Safety, Income & Growth

Third Quarter 2018 Earnings Conference Call

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PRESENTATION

Operator:

Good morning, and welcome to Safety, Income & Growth's Third Quarter 2018 Earnings Conference Call. If you need assistance during today's call, please press star, zero. 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:

Thanks, Lisa. Good morning, everyone, and thank you for joining us to review SAFE's Third Quarter 2018 Earnings. With me today are Jay Sugarman, Chairman and Chief Executive Officer, Andy Richardson, Chief Financial Officer, Marcos Alvarado, President and Chief Investment Officer.

This morning we plan to walk through a presentation that details our third quarter 2018 results. The corresponding presentation can be found on our website at safetyincomegrowth.com, in the Investor Relations section. There'll be a replay of this conference call beginning at 1:00 pm Eastern Time today. To dial into the replay, it's 855-859-2056 with a confirmation code of 8496197.

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 may be forward-looking. SAFE'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 report. SAFE disclaims any intent or obligation to update these forward-looking statements except as expressly required by law.

Now, with that, let's turn the call over to our Chairman and CEO, Jay Sugarman. Jay?

Jay Sugarman:

Thanks, Jason. During the third quarter, we saw a growing interest in our modern ground lease structure from both new and repeat customers, with an increasing recognition that working with SAFE can lead to more efficient capital structure and reduce levels of interest rate and maturity risk. With markets getting choppy, SAFE's market-leading expertise, customer-focused approach and committed sponsorship from iStar have enabled us to grow our footprint and begin expanding across more markets as we continue to grow and diversify the portfolio.

Deals this quarter included office, multifamily and hospitality ground leases in three of our target markets: Washington, D.C., San Diego and Phoenix, and we have a strong pipeline going into the end of the year and into the first quarter of next year. We've also been working on several new approaches to help us capture the largest market share possible and further demonstrate the superior returns our customers enjoy by making their capital structures more efficient.

Because we believe the market will begin to understand the power and value of our platform as our portfolio reaches scale, we have spent most of our time working on building our business and getting in front of potential customers. With our portfolio approaching a billion dollars in assets and Value Bank approaching the $2 billion mark, we should be able to better demonstrate the significant value of the Company as it reaches scale. This value is driven by the high quality cash flows thrown (phon) off by our ground leases, and the significant capital appreciation potential embedded in the future residual interest.

As you can see in our earnings deck, quarterly cash rents have grown over 30% year-over-year, and our future capital appreciation potential has reached almost $1.6 billion.

With that, I'll turn it over to Andy to walk through the quarter in more detail. Andy?

Andrew Richardson:

Thank you, Jay, and good morning, everyone. My remarks this morning will refer to the slides from our earnings deck that we posted on our website earlier today.

Let me begin with Slide 3. Over the past year, our focus has been working to create solutions that unlock value for our customers and enable them to make higher returns. During that time, we have worked with customers, advisors, lenders and brokers to understand their unique needs and address their concerns. As Jay mentioned, now we are ready to shift our emphasis towards scaling the business.

For the quarter, net income was $0.11 per share, versus a loss of $0.04 for the third quarter last year. FFO was $0.24 per share versus $0.08 in the prior year period, and AFFO was $0.07 per share versus $0.11 in the prior year period. AFFO this quarter includes $0.05 of cost from investments in growth and efficiency, which I will discuss later. Also, if the annual Park Hotels participation payment received during the first quarter was recognized ratably during the year, we would have recognized an additional $0.05 of earnings during the third quarter.

Adjusting for these items, AFFO would have been $0.17. In addition, AFFO this quarter now includes the reimbursable expenses owed to our manager that had been waived in prior periods. Year-to-date, net income was $0.41 per share, FFO was $0.78 per share, and AFFO was $0.53 per share.

