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STAR.N - Q1 2022 iStar Inc Earnings Call

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PRESENTATION

Operator

Good morning, and welcome to iStar's First Quarter 2022 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, Senior Vice President of Investor Relations and Marketing. Please go ahead, sir.

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

Thank you, and good morning, everyone. Thank you for joining us today to review iStar's first quarter '22 earnings. With me today are Jay Sugarman, Chairman and Chief Executive Officer; Marcos Alvarado, President and Chief Investment Officer; and Brett Asnas, our Chief Financial Officer.

This morning, we published an earnings presentation highlighting our results, and our call will refer to these slides, which can be found on our website at istar.com in the Investors section. There'll be a replay of the call beginning at 2:30 P.M. Eastern Time today. The replay is accessible on our website or by dialing 1-866-207-1041 with the confirmation code of 9197888.

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 expressed and 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. - Executive Chairman & CEO*

Thanks, Jason, and thanks to everyone joining us today. During the first quarter, we continued to execute on our stated strategies of simplifying iStar, strengthening the balance sheet and scaling Safehold.

The major event in the first quarter was the closing of the net lease platform for just over $3 billion. The sale generated substantial earnings, added over $1 billion of net cash proceeds to the balance sheet and retired all our secured debt obligations. We're delighted our net lease team will have a new home at Carlyle to continue creating value, and we want to thank Barclay and everyone who has been part of our net lease team for the many years of profitable investing on behalf of iStar shareholders.

While the net lease sale is helping strengthen the balance sheet and simplify the portfolio, we continue to scale Safehold and generated another strong quarter of originations, adding a number of very attractive new investments, customers and cities to Safehold's portfolio. Our investment team continues to make ground leases an attractive tool for building owners and developers in top cities across the country, helping us reach the $5 billion portfolio milestone ahead of schedule, and we believe the economics of Safehold and the modern ground lease business remain compelling.

Our message at Safehold is straightforward. We have a valuable existing portfolio of over $5 billion of high-quality ground leases with long-term financing in place at attractive spreads and inflation kickers that will boost spreads over time if inflation remains elevated. We have a valuable go-forward business where each new deal is priced to be accretive under various inflation models. And we have a valuable pool of baked-in capital appreciation, our UCA portfolio, that is growing rapidly and represents an estimated $9 billion captive asset.

Helping the market to see value in each of these 3 components is very important for iStar shareholders. Since right now, our Safehold position appears to be trading significantly below its intrinsic value and the negative impact to iStar's share price has been meaningful. We will work to address this value gap and also highlight the safety and market opportunity of the Safehold business as a key part of the go-forward plan this year.

With that, let me turn it over to Marcos and Brett to go into some more detail. Marcos?

Marcos Alvarado - *iStar Inc. - President & CIO*

Thanks, Jay, and good morning, everyone. Let me begin on Slide 3. Our results this quarter reflect continued progress across our 3-part strategy to simplify the business, grow the ground lease ecosystem and strengthen the balance sheet. As Jay mentioned, during the first quarter, we closed on the sale of our net lease portfolio, which was the driver for significant gains and a more streamlined business.

We also strengthened the balance sheet using proceeds from the net lease transaction to repay all of our secured debt. And subsequent to the end of the quarter, we completed an exchange of $194 million of convertible notes for common stock and a small amount of cash. Additionally, Safehold saw strong results during the quarter and closed $677 million of originations, while UCA grew by $1.3 billion.

Slide 4 details our earnings results. For the quarter, net income was $610.9 million or $8.85 per diluted common share, and adjusted earnings were $607.5 million or $7.79 per diluted common share.

Moving to Slide 5, we detail the impact of the net lease transaction. As a result of the sale, the ground lease ecosystem assets, along with cash on hand, represent approximately 80% of our $4.1 billion asset base. Since the beginning of 2019, one of the core components of our strategy has been to transition to the ground lease ecosystem as the primary focus for the organization. Non-core investments related to our traditional real estate finance business, along with our strategic and legacy assets, now make up 20% of the balance sheet.

