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STAR - Q2 2017 iStar Inc Earnings Call

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PRESENTATION

Operator

Good day, and welcome to iStar's Second Quarter 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 and Head of Marketing*

Thank you, Tony, and good morning, everyone. Thank you for joining us today to review iStar's Second Quarter 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. The dial-in for the replay is 1 (800) 475-6701, with the confirmation code of 427961.

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 of the Board and CEO*

Thanks, Jason. Our second quarter was highlighted by two major accomplishments; the first involved the successful conclusion of our legal case involving our Bevard position, leading to the disposition of this land asset [compared] at basis of $102 million, for approximately $234 million, generating strong income and significant cash that can now be redeployed. The final item in dispute, the amount of legal cost recovery is now under separate review by the Court.

The second accomplishment was the successful launch of a unique public company focused on becoming the leading player in the ground lease industry. We named this company Safety, Income and Growth, to highlight the attractive investment characteristics that make ground leases compelling. And our goal is to become a leader in the space by offering a range of capabilities to owners, developers, institutions and families that set us apart and enable us to rapidly grow our portfolio. The steps leading up to the launch of Safety, Income and Growth helped generate a sizable realized profit this quarter, and our significant ownership stake includes a large embedded gain and positions us to benefit from Safety, Income and Growth's future expansion. This is a business into which we hope to invest meaningful amounts of capital over time.

With the large cash infusions from these 2 transactions, our liquidity has now reached almost $1.2 billion. And we've begun targeting sectors where we can take advantage of our full suite of skills and capabilities. While the environment has made us somewhat cautious and willing to be patient, we expect to be able to find attractive ways to deploy this stockpiled cash.

I'll talk more in a minute about some of those areas and some of the opportunities we're seeing in our larger West Coast land assets. But let me first turn it over to Geoff to give you more detail on the quarter. Geoff?

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

Thanks, Jay, and good morning, everyone. This morning we reported earnings for the second quarter, recognizing net income of $177 million or $2.04 per diluted common share, and adjusted income of $198 million or $2.28 per share.

The quarter's results were dominated by the 2 transactions Jay just highlighted, Bevard and Safety. Let me walk you through both in more detail because there are a lot of moving parts.

First Bevard. As we talked about in the past, we've had litigation with Lennar relating to the Bevard land asset going back 9 years to 2008. The process involved an original judgment in our favor, followed by several appeals by Lennar, all of which we won. At the end of the day, we won a final judgment and received net proceeds of $234 million, inclusive of our $102 million original basis in the land as well as $125 million in interest, real estate taxes and income net of noncontrolling interest.

Only one item remains open with this asset; the collection of our sizable legal fees which were awarded under the judgment.

On a final note, Nina Matis, our CIO and CLO, and our internal and external legal teams deserve a great deal of credit here.

Secondly, Safety, Income and Growth, or SAFE. I'd like to spend a little bit more time on SAFE, because not only did it have enormous impact to Q2, but we also expect it to be a growing part of our investment strategy going forward. Let me start by giving you some background on how we got interested in ground leases.

As we worked to find whitespace post-financial crisis, we kept hearing a theme of investors' desires for safe income, inflation protection and upside potential. As we asked ourselves the questions of where we could find this trinity, we realized it was right under our noses.

Specifically, iStar had accumulated a portfolio of 12 ground leases starting as far back as 1995. As we examined and pulled apart the cash flows of these unique assets, we realized that we had identified a very interesting opportunity for growth.

Our initial desire was to build this business within iStar. But as we explored cost of debt, capital, cost of equity capital and the optimal tax structure for this new venture, we realized we needed a standalone de novo vehicle.

Fast forward, on June 27, we raised $250 million for Safety through an IPO and private placement. And post-closing, we have acquired $142 million of new investments to complement the $340 million initial portfolio.

We are very excited about Safety, and believe it will have material positive implications for iStar. Specifically, iStar owns 28% of Safety, has 2 board representatives, and is the manager of the vehicle. We will earn dividends on our stock positions as well as management fees, starting in July of 2018.

With respect to Q2, the Safety transaction generated cash of $285 million for iStar, as we financed the portfolio for $227 million in March and sold 51% of the remaining equity position in April for $57.5 million, in cash, to 2 institutional partners.

Our remaining 49% equity ownership was diluted by the IPO to a 17% ownership position in Safety. And we can currently purchase an additional $45 million of stock in a private placement which brought our ownership back up to 28%, where it stands today.

From a GAAP standpoint, our initial basis was $161 million in these assets. And the difference between that and the $340 million of consideration we received was $123 million gain from sale that shows up on our income statement this quarter, and a $56 million gain that will show up retrospectively in our second quarter 2017 income statement, once the new revenue recognition rules go into effect in January of 2018.

