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Q2 2020 iStar Inc Earnings Call

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PRESENTATION

Operator

(Operator Instructions) Good morning, and welcome to iStar's second-quarter 2020 earnings conference call. (Operator Instructions). At this time for opening remarks and introduction, I would like to turn the conference over to Jeremy Fox-Geen, Chief Financial Officer. And also as a reminder, this conference is being recorded. Please go ahead, sir.

Jeremy Fox-Geen ***iStar Inc - CFO***

Thank you, and good morning everyone. Thank you for joining us today to review iStar's second-quarter 2020 earnings. With me today are Jay Sugarman, Chairman and Chief Executive Officer, and Marcos Alvarado, our President, and Chief Investment Officer. This morning we published an earnings presentation highlighting our second-quarter results, and our call will refer to these slides, which can be found on our website at iStar.com in the Investors section. There will be a replay of the call, beginning at 1:00 p.m. Eastern Time today. The replay is accessible on our website or by dialing 1 (866) 207-1041 with the confirmation code of 2077911.

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 Sugarman ***iStar Inc - Chairman & CEO***

Thanks, Jeremy. The last four months have been extraordinarily challenging ones for the United States. The toll of COVID on families, businesses and our economy continue to grow, and the full impact is still being felt across the country. We offer our sympathies to those affected and our thanks to those working to help us overcome this challenge. And we also hope the renewed focus on racial equality and equal opportunity can help set us on the right path for the future. A prosperous US, where all are respected, where all can contribute, creates the best long-term environment for iStar to execute on its strategy, and we hope better times are ahead for all.

Despite this difficult environment, we continue to focus on the core strategies we laid out last year. Growing Safehold by reinventing the ground lease sector, recycling capital from legacy assets into go forward assets, and keeping plenty of liquidity and a strong balance sheet. Our quarter was a relatively quiet one and most customers across business lines continued to pay. We saw two things that are worth mentioning. One, with long-term interest rates falling significantly since the beginning of the year, the value of our long-tail cash flows have increased materially. Our interest in Safehold and its ground lease portfolio is worth substantially more at today's lower interest rates. And that may be true for many of our net lease assets as well.

We believe the intrinsic value of Safehold continues to be much higher than the current trading price, and as a result, we believe iStar's $1.7 billion investment position in SAFE has significant embedded value beyond its current market value. Two, the longer COVID negatively impacts the economy, the more stress certain real estate sectors will feel. While we see the negative impacts on parts of our portfolio being more than offset by the positive value created by lower rates, we are watching hotel and entertainment markets carefully for signs of recovery, and working to understand the runway cushion borrowers and tenants have created for themselves.

Most seem to be fine for the near term, but if COVID shutdowns extend into the fourth quarter and into 2021, we can expect further pressure on those asset areas. Fortunately, our pivot to ground leases is creating significant value and balance sheet flexibility, and we have plenty of opportunities ahead of us to deploy capital at attractive rates. As real estate transaction activity picks up during the second half of the year, we'll remain focused on growing the ground lease ecosystem, recycling legacy dollars into that space to strengthen the balance sheet, and helping shareholders understand the sizable value building up inside of iStar. With that let me turn it over to Jeremy now to go through the details. Jeremy.

Jeremy Fox-Geen ***iStar Inc - CFO***

Thank you, Jay. My comments will refer to the earnings deck that we published this morning. I'll begin on slide 3 with a brief overview of the activity during the quarter. We continue to make progress against our strategy during a quarter dominated by the economic slowdown due to COVID-19 and scaling Safehold. Despite a significant reduction in real estate transactions, we closed 4 transactions within Safehold for $61 million. Our post-COVID pipeline continues to build, and our investment's team is focused on generating new opportunities for continued growth.

Our investment in Safehold today has an unrealized gain of $840 million strengthening our balance sheet. As of yesterday, we have $422 million of cash and undrawn revolver capacity, and no corporate debt maturities for 2.2 years. This liquidity position enables us to be patient and thoughtful as we continue to scale Safehold and work to maximize the value embedded within our existing portfolio and simplify our business. We sold legacy assets worth $16 million during the quarter primarily at Asbury Ocean Club and Magnolia Green. And this legacy asset portfolio now represents 14% of our total book.