In terms of investment activity, this quarter we closed a hundred and six million of new ground leases, comprised of four fully-funded investments and one forward funding commitment, which brought our aggregate portfolio to $770 million. At the end of the quarter, Value Bank was $1.6 billion, or $0.86 per share. Furthermore, we hired an experienced investment professional, Tye Palonen, to focus on West Coast expansion, and added a new bank to our revolving credit facility, upsizing it by $50 million to $350 million. We also made additional investments in marketing and R&D, all of which has helped facilitate growth. Currently, our pipeline has over $400 million of deals under LOI.

Slide 4 shows our portfolio rent growth. For the third quarter, quarterly cash rent was $7.6 million, up 34% from a year ago. Quarterly cash rent shown on this slide allocates the Park Hotel annual percentage rent on a pro rata basis to each quarter, and at September 30, our annualized in-place cash rent, which gives full quarter credit to the ground leases we closed in the middle of the quarter, stood at $31.2 million.

Slide 5 details our G&A for the quarter. As a reminder, iStar previously waived all Management fees and reimbursable expenses owed through June 30, 2018. This quarter we began to pay iStar a quarterly Management fee equal to 1% of total equity per annum in the form of SAFE stock. For the third quarter, the fee equated to approximately 46,000 shares that will be issued in the fourth quarter.

G&A this quarter includes approximately $0.02 of cost related to having our current auditors, Deloitte & Touche, issue audit opinions on financial statements for the years prior to 2018, which were previously allotted by PricewaterhouseCoopers. We believe this upfront investment will result in future cost savings and efficiencies when accessing the capital markets. We also invested $0.03 per share on R&D targeted towards scaling the business.

Separately, the Board granted iStar waiver to increase its ownership limit from 39.9% to 41.9%, and iStar subsequently purchased an additional 130,000 shares of SAFE in the open market, bringing its current ownership to 40.5%.

Moving ahead to Slide 6, which shows our dividend payments; for the third quarter, we paid a $0.15 per share dividend for a total of $0.60 over the trailing 12 months. Our target is to pay out between 95% and 100% of AFFO. As we continue to invest and scale the portfolio, we expect to be able to grow the dividend.

Let's turn to our new portfolio investments on Slide 8. The third quarter consisted of $106 million of investment activity that was comprised of four new ground lease investments that totaled $76 million, and one forward purchase commitment for $30 million, bringing our aggregate portfolio to $770 million, 16% sequential increase and more than double what it was when we went public.

The aggregate portfolio includes $706 million of ground lease investments that we currently own, and $64 million of deals we have closed as forward purchase commitments. Creating a SAFE ground lease on a to-be-built development project is one of the innovative ways we've been able to help developers reduce their risk and increase their returns. This new structure provides a portion of the capital required for development, resulting, upon completion, in a brand new building securing our ground lease position.

Slide 9 describes the metrics for the quarter's investments. Seventy-two million of the investment activity this quarter related to new space ground leases that we originated. These generally had metrics and structures in line with our target, such as a weighted average going-in cap rate of 4.1%, with weighted average fixed annual rent escalations of 2%, and periodic CPI look-backs to provide additional inflation protection. Ground rent to underlying property NOI coverage of 4.4 times, and our basis as a percentage of combined property value, was 30.7%. These leases all have 99-year terms.

In addition, we purchased an existing ground lease in Washington, D.C. for $34 million. What is particularly attractive about this investment is that it includes a rent reset in seven years based on 8% of the fair market value of the land, and a similar reset every 10 years thereafter until 2075.

Slides 10 and 11 provide some detail on the deals we closed. The Balboa Executive Center is a five-story, Class A office building and SAFE's second ground lease in the San Diego MSA. We've also seen nice demand in Washington, D.C. MSA, and now have five ground leases in the market, including the third quarter investment in ground leases under the Hyatt Centric hotel and the Jefferson, and our forward purchase commitment on a ground lease underlying a multifamily asset in the area. Lastly, we expanded our geographic footprint with The Madison, a Class A office building, and our first ground lease in the Phoenix market.

Slides 12 and 13 detail the diversification in our portfolio. The slides show that we've doubled our investment in Washington, D.C. and expanded our ground lease offering into Phoenix.