And before we dive into the details, I want to note 2 things about this quarter's earnings presentation. First, a number of the slides here are presented pro forma for the distribution of a portion of the sale proceeds owed to the partners in our net lease joint ventures and participants in the company's long-term incentive plan, iPIP. These distributions will be made subsequent to the end of the quarter. You can see the details for these adjustments in the Pro Forma Supplemental Financial Data slide in the appendix.

Secondly, this quarter, we are presenting our assets with the exception of SAFE stock based on GAAP carrying values. For SAFE, we are still using the market value. In the past, we have presented the portfolio using gross book value, which primarily grossed up our carrying values for accumulated depreciation. With the sale of our net lease portfolio, the bulk of our accumulated depreciation is gone and the difference between our total carrying value and gross book value is down just to $58 million.

With that, let's continue on to Slide 6, which presents a more detailed makeup of our remaining pro forma balance sheet. We ended the quarter with $1.4 billion of pro forma cash. We had $1.8 billion of investments related to the ground lease ecosystem and $825 million of non-core assets. Turning to the right side of the balance sheet, we had $2.1 billion of debt at the end of the quarter, $64 million of accrued expense associated with iPIP, $96 million of accounts payable and other liabilities, $12 million of non-controlling interests, mostly associated with iPIP, and a $305 million liquidation preference on our preferred equity.

In addition to the $75 million we've already accrued for iPIP between liabilities and NCI that I just mentioned, we provide an estimate of the amount payable but not yet accrued under the terms of the plan. The unaccrued estimate of $105 million represents the undiscounted value that would be distributed based on the assumption that our SAFE stock is valued at the recent market price of $43.05 per share and the other investments in the iPIP pools perform and are monetized as currently underwritten.

Further, while the plan calls for distributions to be made to management in the form of 50% in cash and 50% in STAR stock once assets are monetized, if our shares are SAFE [or the] last material asset in an iPIP pool, the Board may elect to sell iPIP by distributing shares of SAFE [and stay]. In total, our common equity as adjusted for SAFE's market value and the unaccrued iPIP estimated distribution was approximately $1.4 billion or $17.75 per diluted share.

Moving to Slide 7, we provide a more illustrative overview and bridge to our equity value per share. As we did with our portfolio metrics, we are no longer presenting adjusted common equity, which was gross of accumulated depreciation.

And with that, let me turn it over to Brett to go through the portfolio in more detail. Brett?

Brett Asnas - *iStar Inc. - CFO*

Thank you, Marcos, and good morning, everyone. Let me talk about each of our asset segments, beginning with Safehold on Slide 8.

At the end of the first quarter, we owned approximately 40.1 million shares of Safehold with a carrying value of $1.4 billion and a market value of $1.7 billion. As Jay alluded to, Safehold's year-to-date stock decline has impacted the value of our investment. However, SAFE's business has continued to make strong progress in the first quarter originating 10 new ground leases for $677 million. In addition, we participated in Safehold's equity raise with a $191 million investment. Safehold ended the quarter with over $1 billion of available liquidity to fund their growing pipeline. First quarter performance resulted in strong year-over-year earnings results with 35% growth in SAFE's EPS.

Turning to Slide 9, let's take a look at our investments in the ground lease ecosystem. As we have discussed, iStar has been building its ground lease adjacent businesses, consisting primarily of our Ground Lease Plus product as well as leasehold loans through our SAFE/STAR program. Generally, we are investing in both of these products through fund structures with third-party partners. Our net carrying value for these investments is $97 million and is comprised of 4 Ground Lease Plus assets and 3 leasehold loans with targeted returns between 9% to 12%. In addition, we have $116 million of unfunded commitments associated with these investments.

Slide 10 highlights what remains of our non-core assets. Our remaining real estate finance business totals $332 million, consisting of 9 performing loans and 1 non-performing loan. Regarding our legacy and strategic assets, we ended the quarter with $75 million of short-term legacy assets, $59 million of strategic assets and $304 million of long-term legacy assets comprised of Asbury Park and Magnolia Green.