To slide 4 with more on Safehold. Safehold collected 100% of its ground rent demonstrating the safety of its cash flows, and it saw 39% year-over-year EPS growth reflecting our success in scaling the business. Its ground lease portfolio is now $2.9 billion and it has approximately $900 million of purchasing power to continue its growth assuming a 2:1 leverage. As Jay mentioned, our investment in Safehold today is worth approximately $1.7 billion, a $1.1 billion increase in value year-over-year.

Slide 5 details how we meaningfully strengthened our balance sheet over the past year and improved our credit metrics. Our unencumbered asset base increased by approximately $900 million to $4.3 billion. Unencumbered assets to unsecured debt remains at a comfortable 2x. We have a runway of 2.2 years before any corporate debt maturity, and our leverage sits at 1.4x debt to adjusted equity based on Safe's market value. We remain primarily an unsecured borrower with unsecured debt representing 68% of our total debt, and we have no repo facilities.

We were pleased to see that Fitch recognized this progress and put our credit rating on positive outlook in July.

On slide 6, we show an update on the progress we've made monetizing our legacy assets over the past year. We sold legacy assets worth $227 million reducing the portfolio by 15% to $819 million. Most of that reduction is being concentrated within our short-term legacy assets which are down 29% bringing that balance down to $286 million. And at the same time, we've made good progress within our long-term legacy portfolio. As sales in Asbury Park and Magnolia Green over the past few quarters have outpaced our remaining CapEx requirements.

That said, we expect that the slowdown due to the economic impact of COVID-19 may delay the near term pace of monetization of our legacy asset portfolio.

Slide 7 shows our earnings for the quarter. We reported a net loss for the quarter of $23.3 million, which is a net loss of $0.31 per share and an adjusted loss of $0.04 per share. For the first half of the year, we reported a net loss of $44.8 million which is a net loss of $0.58 a share and adjusted earnings of $0.10 a share.

On slide 8, you see our investment activity within iStar for the quarter. Transaction activity was muted. We funded $113 million of investments during the quarter, comprised of $85 million of loan, net lease and strategic fundings, $12 million of capital expenditures, and $16 million of stock repurchases.

Year-to-date, we've bought back 2.5 million shares for nearly $28 million, reducing shares outstanding by 4%. Earlier this week, our Board reinstated our authorization to repurchase up to $50 million of iStar stock.

Slide 9 shows the makeup of our investment portfolio. Now let me give an update on collections by business line. Safehold, which represents 30% of our portfolio received 100% of its ground rent for the second quarter. With respect to our net lease portfolio, during the quarter, we reached an agreement with our long-standing tenant, Bowlero to apply $10 million of cash proceeds we received from recent sales of Bowling venues towards the next few months of rent.

We had been holding this cash as an acquisition reserve for the purchase of new Bowling venues. In exchange, we terminated that purchase commitment. Bowlero represents approximately $700 million of our $2.2 billion net lease portfolio and represents approximately 75% of our entertainment exposure. As for the remaining $1.5 billion in our net lease portfolio we collected 98% of our rent for the quarter. Within our real estate finance portfolio, which represents 14% of our portfolio overall, we collected 94% of our interest due, excluding one pre-existing legacy non-performing loan.

The uncollected balance relates to a senior loan on a retail and entertainment property. Finally, for our operating properties, which represent only 5% of our portfolio, we collected 80% of rent owed during the quarter. We reached agreement with many of the tenants who were not able to pay to provide relief in the form of short-term deferrals to be paid back over the course of the next 12 to 24 months.

Finally, on slide 10, we show our book value per share, which illustrates both the value created through Safehold and iStar's current trading discount to that value.

Including SAFE's market to market our book value per share stands at $19.55 and at $23.84 when adjusted for depreciation, amortization, and CECL allowance. Our current stock price represents a meaningful discount for this value.

In conclusion, it was a relatively muted quarter for transaction activity due to the economic impact of COVID-19. However, we remain committed to our strategy of scaling Safehold, strengthening our balance sheet, so that we can support that growth at iStar, and simplifying our business, recycling capital from our legacy assets into the ground lease ecosystem.

With that let me turn it back to you, Jay.

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

Thanks, Jeremy. And as those numbers show we believe iStar is trading well below adjusted book. But that's based on SAFE's trading price. And for those interested, we're happy to walk through the reasons we believe SAFE's existing portfolio is significantly undervalued in the market, and why future growth and capital appreciation create even more upside. Our top priorities now are to execute on SAFE's growth potential and demonstrate its powerful upside for STAR's shareholders.

We are confident in our ability to do both. Operator, let's go ahead and open it up for questions.