Slide 14 highlights some of the key credit metrics that we believe demonstrate the safety embedded in the portfolio. Just a few things that I would like to note; our annualized cash rent, including percentage rent, was $31.2 million or 4.4% returns on our basis. If you include straight-line rent, our annualized GAAP rent is $51 million. All of our leases have some form of rent escalators embedded in their structure, such as fixed rent bumps, CPI-linked bumps, percentage rent, or a combination of these. Of the leases with fixed bumps, the average annual bump is 1.8%.

The safety derived from our ground leases is highlighted in the credit metrics shown on the bottom part of this slide. Annual cash flow from the properties sitting on top of our land covers our annual cash rent at 4.7 times, and our cost basis represents 34% of the combined property value. For comparison, the average AAA loan-to-value in commercial mortgage-backed securities is approximately 42%.

Moving to Slide 15, which represents our pipeline; our near-term pipeline consists of $853 million of deals, including $408 million of deals with signed LOIs, compared to $141 million under LOI at the end of last quarter. We are very encouraged by the growth in the pipeline. The deals under LOI, assuming they are completed, are set to close during the fourth quarter this year through the first quarter next year.

Slide 16 provides an update on Value Bank. Value Bank grew 16% during the third quarter to $1.6 billion, or $86 per share. Recall, at the expiration of a ground lease, the building and all improvements revert to SAFE. Since our investment was only the cost of the ground, the value of the building plus our cost basis on the land is what we refer to as Value Bank. To calculate Value Bank, we rely in part to an annual independent appraisal from CBRE on our property, and we use our underwritten total development cost on forward purchases. In effect, we use Value Bank to track the embedded capital appreciation potential at lease maturity, which should grow with every ground lease we originate or acquire.

Onto Slide 18, let me discuss our debt and leverage. Our debt is straightforward: $227 of long-term fixed rate debt due in 2027, secured by our initial $340 million portfolio and $71 million of asset-specific debt against our Hollywood investment. We upsized our revolver by $50 million, increasing total capacity to $350 million. We drew down the revolver facility by $64 million during the quarter to partially fund origination activity, bringing the revolver to an outstanding balance of $74 million at the end of the quarter. Based on our two-to-one leverage target, $15 million of cash on hand and undrawn excess borrowing capacity on our credit facility as of December 30, we have a little over $200 million of dry powder for additional investments.

Finally, let me provide an update on our interest rate protection. We put in place interest rate protection covering all of our ground leases that are not yet financed, or that are financed with floating rate debt. This includes deals for which we have forward purchase commitments. Our interest rate protection consists of both long-term fixed rate debt and long-term rate-locked hedges that afford more than 10 years of interest rate protection, sufficient to allow protected two times leverage on the existing portfolio.

In sum, this was a solid quarter as we further expanded the portfolio, grew the pipeline and brought in new talent and resources. SAFE continues to educate the marketplace on a better way to invest, to own and operate real estate.

With that, I'll turn it back to Jay.

Jay Sugarman:

Thanks, Andy. I want to point out that one of the benefits of having a company with iStar's sizable resources as both our manager and largest shareholder, is our ability to utilize and leverage off of iStar's scale as the SAFE platform scales. We continue to see places where the companies can work together and provide solutions that are mutually beneficial for both companies. This is another reason we are convinced SAFE will be able to grow successful into a very large business and begin to see its significant value recognized by the marketplace.

Now let's go ahead and open it up for questions. Operator?

Operator:

Thank you. Today's question-and-answer session will be conducted electronically. To ask a question, please press star, one at this time. We will take as many questions as time permits. Once again, please press star, one to ask a question. We'll pause for a moment to assemble the roster.

Our first question comes from the line of Collin Mings from Raymond James. Your line is open.

Collin Mings:

Hey, good morning.

Jay Sugarman:

Morning.

