an attractive capital solution for high-end owners of commercial real estate. We are big believers in the potential of this idea, and we have continued to increase iStar's ownership since the IPO via open market purchases.

As we enter 2018, we're seeing increased traction in multiple property types and working with repeat customers who understand and appreciate the improved returns our transaction-friendly ground lease structures have delivered for them.

We've trademarked this new modern ground lease as the SAFE Ground Lease™, and we expect this business to continue to grow and expand as its benefits become more widely understood.

And with those highlights, let me turn it over to Geoff for further details. Geoff?

Geoffrey G. Jervis - *iStar Inc. - COO & CFO*

Thanks, Jay, and good morning, everyone. As Jay mentioned, 2017 was a very strong year for operating results at iStar.

We earned net income of $1.56 per share and adjusted income of $2.57 per share. These figures are well above our initial 2017 guidance and in line with our revised guidance. For the fourth quarter, we recorded a net loss of $0.07 per share and adjusted income of $0.40 per share.

When you compare 2017 to 2016, the results are even more impressive. In 2016, we earned $0.60 of net income and $1.15 per share of adjusted income. Year-over-year, adjusted income growth is more than 120%. Looking back further, we have a compound annual growth rate for adjusted income of over 100% in 2015 to 2017, having earned over $4 per share for our stockholders. Despite these impressive financial results, our stock price has underperformed. Rest assured that we're well aware of this dynamic and are working hard to address stock performance in 2018.

Our recent successes go beyond just our bottom line financial results. This year, we not only eliminated all near-term corporate maturities, but also materially extended the duration of our liabilities and reduced our total cost of debt. As a result of these successes, we achieved upgrades from all 3 rating agencies with both Fitch and S&P rating us BB-.

On the asset front, we took our ground lease business public, listing Safety, Income & Growth on the New York Stock Exchange and earned $180 million on gains, $123 million of which we were able to recognize in 2017 and an additional $55 million of which we will take in Q1 2018.

And more recently, Marcos Alvarado joined our team at Chief Investment Officer and has already had an impact on the origination team and our expectations for activity in 2018.

Before I jump into the details on the quarter, I'd like to first touch base on some tax and accounting matters. First, a new accounting standard related to partial sales of nonfinancial assets became effective on January 1, 2018. This standard directly impacts our gains from the sale of SAFE assets. As I just mentioned, while we earn gains of roughly $180 million on the SAFE transaction, we had yet to be able to realize $55 million of those gains as well as $20 million of other gains from similar transactions. This entire $76 million is hung up on our balance sheet.

The new rules require us to recognize these gains. We had two choices in how to do so; restate our earnings from prior quarters in future filings to reflect these gains or simply add the $76 million of gains to opening equity in Q1 2018, increasing book value, but not having any income statement impact. We chose the latter as it is more straightforward. When we do recognize these gains in Q1 2018, we will include them in Q1 2018 adjusted income as the first impact to our financial statements from these gains is a 2018 entry.

In addition, there were many questions from investors as to how tax reform will impact iStar and the real estate industry. In general, most REITs will not see significant direct impacts from tax reform. Of note, 1031 exchanges were left in place and rents remain a permissible deduction. REIT dividends will now benefit from a 20% deduction for passthrough earnings, although the meaningful corporate tax rate reductions make the REIT structure relatively less attractive.

Tax reform act specifics to iStar would -- tax reform act specific to iStar was positive, yet minimal, as it reversed the previously-recorded tax provision of $6 million. While our substantial NOL shields us from having almost any taxable income, we were still subject to alternative minimum tax from the significant gains we earned during the year. This $6 million reversal is a result of the AMT going away under the new law. Over time, we'll get back to $6 million of cash that we've already paid to the IRS.

Lastly, we've been closely watching rates move higher and have begun to see lenders and real estate investors adjust their benchmarks and cap rate targets. To mitigate to these pressures on real estate is a generally agreed upon correlation between rents and inflation. That said, our loan book is predominantly floating rate and our debt is predominantly fixed rate. As a result, the impact of each 25-basis-point increase in LIBOR is approximately $1 million increase to the bottom line. We have intentionally designed this positive correlation of LIBOR and plan to keep the construct going forward.

Now let me turn to our portfolio. At year-end, our overall portfolio of loans, net leased assets, operating properties, land and cash available for investment stood at $4.9 billion on a gross basis. This is primarily comprised of our 4 business lines; our core business line of loans and net lease and our noncore legacy operating property and land businesses. Our real estate finance portfolio at the end of the quarter was $1.3 billion, including $177 million of nonperforming legacy loans. The largest of which is the $146 million Hammons loan that remains in bankruptcy. As this loan is in active litigation, we are unable to discuss the investment further. The rest of the loan portfolio continue to perform well, and we took no specific reserves in Q4.