QUESTIONS AND ANSWERS

Operator

Thank you. Ladies and gentlemen, (Operator Instructions). We will take as many questions as time permits and proceed (Operator Instructions). Our first question comes from Stephen Laws with Raymond James. Please go ahead.

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

Jay, I guess I'll first start with the ground lease. I know that's what you've been excited to help for a couple of years now, and not that you needed anybody to reinforce it. But I saw some articles last week about some new -- some other companies increasing their presence are looking to deploy more capital into ground leases. (inaudible) was mentioned specifically. Can you talk about the competitive environment there? What that's doing to returns and whether or not the opportunity may be so large that the competition doesn't move the needle yet? But can you maybe expand on kind of the competitive landscape for the ground lease business?

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

Yeah, sure. You know I think the punch line on this one is, we are in more places, with more people, with more products than anybody else in the space by, I would say a factor of 10. So, there is -- there are people looking at this space, but we've got a full-fledged team across the country engaged in the top 30 markets and we don't see anybody who shows up in more than a fraction of the opportunities we're pursuing.

So, it's still early in the game for this reinvention of the ground lease space, and certainly, others are paying attention and I'm starting to see some of the things we saw. But the real value that we see in SAFE that we've not seen anybody else really be able to do is to create a permanent light vehicle that is really building the whole ecosystem around ground leases. And so, we've got something that's a, larger; b, more expansive and c, has a business strategy and time horizon that we don't see anywhere else.

So, right now, the competition is not an issue. It's really COVID. It's just hard to get transactions done when the markets are frozen. So, we fully expect when the markets reopen, we'll continue to be the ground lease leader, but we'll also expect people to continue to try to do deals as well. It's just we haven't seen anybody be able to put the time, effort, and frankly the financial resources behind it that we have.

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

I appreciate that coloring. And moving to the -- I guess the other part of the net lease business or at least some of it, but the movie theater exposure I saw, I believe, AMC reached an agreement with EPR of about some of their agreements master lease structure they went into. But can you talk about how your investments there are performing? If they've been any material changes since you guys last gave an update to the market?

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

Yeah, look, as I said in my comments, we're watching those markets closely. The longer COVID continues to impact those companies the more concerned we get frankly. They've built decent runways, some better than others, but I think our overall exposure to the sector is relatively small compared to our overall portfolio. So again, we think the positive impacts of low rates is going to outweigh anything negative, but certainly, theaters are one of the places we're concerned about. Like AMC is blazing a new trail here. We haven't seen the specifics around what -- how they participate in some of the at-home streaming dollars that might be created going forward.

But we don't see anything positive coming out of this COVID period. So that's one that we've got our eyes on, and certainly think we're going to get nicked and scratched on that sector. We think Bowling on the other hand, there has been no systemic change. We think people will have birthday parties and corporate parties again. It's a temporal issue, it's not something changing the industry systemically. So we have a different viewpoint about that, and maybe a theater box that may vary. We have some really good locations.

We certainly expect them to be leading theaters coming out of whatever happens. But some of them may need to be re-thought, and so we'll be part of that process with our tenants. Right now, our 2 largest tenants of the 3 are paying. So, good news so far, but certainly on our watch list in terms of that industry in particular.

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

Right, thanks for the comments, Jay and happy to see the repurchase authorization this morning too. So glad to see you guys are continuing that. Thanks.

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

Thanks, Steve.

Operator

Our next question comes from Jade Rahmani with KBW. Please go ahead.

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

Thank you very much. As a follow-up to Stephen's question, if you put the net lease portfolio together with the loan portfolio, could you perhaps ring-fence or put some quantitative parameters around the magnitude of headwinds you could see in those portfolios? We've seen the mortgage REITs get to about 5% of loans on non-accrual. A few companies have made asset sales at around 96% of par. You haven't seen any draconian haircuts to par value, but I was somewhat surprised by the lower collection rate in the portfolio, which seemed attributable to one loan, but I think it'd be helpful if you ring-fence this issue.

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

I'm not 100% sure what you're saying, Jade. When you say ring-fence, what do you mean?

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

Well, if we take the sum of the net lease portfolio and the sum of the loan portfolio, what level of either loss or impairment do you expect to incur?