Collin Mings:

First question from me, just you mentioned roughly $200 million of dry powder just given where the debt levels stand. But just in context of the $400 million under LOI, share with us how you're thinking about your current cost of equity at this point to fund additional growth, and then just the potential for iStar to continue to grow its ownership?

Jay Sugarman:

Sure, thanks. Yes, we're very pleased that the pipeline continues to grow. On the capital side, I'd make three points. One, as you saw, we remain underleveraged relative to our targets, need more diversity to get best execution, so a bigger portfolio will get us better execution which will get us closer to our leverage target. Two, I would agree with you, iStar has a lot of firepower, has obviously demonstrated an interest in acquiring more as evidenced by their open market purchases, so that's been certainly a supportive feature. Then, fundamentally we believe there's a larger pool of investors who've expressed interest in providing capital once we've reached some of our scaling milestones. We believe that's sort of a double barrel thing. When we reach scale, not only do we have a lot more investors interested, but it comes at a much higher, hopefully, price, that recognizes the value of the platform.

In terms of cost to capital right now, we're more focused on building the business and bringing in the types of investors who understand where the value exists inside the portfolio, but we do have capacity across a number of different fronts.

Collin Mings:

Okay. Then just as we're talking about the LOI, or the deals under LOI and the fact that, again, you're very focused on growing that pipeline, just—can you share with us what that mix between originations and acquisitions is, as you think about that pipeline funnel that you referenced?

Jay Sugarman:

Yes, I think we've said in the past, the business is very much about creating ground leases, not just buying them. We do have a couple interesting acquisition opportunities on the table in the pipeline. But by number of transactions, it's materially weighted towards new ground leases, but by dollar volume it really depends on the size of the things we think we can acquire attractively. You'll see a mix; again, by number, you'll see more time, effort and execution around new ground leases, and by dollar we'll continue to acquire things, but that tends to be a little more episodic.

Collin Mings:

Okay. Just maybe on the acquisition front, and recognizing that you put some details out in the prior press release as well as touched on it a bit in the slides, but can you just expand on that opportunity you see with the Hyatt ground lease in D.C.? Obviously a low initial cap rate. How much of that was a function of the reset feature, or is that also maybe a little indicative of the cap rates you're seeing as you're pursuing some high quality acquisition opportunities?

Jay Sugarman:

Yes, I guess two things. One, we're driven mostly by LTV coverage, quality of land, quality of operators in building markets. If we can acquire something long-term that we think has very strong metrics, we think that's a good place for SAFE to play. This one has some unusual, obviously, lease dynamics. It's a relatively short-term lease, it's only got 56 years left. The next big bump and reset takes place in about seven years, and you have a sponsor that has a significant amount of capital invested, junior to us, and an institutional lender with significant capital (inaudible) junior to us.

That was a one-off in terms of an unusual combination of metrics that we kind of like. More often than not, the stuff we create is longer and a little more similar in nature. I wouldn't tell you, in the acquisition side, we can give you specific guard posts around where things are, but when we look at the IRR, we look at the LTV, we look at the coverage, we look at the amount of capital in the leasehold envelope, it kind of lines up with everything else we've been trying to do.

Collin Mings:

Okay, and then just—I guess maybe—just one more from me. Jay, kind of looking—from the interview that you did with REIT Magazine and some of the talking points there, just more broadly, just talk on the education process and how the reception for this ground lease platform is being received, just given as you continue your outreach and education efforts.

Jay Sugarman:

Yes, that is a critical part of this task for us. As I said, we've been spending a lot of time really in an education phase, knowing full well that some of these education processes would not lead to deals, but we felt it was worth the time and effort to go out and really help people understand the very basic logic of splitting two fundamentally different investments apart. It's a logic that is endemic to every other part of the investment world. Somehow in real estate, we continue to require people to own fundamentally different investments, one high return, five to 10 year holding period, very actively managed, together with a much lower return passive, very long-term hold period asset. I think that message is getting through. We feel pretty good about that.