All in all, this transaction will add $180 million of equity value to iStar. Combined with Bevard's impact of $125 million to book value, we will have added approximately $300 million to book value, a gain of over 100% in terms of unadjusted GAAP book value, and approximately 40% gain to adjusted book value, which adds back real estate related depreciation when calculated.

As we said last quarter, we think this is a game changer in terms of our equity base, and should result in added pressure for our arguments with the rating agencies for upgrades at iStar.

Investment activity picked up in the second quarter as we originated $241 million of new real estate finance and net lease transactions, despite the focus on launching SAFE. From a portfolio standpoint, we not only invested in our real estate finance and net lease businesses, but also made significant progress in our operating property and land books and expect to continue to monetize additional projects by year-end.

Our results in the second quarter enhance the key credit metrics of liquidity and debt to equity at iStar.

We remain in a strong liquidity position with nearly $1.2 billion of cash and available capacity on our revolver, and our leverage has fallen to 1.5x, well below our target range of 2 to 2.5x.

We continue to have a very regular dialogue with the rating agencies and remain optimistic that all of the significant progress across the many facets of our business will translate into upgrades from Moody's and S&P, commensurate with those readings we recently received from Fitch.

Looking at the liability detail, the sale of SAFE included the assumption of $227 million of debt that we had on our balance sheet at March 31. Our next maturity is $550 million of unsecured notes that are due on November 1. And we are currently exploring several options to address this maturity.

We are reiterating our net income guidance of $2.15 to $2.65 per share, raised in May from our initial guidance of $0.65 per share and our adjusted income guidance of $3 to $3.50 from our initial guidance of $1.50.

This guidance, of course, is predicated on the successful closing of certain asset sales and on the macroeconomic environment remaining favorable. Some of the assets being marketed are expected to close towards the end of the year. So it is possible that those sales and their associated profits could slip into early next year. And we will update the market on our progress each quarter.

And with that, I will turn it back to Jay.

Jay S. Sugarman - *iStar Inc. - Chairman of the Board and CEO*

Thanks, Geoff. So some good outcomes in earnings this quarter. Going forward, we'll continue to move to realize value and assets we have repositioned over the last few years, including going to market with several assets in the coming quarters, including both our Highpark and Great Oaks land positions. These have been complicated projects, but we're getting to the point where they will be desirable, ready to build lot inventory in the next few quarters. So we will test the market and make some decisions based on what we hear.

On me know investment front in addition to our [regular way] finance and net lease deal flow, we've made several investments in the senior living and single-family rental sectors, and continue to push forward with our Asbury oceanfront developments as having the potential to generate strong returns down the road.

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We're pooling our cash and monetizing assets together with expanding our ground lease business is our primary focus right now and should keep us quite busy through the end of the year.

Okay, operator. Let's open it up for questions.

QUESTIONS AND ANSWERS

Operator

Thank you (Operator Instructions) We'll take your first question in queue from Jade Rahmani with KBW.

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

I was wondering if you could comment on how you're thinking about deploying capital for the rest of the year and also into next year. For example, in your comments on Safety, you say you expect to deploy large amounts of capital. Is that referring to Safety's own available capital? Or does that contemplate iStar making co-investments alongside Safety?

Jay S. Sugarman - *iStar Inc. - Chairman of the Board and CEO*

Hey, Jade. Well, let's go with the first piece in terms of deploying capital. I think as we mentioned, have been a little bit cautious. I think we prefer new and better assets to existing commodity assets. That's been consistent over the last couple years for us. We're seeing some good opportunities to deploy capital there. We are still looking for areas where there's less capital. Obviously, the markets are pretty flush right now. So we're trying to stay away from some of the more commoditized return areas. And we'll continue to poke and probe in those areas to see if we can find things that our skill set, our capabilities help us unlock a little bit of excess return. But as we said, we're willing to be patient until the right deals show up. On SAFE and Safety increment growth, I think our view has been get this thing into a public format where it has a cost of capital where it can expand and grow as fast as we think the opportunity will allow us to. Certainly, iStar plans to be a large shareholder there. So we will deploy capital directly into it. But as you mentioned, there are also going to be opportunities where we can work in conjunction either in a debt capacity or as a co-investor. So there may be opportunities to deploy capital more directly. Haven't seen that. There's a lot of liquidity at SAFE right now. We've got about $600 million of buying power. So it's nicely capitalized. But over time, we think the opportunity in this whole sector is very, very big, and we would expect iStar to deploy significant capital as well.