Slide 11 summarizes our investment activity for the quarter. iStar invested a total of $247 million during the first quarter. This includes $202 million of Safehold share purchases predominantly through our participation in Safehold's equity raise, $29 million in the ground lease ecosystem through Ground Lease Plus and leasehold loan fundings and $16 million of CapEx on legacy assets and other investments.

Slide 12 shows the makeup of our portfolio. At the end of the first quarter, we had total assets of $4.1 billion, of which 80% is related to the ground lease ecosystem and cash. For the remainder, real estate finance represents 8%, land and development 7%; operating properties 3%, and 2% was strategic and other investments.

Slide 13 presents a snapshot of our $2.1 billion of debt. During the quarter, we repaid $1.2 billion of consolidated debt, representing 100% of our secured indebtedness, leaving us with $1.7 billion of debt at quarter end across 3 series of unsecured notes, $100 million of trust preferreds and $288 million of convertible notes.

Subsequent to the end of the quarter, we further reduced our debt balance by completing privately negotiated exchange transactions with certain holders of our convertible notes in which we exchanged $194 million of notes for 13.75 million shares of our common stock and $14 million of cash. The purpose of this exchange was to further strengthen and simplify our balance sheet, save interest expense and preserve cash. Because these convertible notes were trading at a substantial premium, this consideration will result in a P&L impact of approximately $130 million loss on early extinguishment of debt in the second quarter that will be offset by $311 million of new equity on the balance sheet. We estimate that these offsetting figures, combined with additional shares issued, will result in a minimal impact to our total equity value per diluted share.

So, in conclusion, it was a strong and transformational quarter for us in which we made a lot of important progress on each part of our strategy.

With that, let me turn it back to Jay.

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

Thanks, Brett. So Brett mentioned the convert cleanup as another part of simplifying the balance sheet and putting us in the best position to maximize the value of our ground lease ecosystem opportunity. Many of you have asked what a simpler architecture between iStar and Safehold might look like. And we previously said that our Board expects to evaluate transactions that could change that architecture with the goal of unlocking value at Safehold. While no meaningful conversations have yet taken place, we look forward to updating you at the appropriate time in the future on any progress.

Okay, operator, let's go ahead and open up the lines.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Stephen Laws.

Stephen Albert Laws - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Jay, I guess, first, could you talk about how you're going to use cash from here, given your options to pay down debt? I know you have the remaining $93 million maturing in Q3, stock repurchases, buying SAFE, kind of how you think about the uses of cash at this moment?

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

Yes. I think, nothing is as economically attractive as the ground lease business growth. We still think those 3 components really create a compelling place to put cash. So growing that ecosystem is still the prime mission. But you're right, cleaning up some other parts of the capital stack that are smart, certainly things we can consider. So we're evaluating everything and anything right now to make sure we make the best possible decisions as we go through the year, both with respect to the cash and with respect to the future architecture.

Stephen Albert Laws - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Great. And I guess, a couple of more specific questions. But what's left of the real estate held for sale and discontinued ops line on the balance sheet? And then, when we look at the real estate finance portfolio, I don't think you break out the senior loans in this deck, but I think the duration on those would probably be less than half a year now. So kind of what are your plans for the longer duration of investments in that real estate finance portfolio?

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

Yes, you can see that breakdown. I think it's [4 pages] of breakdown. We put that in there trying to give you the best snapshot we can in terms of the pieces of that legacy puzzle. You're right, the senior loans have a relatively short maturity. A couple of them have extensions on them. So, we think they're good assets. And if we wanted to monetize them to redeploy that capital, we certainly think most of them have that potential.

We're looking at Asbury and Magnolia Green as really the 2 that are difficult to see a path to liquidity in the near-term. Both continue to form along their business plans. And then when you look at strategic and short-term, those are assets historically we've said short-term means we can reach liquidity in probably that 12, 18, 24 months of the outside date. And that still feels like assets that are moving closer and closer to liquidity, some of the strategic stuff is discretionary. We're in contact with possible places where that could be monetized. So, I think that breakdown still feels right to us in terms of thinking about time frames, nearness to liquidity.