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

Okay. Look, it's still too early to give you a high confidence kind of number. We still feel confident in our loan portfolio. We have gone through that pretty carefully, and as I keep saying the variable here we can't identify is, how long is COVID going to go on. Certainly, the hospitality sector is not a place that can withstand COVID for extended periods of time without material impacts, and we've been thoughtful about that. Again, that represents a relatively small part of our overall portfolio, but we are watching it carefully.

So certainly, the hotel and entertainment assets are where the action will be if there are going to be losses. And if they're going to be issues, we evaluated at the end of the second quarter, and still feel pretty comfortable. But we are thoughtful and watchful as we head into the third and fourth quarter of whether we see the economy coming back, whether we see those types of assets opening up and seeing decent results, or whether they're going to go into a difficult winter. And we'll certainly need to evaluate them every quarter.

But, again, what I'd like to convey is while we certainly expect there to be some pain on that side, the conditions that create that pain i.e. slow economy, difficult conditions has driven interest rates down to a point where the magnitude of the value creation, not just in our net -- our ground lease portfolio, but in some of our very strong long live net lease assets. At least right now, to be honest, it feels like that is a bigger uplift than some of the concerns we have on the downside. That could change if COVID looks like there's not going to be a solution until mid or late 2021. But that's something we've evaluated at 6:30 with the best information we have, and it's given you the benefit of what we know today, but it could certainly change.

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

Okay. And in terms of the Safehold portfolio, 19% at hotel, how are you thinking hospitality exposure in that portfolio?

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

Well, we don't think hotels have lost 70% of their value permanently. So again, we think there is a temporal component to hotels, which is mostly the equity and the leasehold lenders have to figure out. That could be 6 months, 12 months, 18 months. We've heard some hotel experts tell us it would be 2024 before we reach 2019 numbers again. But those are frankly not issues for a ground lease. What would be an issue for a ground lease is an asset type where the demand base just disappears, and we have heard people talk about some of the convention hotels or some of the business hotels being -- having more long-term impacts.

Our initial evaluation of that is, again, it's not creating the kind of diminishing value that would impact our ground lease positions. So, we are evaluating both temporal impacts, which at least at this point as you've seen from our pay rates, we think our equity sponsors don't believe are permanent, and certainly don't believe that the leasehold lenders would think are permanent. But if this continues and people change their behavior, and zoom replaces 20% of hotel demand, we'd have to rethink just sort of how we go about attacking the hotel market.

But right now, again, we're seeing strong collections and we're seeing sponsors who believe in their assets. So, I can't say there won't be any changes in the hotel industry, we certainly believe there will be, but right now the temporal impact shouldn't have to be a problem for our ground lease portfolio.

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

Thanks for that. Turning to the land portfolio. Could you give an update as to the anticipated duration, timeline to monetization both for the long-term and the short-term buckets if you are going to apply some kind of the discount rate to carrying values even though ultimately iStar may receive those values back just the timeline, it takes to monetize? What would be your expectation for that?

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

Yeah. Again, let's take a base case of COVID impact to the economy through the early parts of next year, and then people see the light at the end of the tunnel and things start to turn around a little bit. What we have seen in the land side that was a bit of surprise is with low rates. We're actually seeing strong demand around the country for land. There are pockets that are still being impacted but overall, that market has been surprisingly strong. So those transactions probably are not as delayed as we originally thought they might be.

So again, I'd give us on the short-term pool probably out through the end of 2021 feels like a good sort of timeframe to whittle away at that portfolio with some decent-size transactions. The long-term, as you know are three main assets. No real changes under the net leased one. I would say Magnolia Green continues to be a strong performer in terms of price points across the housing spectrum and haven't seen as much of an impact from COVID as we initially thought. So that one still seems on track, but that has been and will continue to be a three to four to five-year sell-out.

And then Asbury we did take a pause down there. We felt like some of the assets we have on the marketplace, we just weren't going to be able to get people in to visit and transact, and there was really no government permitting going on. So those got pushed back a little bit, but the interested parties are still interested. So again, we think by the end of the year and certainly, by the end of next year, Asbury has reached kind of peak capital, and now we see it as a source of funds going forward.

Good things slip a year because of COVID. Yeah, I think that's a fair approximation of what we see right now. But again, the surprise there is with low-interest rates. The demand for housing assets, whether they're single-family or whether they're multi or condo certainly in our markets has been stronger than we thought.

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

And so how long do you think Asbury would take to be fully monetized or perhaps moved into another alternative structure?