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

Can you remind us of iStar's target returns? Historically they've been quite high. Have those been reduced; for example, when you contemplate co-investments alongside Safety? But also the single-family rental and seniors' living space that you mentioned.

Jay S. Sugarman - *iStar Inc. - Chairman of the Board and CEO*

Yes. Look, I think we're constantly looking at our cost of capital and also where market opportunities on a risk reward basis fall. You're right, we typically focused on higher yielding stuff, both because historically we've been able to extract some excess return, but also because our cost of funds really put us in a position where that was the best use of our capital. As we work down our cost of capital, as we find new opportunities that can be up and down the capital stack, I think we see the whole opportunity set as possible for us; maybe financed slightly differently than we are corporately today. But I don't think anything's precluded. What we're really looking for is, where can we put out capital where we think we're generating excess returns on a risk-adjusted basis? And can we extract kind of the mid-teen returns on an ROE basis that we're looking for. So that really hasn't changed. But how we find it, where we get it and how we finance it to achieve those returns can change.

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

And how do you feel about repurchasing your own securities?

Jay S. Sugarman - *iStar Inc. - Chairman of the Board and CEO*

Always an opportunity. We think we've certainly put enough cash away that it's on the table. Right now we're looking at all alternatives and trying to figure out what's the best way to move forward here to really make the biggest impact. If that turns out to be acquiring our own securities, we would do that.

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

On the asset sale front, can you put a dollar amount or range around the assets being marketed for sale? And are there other assets beyond Highpark and Great Oaks that you're marketing?

Jay S. Sugarman - *iStar Inc. - Chairman of the Board and CEO*

Yes, I'd say we're probably in the $0.25 billion range in terms of things that are being actively looked at. Again, we are somewhat opportunistic in terms of trying to decide when is the optimal moment to sell something? And we're going to constantly test the market and look at our portfolio and make those decisions. But a good starting number would be $250 million.

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

And just lastly, could you comment on what drove the $10 million impairment in the quarter?

Jay S. Sugarman - *iStar Inc. - Chairman of the Board and CEO*

Yes. It was a land asset that would have required a lot of time, attention and resources to really push full value. And we've decided to redeploy some of those resources elsewhere. So little bit of a change in strategy. We'll see where that one goes.

Operator

Our next question in queue will come from Ben Zucker with JMP Securities.

Benjamin Ira Zucker - *JMP Securities LLC, Research Division - Research Analyst*

Just looking at the loan portfolio quickly. It looks like repayments came in a little bit higher than new commitments. But I think most people understand that the repayment element is kind of out of your hand and just a natural part of the business. So it's actually encouraging to see the pickup in loan originations. I also saw a little pickup in the weighted average yield, especially on the 3.0 book. I'm not sure whether that was coming from just a payoff of a lower yielding loan. But could you talk about just the type of specific lending inquiries that you guys are mostly reviewing now and quoting? And maybe just like what would be your core product? I know it's getting a little bit more into the whitespace and construction space. But any color there would be great.

Jay S. Sugarman - *iStar Inc. - Chairman of the Board and CEO*

Yes. I can't share too much detail. But I'd say again just big themes. We're very cautious on commodity real estate that's run up in price. We think, candidly, more because of the investment environment than because of any positioning of the actual real estate or quality of the real estate. So we're looking for higher quality real estate, which new stuff does attract us because we know it's absolutely current, no risk of obsolescence, no risk of somebody building something better tomorrow morning. So we definitely leaned harder towards new and better versus older, existing or commodity. But again, this central idea of trying to provide something where we can get excess return, where we have a skill set capability or knowledge insight that allows us to do something that the market can't do, is always attractive to us. So some of the stuff we're focusing on right now has come just through our network of looking at what the market does well and what the market maybe doesn't do as well as it should in comparing and contrasting those risk rewards. So yes, we've done some new stuff in the construction area, we think particularly on product types that we think are well-positioned for what's going on in the marketplace. As you know, we've typically shied away from retail, so we haven't done much there. But we're definitely seeing some hospitality markets that are starting to look interesting. So I can't give you a commodity answer because we tend not to focus on things that are right down the middle. We're trying to find the things that, from a risk standpoint, we think the market either hasn't gotten right, or, from a capital standpoint, there's still a little bit of a shortage of capital. So that's about the best we can say.