Obviously, there's a few things in here that are still a little less liquid to us, we try to call them out. NPLs are trickier, some of the longer-term assets will be trickier. But nothing has really changed strategically in our minds in terms of this as a source of capital for the rest of the business. None of these are things that we want to hold on to long-term, but we want to see the successful conclusion of the business plans we've put in place on those longer-term assets. And our asset management team is doing a great job of prudently and consistently bringing things to market, monetizing them and moving on.

Operator

Our next question today will come from the line of Jade Rahmani with KBW.

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

With the cash position that iStar is sitting on and the decline in SAFE's stock price with the changing interest rate outlook and yet your continued bullishness on the ground lease business, is there a world in which STAR might just be able to acquire the 35% of SAFE it doesn't own, realizing the comp, the story will not be as simple as perhaps conceived previously, but iStar is the company with the $1.4 billion in cash and you continue to believe that SAFE is trading at a material discount to its NAV. So, is that something on the table? Or are there too many complexities with respect to liability structure, credit ratings on both sides of that equation?

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

Yes, Jade. I think you hit the nail on the head. There are -- this is an interesting moment in time in the markets. We think there's a significant delta between intrinsic value and where certainly Safehold is trading. I think the mandates for the Board are pretty clear to try to maximize value. Are there things that we can do in that corporate architecture to unlock that value rather than to talk about specific strategies, I would just say under that heading, we will certainly look at all alternatives and make sure we try to find the one that gives us the best path forward to unlock that value that to us, it's just a little bit surprising.

Yes, this has been a very quick move in rates and a very quick move upward in inflation expectations. But at least on the screen, long-term inflation expectations are 2.5% still. So we think when you're in a business like Safehold with long-term value creation, that's something we think we can continue to execute on very attractive deals. So, I don't think we want to do anything abruptly, but we want to be thoughtful, prudent and move forward on things that can unlock value. We love the idea of SAFE as a pure play, but obviously STAR's Board will look at the full menu of options and will try to come up with something that unlocks the most value.

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

And so, with that in mind, I guess 2 questions. Number one, how do you sit on the cash? Do you -- I mean, if I were the management team, I would sit on the cash and not do anything with it until there's some clarity because why would you start going to clean up the liability structure, buying back debt, redeeming debt if that cash could be potentially used for other means. So that would be question number one.

Question number two. In terms of the actual dynamics between management and the Board, is iStar's management team presenting various options to the Board or is the Board proceeding to hire independent outside advisers to come up with the framework? Is the framework coming from iStar or is it from independent advisers?

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

So, on the cash question, I agree with you that we're not looking to do anything imprudent here. So we will take our time and be thoughtful, watch the market, see exactly where the opportunities best present themselves. On the flip side is, we don't really want to sit on dead cash for a long, long time. So there is a lot of thought going into the go-forward business opportunities here, which plays into the second question you asked, Jade, which is management, because of our position between both companies, it cannot drive the conversations, but we can provide the analysis.

We can provide the work and we continue to put together our thoughts on what different alternatives might look like and then present that to the Board who will need outside advisers. This is a situation where you have affiliate issues. So, management can't be the decider here, but we can provide the thought about the business, about the market, about the impacts, and we are doing a lot of that work to put together our thoughts in terms of how do we unlock this value, how do we get the most investors to understand what's happening with this modern ground lease industry with the potential we're building there. And right now, that is -- it's a little trickier to lay out that path in the near-term, but the long-term path is still what we said for 5 years now, which is, we are changing for the better an industry that has $6 trillion, $7 trillion of assets.

And we think we've really just begun the journey. So, I think we always want to keep that context in mind as this business has just started. It's made great leaps and bounds so far. Right now, it feels like the market doesn't fully appreciate it, but we've been in this situation before, and we definitely believe all 3 components of value will -- at the end of the day, that's what's going to win out is if you're really creating the kind of value we think we're creating, it will be recognized in the share price.

Operator

We'll go next to the line of Jade Rahmani with KBW.