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

We were using three to five years. Some assumptions embedded in that for sure. I still think that's a reasonable timeframe. Could that slip a year, I think so. But we've got a pretty good plan of how these assets will play out. And at least right now, we don't see a multi-year impact. We see maybe 6 to 12-month impact.

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

Okay. Are there any other callers in queue? I was going to ask a couple of follow-ups on the ground lease space.

Operator

There are no other callers in queue. (Operator Instructions) Please go ahead, Jade.

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

Thanks. Are you seeing any ability to get higher cap rates than previously, just maybe based on scarcity of capital and also some of the changes that are being spoken about in the office sector with respect to some decline in lease terms, duration of office leases?

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

No, again the ground lease is really in that double A, triple A slice. And if you look at any double A and triple A bonds out in the marketplace they've tightened materially. That price is not widening. So, on the high-quality stuff, we've actually seen rates come down. We've not seen them go up. So that our market is responsive to where dollars are flowing in very high-quality stuff. Where I think you're seeing cap will be a little bit more scarce is stuff that is hard to underwrite lower quality and that doesn't really relate to what's happening in the ground lease sector. So it's not really about price is widening.

In fact, with base rates going down I think the dynamic is actually the opposite. What is happening is values are changing. And as you mentioned, office people are trying to get their hands around if net income goes down, but cap rates also go down, what's the net-net impact of that? And we've looked at Japan and to Europe to see what happens when rates go down and stay lower longer. Well, cap rates tend to chase them down. So, if you have good strong committed cash flows this market environment actually is a positive for you.

What I think you point out is what if the cash flows are not locked in? What if they're a variable? What if you've got a lot of tenant role? I think that's a trickier equation right now, and we certainly think people are going to be more cautious in terms of valuing office assets that have that characteristic. So, we haven't seen that battle take place yet because there just aren't a lot of transactions to see where it is, but that's the bid-ask in the market. And again, from a ground lease capital provider, we think we can provide long-term very stable capital to focus in that environment.

As long as they believe that their assets haven't diminished dramatically in value, we think there is a lot of people who want to play long term in whether it's New York or San Francisco or Boston, and we're here to provide capital to them at appropriate levels. Again, we never like to get into a quote, oversized, unquote ground lease and there's plenty of those out there in the world. You won't see us buying something that represents 65% to 75%, 80% of today's value. That's not our business, but at 35%, 40% of today's value we think we provide some of the most efficient capital in the market.

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

And have you guys put out a sensitivity with respect to SAFE's NAV or fair value relative to changes in discount rate, but if the discount rate moves by 50 basis point, what would be the net impact to value?

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

Yeah, we actually do that every day. But just to give you some round numbers, if you run the bond math on our existing portfolio at SAFE today using these ultra-long-term ultra-high grade bonds that we look at, SAFE is approaching $100 a share of bond value trading at 50. Well, if you take that metric and you realize that iStar runs 1.7 billion of stock today. The intrinsic bond value of SAFE that would flow through to iStar yeah, that is an -- almost a doubling in value. So as I said in my comments, we really need to do a good job of helping people see what you just mentioned, which is rates coming down 100 basis points on the 30-year since the beginning of the year, and 150 basis points since we went public.

We have some of the most attractive long-term high-quality cash flows in the world and certainly in the US market. So I'm not surprised that there are a lot of other factors that people are focused on, but we will make sure we get people to focus on that last 50 basis points of change in the ultra-high-grade bond world, has created enormous value for SAFE that we don't think is reflected in the stock. And enormous value for STAR indirectly, that we certainly don't think is reflected in its value. So, we will do a little bit better job of getting people to just put those numbers to paper, and I think some people will be surprised how good they look.

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

Thanks very much for taking the questions.

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

Thanks, Jade.

Operator

Thank you. And ladies and gentlemen (Operator Instructions) One moment, while we wait. Mr. Fox-Geen we have no further questions at this time.

Jeremy Fox-Geen ***iStar Inc - CFO***

Thank you. If you should have any additional questions on today's earnings release, please feel free to reach out. Operator, would you please give the conference call replay instructions once again. Thank you.

Operator

Thank you. Ladies and gentlemen, this conference will be available for replay after 1:00 p.m. Eastern Time today through midnight, August 20th. You may access the AT&T teleconference replay system at any time by dialing 1 (866) 207-1041 and entering access code 2077911. Those numbers again are 1 (866) 207-1041 and with the access code of 2077911. That does conclude our conference for today. Thank you for your participation and for using AT&T Teleconference service. You may now disconnect.