One of the things that we're doing and we'll continue to try, and I mentioned some new approaches, is to try to simplify the process for folks so that once they understand the merits and the logic, it becomes relatively easy for them to execute with us. We're looking at some of these one-stop shop capabilities that we can put together with iStar that really minimize the variables on a deal. Andy talked about this pre-construction commitment to get in earlier in the process, so we're not trying to educate people at the end of a process but very early in the game. The deal we did on that multifamily transaction in D.C. was a good indicator of how we like to get in, explain it and then actually put our stake in early. We don't mind closing a ground lease a year from now or two years from now if the whole capital structure's already been put together and we know that construction is taking place.

There's a lot of ways we can actually take that education component and amplify it by making the process simpler, easier, earlier for customers, and I think you'll continue to see us try to push deeper into the marketplace with that kind of thinking. That should open up more and more of the opportunity, based again on this logic and merit that we see people grasping relatively quickly.

Collin Mings:

All right, I appreciate the extra color there. I'll turn it over.

Operator:

Our next question comes from the line of Rich Anderson from Mizuho Securities. Your line is open.

Richard Anderson:

Thanks, good morning. Jay, on the forward commitments, $64 million currently in the portfolio, how—I think you just kind of said it. They could be extended out to one or two years, is that sort of the timeframe you're thinking about on those?

Jay Sugarman:

Yes, it…

Richard Anderson:

Okay.

Jay Sugarman:

It depends on the construction period on the West Coast. The approval processes are longer, on the East Coast it's a little bit shorter.

Richard Anderson:

But are you—you're not recognizing any rent, or are you, in your rent numbers that you describe in the press release here?

Jay Sugarman:

No, but…

Richard Anderson:

Okay.

Jay Sugarman:

We try to highlight for you in the portfolio composition, which are how many assets are on that forward commit basis.

Richard Anderson:

Yes, okay. On the $0.05 in AFFO, is that—is there anything about, particularly the $0.03 of R&D spend, is anything about that recurring, or is that all a one-time event type of thing for the third quarter?

Jay Sugarman:

The expenses, I would describe it as one-time in nature, but it may expand over a couple periods. We have some interesting ideas that we need to do the state-by-state legal work and really understand what we can achieve. If we're able to come up with these new approaches, we want to be able to sit in front of customers and say, we worked through all the pieces, this is how it works, this is the document you'll be looking at. You don't want to show up and go, we're figuring this out with you, so we're putting in the time and money upfront to make sure we've really thought through all the iterations for our customers so when we show up and say, this is an executable idea, we're not trying to play catch-up.

Richard Anderson:

Right, make it easy for them to smooth out the process.

Jay Sugarman:

Exactly.

Richard Anderson:

If I can get back to the dry powder question, you said you have a bunch of different opportunities once you get past the $200 million of remaining dry powder to raise some form of equity. Could that include private equity coming in through a joint venture channel, something of that sort, or can you describe some of the alternatives? Or is it not appropriate at this time to get into some of your strategies to keep the engine going?

Jay Sugarman:

Yes, I think you can imagine the full range of things we'd consider, we're just looking at the best execution for the business. But I feel good about the number of people who've expressed interest in the business.

Richard Anderson:

Okay.

Jay Sugarman:

They like the fact that we're under-levered right now, they like the fact that there's a lot of firepower sitting at our sponsor and largest shareholder. If we're fortunate enough to be able to put money out faster and actually get this diversification and scale that we've been really trying hard to reach, I think that'll give us a lot of good options.

Richard Anderson:

Okay, and then last for me, I was just looking back at the second quarter and you had $141 million under letter of intent. Is it safe to assume that all of the $106 million came from that bucket, or is there ever a time where you can move so fast, where it circumvents the LOI bucket and becomes a hard investment in the following quarter, or is it all from that $141 million?

Jay Sugarman:

I wish it were true more often that we can move really quickly with a customer. So far it's proven out as it does take a little bit of time, so yes, you're right. Most of those deals came from the preexisting bucket.