On the new investment front, we originated a total of $457 million of new loans, activity that is well above prior quarters and what we hope is a glimpse of things to come.

Our net lease portfolio was $1.35 billion at the end of the quarter, comprised of $1.1 billion of consolidated net lease properties, $121 million of equity investments in our net lease joint venture and $120 million investment in SAFE stock. During the quarter, we sold 1 net lease asset in Sunnyvale, California for $100 million, which generated a $63 million gain. This was an opportunistic sale of an office campus in the strong Silicon Valley market. We regularly review our net lease portfolio to prune and monetize assets, in which we see attractive relative value.

Our operating property portfolio was $629 million at year-end, including $427 million of stabilized commercial properties, $153 million of transitional operating properties and $49 million of residential properties. We continue to make progress with this pool of assets as we moved another asset from transition to stabilize during the quarter.

In addition, subsequent to quarter end, we sold the transitional asset in Phoenix for a gain. During the year, we continued to monetize our $933 million land and development portfolio, selling out 2 projects in their entirety; Tetherow and Sage. In addition, subsequent to quarter end, we sold our Great Oaks property for a material gain. The remaining portfolio include some assets we're currently looking to sell as well as some longer-duration assets that are either illiquid or require additional capital, time and efforts to realize their full value. This quarter, we took impairments of $15.8

million on 2 assets, the amphitheater portion of our Coney Island project and 1 additional property that we expect to market for sale in the near term.

On the right-hand side of the balance sheet, we remain in solid shape at the low end of our target leverage range with no material near-term maturities and liquidity of $660 million. Our balance sheet is well positioned from a defensive standpoint and is more than capable of capitalizing the growth that we foresee in 2018.

Traditionally, we use -- we issue annual earnings guidance on this call. With the new accounting standards and several strategic steps in progress, we have decided not to issue guidance until next quarter.

Finally, this morning we announced a corporate initiative related to our legacy assets. Over the past 6 years, we've generated $2.5 billion of proceeds from the sales of legacy assets and recorded net gains of $700 million. The announcement today relates to the remaining $1.7 billion of legacy assets comprised of a $177 million of nonperforming loans, approximately $600 million of operating properties and approximately $900 million of land. We believe that a comprehensive solution may unlock material value at iStar.

And with that, I'll turn it back to Jay.

Jay S. Sugarman - *iStar Inc. - Chairman & CEO*

Thanks, Geoff. So to sum up the highlights again, a strong quarter for origination, strong earnings for the year, a key hire to help drive investments going forward, growing numbers of legacy assets ready to contribute earnings now and reinvestable capital going forward and a strategic review to fund the best solution for longer-term legacy assets.

And with that, operator, let's go ahead and open it up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And first from the line of Jade Rahmani with KBW.

Jade Joseph Rahmani - *Keefe, Bruyette, & Woods, Inc., Research Division - Director*

In terms of higher interest rates, can you quantify the magnitude of investment adjustments that you have noted in terms of cap rate and return targets?

Jay S. Sugarman - *iStar Inc. - Chairman & CEO*

Yes. Look, the market is trying to adjust. We've seen rates trend up last year. They did a similar thing, came back down. This time, I think, general consensus is they're unlikely to go down again. But I think people are still slowly trying to figure out exactly where this is going to shake out. We're still seeing some pretty aggressive bids across the board, both in the finance side and the cap rate side, where people are obviously accepting lower spreads because the base rates have gone higher. So it's certainly not a basis -- point for basis point change. But you see a little bit of caution moving in, in terms of how pro formas are being presented and what interest rates are, people are starting to anticipate a couple of moves by the fed next year, at least probably three. So everybody is underwriting has had to reflect that. And so it's -- I think, it'll slow down a little bit. Some of the more aggressive assumptions we were seeing in the market. But to tell you, I think spreads are still grinding tighter on a lot of deals, and we seek cap rates holding increase strong for good assets.

Jade Joseph Rahmani - *Keefe, Bruyette, & Woods, Inc., Research Division - Director*

In terms of the 1Q monetization so far, could you give a sense for the Great Oaks gain as well as the Phoenix transitional asset?

Geoffrey G. Jervis - *iStar Inc. - COO & CFO*

Sure. The Great Oaks gain is somewhere in the range of $20-plus million. We still have some calculating to do as it is a complex JV structure. And the Avondale gain is roughly $15 million, that's the Phoenix asset.

Jade Joseph Rahmani - *Keefe, Bruyette, & Woods, Inc., Research Division - Director*

In terms of the strategic initiatives, when I just the land portfolio into a liquidating trust and push for accelerated dispositions as opposed to considering a spinoff. And in terms of viability of a spinoff, is there a capability on development or a some platform value that we should think about that the structure under its own capitalization would create actual shareholder value than -- rather than just moving the pieces to a different entity?