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

Yes, we have another person in the queue, so we can go to the next question.

Operator

Okay. We'll go to the line of Matthew Howlett with B. Riley.

Matthew Philip Howlett - *B. Riley Securities, Inc., Research Division - Senior Research Analyst*

Jay, look, with the decline in the fair value book, I mean, clearly with the decline of SAFE stock and the leverage that's in iStar, your shareholders see this, and they feel the impact. And this can unwind, this can go the other way, given the inherent leverage in there. So, could you just -- the first -- I guess, multiple questions. First, can iStar buyback its own stock or SAFE shares now? What's excluding? That's one. Two, what are -- just generically, what are your advisers telling you in terms of what could be the impact, the internalization via -- at an increased [flow] at SAFE via higher -- getting into new indices. I mean, this is sort of self-fulfilling if there is a merger and this increases the value of SAFE (inaudible). So, just kind of walk me through what can STAR do now in terms of purchasing its own stock or SAFE shares? And two, could you just go over what could be the impact of an internalization?

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

Yes. Great questions, Matt. I think, you kind of understand where we are, which is MNPI kind of takes us out of the box in terms of buying shares in either company. So that's something we have to be very cautious around. Certainly we have lots of thoughts in terms of things that potentially could unlock value, but some of that, I think, would represent MNPI. So we just have to be a little bit cautious on that front. In terms of the impacts, that's what we're evaluating. Like you, we believe increased float, internal management inclusion and more indices availability to more investors is a net plus. How you make that happen is obviously a bit more challenging just in terms of process and procedures and thought process.

So, management's goal here is to show the value of this business to as many investors as possible and give them as liquid a share to invest in that opportunity. How we get from here to there is the exercise, I think, we're all thinking about. It's one that I think when we come out the other side, we feel very strongly the business story is a great one, and lots of investors will want to participate. There's some constraints today that definitely we want to take another look at, and that's been sort of our message over the last year or so. And so, I would expect both boards, and I think we said this on Safehold's call as well, to start evaluating the types of things that could unlock that value sooner rather than later.

Operator

(Operator Instructions) Mr. Fooks, we have no further questions. We do have a follow-up question from Jade Rahmani. If you'd like to take that?

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

Yes. That was great. Thanks.

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

I was wondering if you could just repeat the numbers on what the pro forma capital structure looks like post quarter end. I think you all gave the debt balance of $1.7 billion. I just want to make sure I have those numbers correct.

Brett Asnas - *iStar Inc. - CFO*

Sure. Yes. So what we have after quarter end, we have 3 unsecured notes maturing in '24, '25 and '26. That's $1.7 billion. We have $100 million of trust preferreds. And then, of the convertible notes, we were able to retire $194 million of the principal. So there's $93 million remaining on those notes.

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

And the post quarter end, the fully diluted share count, is that the 78.4 million or has that increased?

Brett Asnas - *iStar Inc. - CFO*

Yes. What we have in the supplement represents the number as of 3/31.

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

It doesn't include the convertible exchange.

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

It doesn't, okay. Do you know what the pro forma share count is? Or otherwise, Jason, when we talk later, I could get that from you.

Brett Asnas - *iStar Inc. - CFO*

Yes. So, if you -- the calculation on the diluted shares are taken over the quarter. So, obviously we'll have to see over the second quarter what that price is. If it were today's priced, it will be approximately 2.5 million additional shares.

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

We have no further questions at this time.

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

Okay. Great. If anyone should have additional questions on today's earnings release, please feel free to contact me directly. Alan, would you please give the conference call replay instructions once again? Thanks.

Operator

Ladies and gentlemen, this conference is available for replay beginning today, May 3, at 12:30 Eastern Daylight Time through May 17th at midnight. To access the executive replay service at that time, please dial toll-free 866-207-1041, internationally area code 402-970-0847 with the access code 9197888. The numbers again are the toll-free number 866-207-1041, International area code 402-970-0847. The access code again is 9197888.

That will conclude your conference call for today. Thank you for your participation and for using AT&T Event Teleconferencing. You may now disconnect.