I will tell you, as the word spreads and as more and more people use this to really create better capital structures with less risk and demonstrate the higher IRRs they're going to deliver, I think the timeframes will shorten. Right now, there's definitely a cycle of education, working through the documents, getting the deals done, but even now we're starting to feel, with some of our repeat customers, we're seeing deals get done in 30 days. I would just tell you, it feels like the funnel, as it gets bigger, will start to include deals where everything's already in place and they can close much quicker.

Richard Anderson:

With 30 days being the short end of that range, is it a year for the long run once you begin a discussion, or is it something smaller than that?

Marcos Alvarado:

Hey, good morning, it's Marcos. I think the groundwork that we've laid over the past year has helped to educate the market, so I would say a year is definitely not the case, it's probably three months to four months on the outside case (phon). What gives me a lot of excitement as we move forward, the last nine transactions we've closed, eight have been organic; five of those have been with repeat customers. On those repeat customer transactions, it's basically seven receipts because we use the same docs (phon). Their legal bills are $10,000, and so it is a much more efficient closing process than closing of financing. We're excited about the prospects going forward.

Richard Anderson:

Sounds great. Thanks very much.

Operator:

Our next question comes from the line of Anthony Pallone from JP Morgan. Your line is open.

Anthony Pallone:

Thanks, good morning. Just would like to go back to the overhead, just want to make sure I understand. In the quarter, you had G&A of $2.8 million on the income statement, and then another $300,000 of other expenses. Where was the $0.03, I think that you talked about, that you called out? How did it divvy up among those two lines?

Andrew Richardson:

Yes, the $0.03 is in the public company and other costs, the $1.5 million, if that's your question. The reimbursables are—that line item is primarily people's cost.

Anthony Pallone:

Oh, I was just looking at the Appendix of the deck, and I'm just seeing the general and administrative of $2,779 and then other expenses of $3.03 million.

Andrew Richardson:

Yes, all of that is in the $2,779.

Anthony Pallone:

Okay. Then, if I look at those combined, basically thinking about those two lines being your overhead, a little over $3 million and then you added back $932,000, so sort of the non-cash pieces and so forth, so that the net hit of overhead to AFFO is a little over $2 million. I guess what I'm trying to understand is, what does that look like on a normalized basis, like 4Q and going into next year? I understand investing in the platform and doing some higher earnings stuff, just trying to understand where it lands?

Andrew Richardson:

Yes, I'd say—basically what we're trying to telegraph here is that that $800,000 plus or minus, $350,000 of that is not going to recur anymore. The other $500,000 was related to R&D. As Jay said, that could—we could have a portion of that come through, also, in the fourth quarter, but ultimately, I would say that, if you were running an expectation, I would expect that there'd be a limited amount of that every quarter going forward. I can't tell you if that's $200,000 or $300,000 or $100,000—I would eliminate from this run rate about at least half a million dollars, based on what we know today.

Anthony Pallone:

Okay, so then, as you start to look out into next year, the overhead that impacts your AFFO seems—it should run somewhere in the $1.5 million-ish range, quarterly?

Andrew Richardson:

If you take the two-eight, right, less the Management fee, which is just over $900,000, you're kind of in the range, $1.5 million, $1.3 million to $1.5 million.

Anthony Pallone:

Then just that other expense item on the income statement, the 303, that kind of stays about the same going forward, or?

Andrew Richardson:

Yes, those are primarily deal pursuit costs, so as we scale the business, that number could increase a little bit, but it's just on a deal-by-deal basis. If we don't close a transaction that we're pursuing, we have to expense the cost associated with that in the quarter that the deal died, respectively.

Anthony Pallone:

Got it, okay. Then, shifting over to some other stuff, then. Just taking a look to the balance of the year, just (inaudible) up, it sounds like the four words are a little bit further out into the future. Do you think you're going to close much in 4Q, actually get some capital out the door?