Jay S. Sugarman - *iStar Inc. - Chairman & CEO*

Okay. There's a lot of stuff in there, so let me take it one by one. The portfolio obviously, as you know, is not homogenous. So we have some short-term assets that clearly we will be accelerating the sales as I mentioned in my comments. We are fortunate to go into 2018 with a nice chunk of the portfolio ready for monetization, you've seen some of that already. We would expect that to continue throughout the year. So that's obviously -- certainly a piece of the puzzle. Some of these assets are instructors that make it difficult to sell right away, some are in JVs. And some of the assets, frankly, I think just longer-term time horizon than something like a liquidating trust would make sense for. But all options are on the table, one of the reasons we've hired third-party adviser is to really explore all different types of ways to as Geoff said, unlock the value that we think is embedded. Clearly, a sale is a great way to do that and some of the assets will benefit from sales and monetizations this year. Some of them, we've used JV structures with strong partners to help a -- minimize the amount of time and effort we have to spend. But give us a chance to realize value up and down the capital structure. And so all of those options are really on the table for that $1.5 billion, $1.7 billion portfolio. Nothing's off the table. And certainly, I think all parts of the things you've mentioned are things that we are considering.

Jade Joseph Rahmani - *Keefe, Bruyette, & Woods, Inc., Research Division - Director*

In terms of the loan book, I think last year's 10-K had some disclosure around maturities. And so I just wanted to confirm there was a December maturity expected of around $170 million? Did you receive that? And I think of January 2018 maturity of $236 million. So have you received those payoffs? Or were they received in prior quarters?

Jay S. Sugarman - *iStar Inc. - Chairman & CEO*

I'm not sure about the specific things you're pointing to. But we -- as you saw, we had over $300 million of capital come in, in the fourth quarter, including some substantial repayments. So if you wanted to check back in a specific asset or two, we can walk you through it.

Jade Joseph Rahmani - *Keefe, Bruyette, & Woods, Inc., Research Division - Director*

And just lastly, on Safety. Since you're sitting on this excess liquidity and already own 40% of the company and it's trading well below book value. You want to internalize the company at this stage, scale it on iStar's balance sheet, retain the branding and independent identity. But capture that value discrepancy now and re-IPO it at a later date?

Jay S. Sugarman - *iStar Inc. - Chairman & CEO*

Yes, look, as I mentioned, we absolutely believe this is going to be a big company. One of the components that we are working towards is a cost of capital and a rating -- unsecured debt rating, which we think helps that business materially. We are disappointed where the stock is, but we think part of that is just simply a little bit slow out of the gate on new originations. We've seen some real take up now as I mentioned, again, some repeat customers who have gone through the process with us who knew -- understand why this is a very different type of ground lease that's lender-friendly, cap rate-friendly, it's custom-tailored to the needs to really create the value they're trying to find in the properties. All that seems to be working. It's just we have not accelerated the volumes the way we would like. And I so I think before we sort of take a major change in strategy, what we're doing is continuing to look at how to best expand that business in a pure play with the prospect of achieving some very high investment-grade ratings on its size. So I don't think we're already after 6 months to give up the ghost here. We still believe -- we're a buyer because we believe and we see things on the ground that suggest the short-term issues in share price performance are things we think will correct themselves.

Operator

(Operator Instructions) And we'll go to Steve Delaney with JMP Securities.

Steven Cole Delaney - *JMP Securities LLC, Research Division - MD, Director of Specialty Finance Research and Senior Research Analyst*

The fourth quarter originations of over $450 million obviously jumped off the page to us and biggest number, I think, we've seen the last couple of years. Could you comment if there are any concentrations in particular loan types represented there? And if there are any large -- specifically, large loans that might be worth highlighting for us?

Jay S. Sugarman - *iStar Inc. - Chairman & CEO*

Yes. We took a hard look at land last year into some assets we had an inside track on, several large assets in New York City really were the predominant part -- portion of that. These were low loan to value inventory loans for borrowers we have done a lot of business with in the past, repeat customers in every case. Who needed year-end executions and needed to turn to somebody absolutely trusted would get it done. There were quite large, they need it to happen quickly. And that's kind of the stuff that iStar is well known for being best call. So we did beat out some of the names that you've seen in our space, we're also capable, but those long relationships, the quick ability to move because of the liquidity we had on our balance sheet enable us to take down -- was pretty attractive set of deals.

Steven Cole Delaney - *JMP Securities LLC, Research Division - MD, Director of Specialty Finance Research and Senior Research Analyst*

Great. That's helpful, Jay. And just to be clear, I think we've recently saw Blackstone do something similar. But these are completed -- completed, but unsold condos, is that correct?