Benjamin Ira Zucker - *JMP Securities LLC, Research Division - Research Analyst*

Well, that makes sense. And maybe as the pendulum continues to swing against retail, that will open up some more opportunities there. Now, while I have you, Jay, the land sales also seemed to pick up nicely. Do you have any sort of outlook for that specific segment? Obviously, you're full-year guidance incorporates certain assumptions there. But I was just wondering if there's anything more specific around what you're seeing so far through the third quarter. Is this pace seemingly holding? Is it going to continue to be lumpy and choppy? As we move along, would you still stick with about $25 million of CapEx per quarter for this book?

Jay S. Sugarman - *iStar Inc. - Chairman of the Board and CEO*

Yes. I mean, we're always hesitant to talk about land in a highly predictive manner because it hasn't proven to be that. But we are starting to get to the eighth and ninth inning on a couple of large assets. You can see the future a little bit more clearly now. As I said in my comments, I think we're ready to test the market on quite a few and see where we go. Some of these are things we can sell in bulk. Some are things we can sell in individual parcels. There is a value pickup by taking it all the way to conclusion. Corporately, we want to make sure that's the best use of our time and resources; in some cases it won't be and in some cases it might. So we're not going to predict in an exact quarter how these things are going to play out. But we will tell you we're seeing kind of the eighth inning, maybe even ninth inning on a couple fairly large assets that have taken a long time to develop. In terms of new capital expenditures, again, we're measuring things where we think there is significant upside. We will change our business strategy as we did this quarter on the asset we took an impairment on, if we don't think it's the best use of corporate resources. We do think the Asbury Park waterfront and oceanfront developments have the potential, if we're right, to lead to a lot more profits in the future. So we think they are worth the time, effort and resources. But we're not making that decision in every case. In fact, we're trying to really pare down the number of places where we're making a significant commitment and focus on the ones we think that have the most upside.

Benjamin Ira Zucker - *JMP Securities LLC, Research Division - Research Analyst*

That's very helpful. And then maybe, Geoff, these questions are better suited for you. I saw a little drop in the reported yield on the net lease portfolio. I think it was 8.4% last quarter, now 8.1%. I'm just wondering, how's that net lease calculated? Is it an average throughout the quarter, so it can be skewed by just the timing of acquisitions and dispositions? Is it a quarter-end metric and it's just blending down as new investments are obviously coming on at lower cap rates? Just wondering if there's anything going on there.

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

Yes. No, not a tremendous amount of activity in that book, other than the removal of the SAFE assets, as those are now in a standalone vehicle. It's a calculation of total NOI over average book value for the period. So pretty straightforward. We did have the stub interest received, a period of stub interest received on the participating rent on one of our ground leases before we sold it; and particularly the Hilton ground lease. And so that did elevate items in the first quarter. But that shouldn't have an impact going forward, as that asset has been sold.

Benjamin Ira Zucker - *JMP Securities LLC, Research Division - Research Analyst*

That's helpful. And then last one for me, and I'll get off of here. Could you just help me understand that $56 million gain that's going to be recorded retrospectively? I mean, in short, are you basically saying that that's $56 million of income coming to the company that's currently not reflected in your numbers or in your $630 million book value?

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

That's exactly what we're saying. So we had roughly $180 million gain. And from a recognition standpoint, we're able to recognize $123 million immediately in this quarter. And through the nuances of GAAP, the balance is hung up and won't be recognized until the new rev rec rules go into place in January of '18. And so when you look at Q2 '17 financials starting in 2018, you'll see the impact. You'll see that additional gain. As a matter of fact, when you look at this quarter a year from now under the rev rec rules, you'll see the $55 million of additional gain in the income statement. So it's just a gain that's just hung up until the rev rec rules change. But from an economic standpoint, we absolutely made that $180 million gain; it's just the nuances of GAAP and how it's reported.

Benjamin Ira Zucker - *JMP Securities LLC, Research Division - Research Analyst*

Okay. That makes perfect sense. I won't ask you to get into the details of the revenue recognition rules on the call. Thanks again for taking my questions. Appreciate the time. And if I haven't mentioned it already, the added disclosure and supplementary data is very helpful and greatly appreciated. So thanks again, guys.

Operator

Thank you. And Mr. Fooks, we have no further questions.

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

Great. Thanks, Tony. 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. Tony, would you give the conference call replay instructions again?

Operator

Certainly. Ladies and gentlemen, this conference will be available for replay after 12 p.m. Eastern Time today, running through August 17, at midnight. You may access the AT&T Executive Playback Service at any time by dialing (800) 475-6701, and entering the access code of 427961. International participants may dial (320) 365-3844. Once again, those phone numbers are (800) 475-6701 and (320) 365-3844, using the access code of 427961. That does conclude your conference call for today. We do thank you for your participation and for using AT&T's Executive Teleconference. You may now disconnect.