Jay Sugarman:

Yes, we're pleased with what we see just in terms of the number of dialogues, the number of LOIs, the number of people proceeding a case, that they're using the ground lease as part of their capital stack. We are a customer-centric business so we work on their timeframe, not our IPO timeframe. Some of those, we'll definitely close in the fourth quarter; some of them, as I said, I think we have a nice pipeline even going into the first quarter of next year. Hopefully that LOI gives us a pretty steady stream of business closings from now until the end of the first quarter. We'll probably be adding to that pile as these dialogues freshen across the country. We're now in 10 or 12 markets, our target market size is approximately 20 to 25, so we're putting conversations and seeds into a lot of new markets and we certainly hope to be able to harvest those.

I can't give you exact timing, but yes, it'll definitely be some sizable growth in the near-term.

Anthony Pallone:

Okay. In the near-term, when you think about yields, how much, or where do you see those trending? I guess with the idea being—it seems like you have in the mix, some of these deals, like the Washington, D.C. one where the going-in yields were pretty low because you've got some other circumstances at play.

Jay Sugarman:

Yes, that deal is somewhat of a one-off, but I would say, we consistently talk about the trophy type gateway city assets that still are in the 3.5-ish range, and the more slow business, solid citizen stuff is more in the 4.25, 4.5 range. That continues to be the general—the AAA quality alternatives that we can play pretty comfortably in. You'll see some anomalies, some that'll be hopefully higher, and some where there's unique underlying lease characteristics that allow us to take a lower yield initially because the IRRs are compelling.

Anthony Pallone:

Last question, then, on that; as you look at IRRs, how did something like the D.C. hotel IRR compare to, say, the other deals in the quarter, when you think through what that reset might look like and the Value Bank there versus the other ones? What are those levels of IRRs to which you're underwriting today?

Andrew Richardson:

I'm going to give you an answer just on a general approach on our lower-yielding acquisitions. As we look out in the future and try to project what those resets will be, we make sure we have a cushion so we're adequately compensated for the risk of taking that lower yield upfront. We think, as we go forward, that those yields in the future will be additive to an organic origination of an example building that's immediately adjacent to that asset. Generally on those deals, we are at lower leverage points, at lower land basis. We feel we're getting compensated for those low initial yields.

Anthony Pallone:

Okay. I mean, do you think the deals, just broadly speaking, as you're underwriting IRRs at six, seven, eight order of magnitude?

Andrew Richardson:

Well, I think if you take our baseline of the 4% kind of initial cash-on-cash return on an unlevered basis, and the bump structures on average have been around 2% on a long-term growth basis, that math is pretty straightforward. With these reset deals it's a little trickier, but in markets that we're lining up side by side and going in we get a similar, or in fact, better return with reasonable assumptions, and if we can get both the risk profile we like and an IRR profile that matches a 4+2 kind of number, we feel pretty good about that.

Anthony Pallone:

Got it. Okay, thanks for the time.

Andrew Richardson:

Thanks, Anthony.

Operator:

Your next question comes from the line of Joshua Dennerlein from Bank of America Merrill Lynch. Your line is open.

Joshua Dennerlein:

Hey, good morning, guys. I noticed that it seemed like you had a lot of office ground lease acquisitions this quarter and it looks like your pipeline on the office front grew. What's driving that, if there's something that's becoming more attractive to office users with a ground lease, or were you actively reaching out for office deals?

Jay Sugarman:

Yes, I guess at this point, we're, again, going where our customers need us, and we're seeing a lot of opportunities to work with players who have long-term hold ideas and need long-term capital. Not just the quarter, multifamily and office seem to be the two that we've been spending the most time with. It was not a proactive decision on our part. We certainly like the asset class in the right markets and the right locations where we think there's a lot of attributes that protect the long-term value.

But if you're asking, did we go out actively to seek that? No, we didn't.

Joshua Dennerlein:

Okay. Then, I guess, it looks like you hired someone to run the West Coast side of the business. How do you think that increases your pipeline going forward, and what's the overall strategy there? Are there certain new markets that you'll be looking at, or just kind of a bigger presence out there is just better?