Jay S. Sugarman - *iStar Inc. - Chairman & CEO*

Yes.

Steven Cole Delaney - *JMP Securities LLC, Research Division - MD, Director of Specialty Finance Research and Senior Research Analyst*

Okay, great. Just want to understand the sort of the phase in the development, if you will. So switching over to the net lease joint venture. We read that, that investment period expires. So I assume at that point you've been doing most of your business in that JV in the last several years. You assume it'll be free starting in the second quarter to do net lease on your own balance sheet. I'm just curious if that is one of the things that Marcos would be looking at? And how you -- how attractive you see that market at this time?

Jay S. Sugarman - *iStar Inc. - Chairman & CEO*

Yes. We also like the net lease market as one of our long-term core businesses. So one of the directives for Marcos and all the teams is how do we ramp up that business. Our sovereign wealth partner has been a great partner and continues to want to do more business with us. So we may tweak that relationship and find an even better way to work together, but I think the ultimate goal is for us to be able to put more capital out into these attractive risk-adjusted returns we've been able to generate. We think this first fund has been very successful in terms of returns. But we'd like to see more volume, we'd like to see more investments, we think we have a footprint that will allow us to do more. So we're working carefully to think through those options and hopefully will have some things to announce next quarter.

Steven Cole Delaney - *JMP Securities LLC, Research Division - MD, Director of Specialty Finance Research and Senior Research Analyst*

Okay. One final thing for Geoff. On the NOLs. You mentioned, with respect to tax reform, I'm just curious, if you could share with us the remaining size of the NOL as of your 2016 return? And if any thoughts about the expected utilization in 2017, given that you had the big real estate settlement and also the SAFE gains?

Geoffrey G. Jervis - *iStar Inc. - COO & CFO*

Sure. Our NOLs are approximately $600 million that remain.

Steven Cole Delaney - *JMP Securities LLC, Research Division - MD, Director of Specialty Finance Research and Senior Research Analyst*

Okay. And that adds up the -- after the filing of the 2016 return of it last fall?

Geoffrey G. Jervis - *iStar Inc. - COO & CFO*

Right.

Steven Cole Delaney - *JMP Securities LLC, Research Division - MD, Director of Specialty Finance Research and Senior Research Analyst*

Okay. Very good. And, Jay, I said that was my last one, but I'm going to throw one quick one in picking up on Jade's commentary. I'm sure that your work with J.P. Morgan, you have some very -- you've a great platform, you've got some high-performing iStar 3.0 and then you've got some tough stuff stop that you're doing your best. I guess, what I would throw out just trying to see how open everybody's mind is on this. If you find the cost in the execution of trying to lay off legacy assets either in a sale or joint ventures. If it's just as too much of a slog, would you consider -- thinking back to the good bang, bad bang structures of the early 1990s. Would you consider taking the 3.0 portfolio and packaging that into a new externally-managed public commercial mortgage REIT? And then STAR continues as an asset manager with 2 public entities and a workout portfolio? Just curious how you would react to that perspective on the situation?

Jay S. Sugarman - *iStar Inc. - Chairman & CEO*

Yes, look, I think that's the kind of thinking that we have a third-party adviser helping us with. We think it's -- probably haven't thought about it quite the way you're thinking about it, but it's something that certainly, we're trying to figure out and maximize the value of the components, we think the core net lease and core finance businesses are growing and thriving. And they make up the majority of the balance sheet. So I think -- we think the legacy portfolio has created a lot of liquidity and a lot of earnings. We'll continue to do that. I think there are some very long-lived assets in there that maybe there is a better solution for then simply following the path we have been on which is fixed, re-manage and re-entitle, stabilized and sell. We still think that's relevant for a big chunk of the portfolio. But there is another chunk that probably needs a different solution. Some of those assets are really good assets. So they're not bad bang in nature. Some of them are just tough assets as you point out and to the extent we can find a good way to isolate them and think about that our value in a different way we will do that. But it's early in that process, we have gone down some interesting angles and again, as I think about next quarter, one of the things we hope to have is a more defined sense of what those steps will be.

Operator

And Mr. Fooks, we have no further questions.

Jason Fooks - *iStar Inc. - VP of IR & Marketing*

Great. Thanks, John, and thanks to everyone for joining us this morning. If you should have any additional questions on today's earnings release, please feel free to contact me directly. John, would you please give the conference call replay instructions once again? Thanks.

Operator

Certainly. And ladies and gentlemen, this replay starts today at 12:30 p.m. Eastern, will last until March 12 at midnight. You can access the replay at any time by dialing (800) 475-6701, the access code is 444427. That number again, 1 (800) 475-6701 and the access code 444427. That does conclude your conference for today. Thank you for your participation. You may now disconnect.