Jay Sugarman:

Yes, look, as we've said, this is an idea that can be used on almost any owner of a high quality institutional asset, that means kind of plus $30 million and above to really maximize their returns and hopefully reduce their interest rate maturity risk. Almost every type of product works; multifamily, we're seeing a lot of take-up from office, hospitality, we've done some industrial. Getting out into more markets of our 25 targets, you can see we've closed deals in Miami and Orlando and Atlanta and D.C., Raleigh, Durham, L.A. and San Diego and Phoenix and San Jose. We want to cover the map as effectively as we can. Because we're somewhat East Coast centric, New York centric, we need to have a strong presence on the West Coast.

We've got a great team out there, we wanted to add additional resources that could really push our ground lease business further and faster. We'd like to be in Portland and we'd like to do more in the Seattle, San Francisco markets, we'd like to be San Diego and L.A., core markets for us. Tye will really help us create a constant presence up and down the coast, together with our existing team that was already starting to use their network and their relationships to bring deal flow. He's got a slightly different network and relationships, so definitely expect to see a pickup in activity out there.

Joshua Dennerlein:

Got it. Thank you.

Jay Sugarman:

Thank you.

Joshua Dennerlein:

(Inaudible) for me.

Operator:

Again, if you'd like to ask a question, that's star, one on your telephone keypad.

Our next question comes from John Massocca from Ladenburg Thalmann. Your line is open.

John Massocca:

Good morning.

Jay Sugarman:

Hey.

John Massocca:

I know you've talked in the past about sizable whale-type transactions that maybe exist outside the pipeline. Are those type of transactions still floating out there, and would those typically be on existing ground leases, or would they be done with kind of the state ground lease format?

Marcos Alvarado:

As Jay's discussed in the past, those come few and far between and are episodic. I think fortunately for us as we look at our pipeline, we have two of those transactions; one of them is organic and created on an acquisition with a new sponsor, and the other one is an existing ground lease. I would say it's a combination of both strategies that we deploy.

John Massocca:

Okay. Then maybe on the financing side, I know you're under-levered at this point and have a lot of capacity in the revolver so maybe this is not top of mind right now; what are some of the long-term debt financing solutions you're looking at as the portfolio continues to grow?

Andrew Richardson:

Yes, on the financing front, it's actually interesting, right, because this business, we talk about how unique it is, and on the right side of the balance sheet, we're also actually thinking it's a priority on developing longer-term financing solutions for these assets. Our capital markets group is actually working with a lender right now and documenting a transaction, financing that we think is going to be unique in the marketplace at a very attractive rate. It also has an interesting feature in that the interest rate will actually step and mirror the underlying rent bumps and the collateral that's going to go in there. That's something we'll talk about more in the fourth quarter, but that's the type of thing—those are the types of things that we're also working on so that the financing matches the investments that we're doing.

Jay Sugarman:

I would just say, more longer-term, Andy touched upon this, when you look through LTV to our portfolio in the low 30s and you look at AAA CMBS bonds in the low 40s range, we think as we get to scale, those sort of securitization options will lead to very accretive financing solutions.

John Massocca:

Understood. Then, is some of that kind of looking into those type of debt financings as part of the R&D spend that's been happening, or is that separate from that?

Andrew Richardson:

Yes, the R&D bucket covers the left and the right side of the balance sheet.

John Massocca:

Okay. That's it for me, thank you guys very much.

Operator:

Mr. Fooks, we have no further questions.

Jason Fooks:

Okay, thank you. If you have any additional questions on today's earnings release, please feel free to contact me directly.

Lisa, would you please give the conference call replay instructions once again? Thanks.

Operator:

Thank you for participating in today's Safety, Income & Growth Third Quarter 2018 Earnings Conference Call. The call will be available for replay beginning at 1:00 pm Eastern Time today through 11:59 pm Eastern Time on November 8. The conference ID number for the replay is 8496197. Again, the conference ID number for the replay is 8496197. The number to dial for the replay is 1-855-859-2056. Again, 855-859-2056.

This concludes today's conference call. You may now disconnect.