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Safehold, Inc. (SAFE)

Q1 2019 Earnings Call

CORPORATE PARTICIPANTS

Jason Fooks
Senior Vice President-Investor Relations & Marketing, Safehold, Inc.

Jay Sugarman
Chairman & Chief Executive Officer, Safehold, Inc.

Andrew C. Richardson
Chief Financial Officer, Safehold, Inc.

Marcos Alvarado
President & Chief Investment Officer, Safety, Income & Growth, Inc.

OTHER PARTICIPANTS

Nikita Bely
Analyst, JPMorgan Securities LLC

John J. Massocca
Analyst, Ladenburg Thalmann & Co., Inc.

Paul D. Puryear
Analyst, Raymond James & Associates, Inc.

Jade Rahmani
Analyst, Keefe, Bruyette & Woods, Inc.

Michael Levine
Analyst, Wells Fargo Advisors

MANAGEMENT DISCUSSION SECTION

Operator: Good morning and welcome to Safehold's First Quarter 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

Senior Vice President-Investor Relations & Marketing, Safehold, Inc.

Thanks, Chris. Good morning, everyone, and thank you for joining us today for Safehold's earnings call. With me today are Jay Sugarman, Chairman and Chief Executive Officer; Andy Richardson, Chief Financial Officer; and Marcos Alvarado, President and Chief Investment Officer.

This morning, we plan to walk through a presentation that details our first quarter 2019 results. The presentation can be found on our website at safeholdinc.com and by clicking on the Investor Relations link. There will be a replay of the conference call beginning at 2:00 P.M. Eastern Time today and the dial-in for the replay is 1-800-585-8367 with a confirmation code of 7664015.

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. Our actual results may differ materially from these forward-looking statements and the risk factors that could cause these differences are detailed and or SEC reports. Safehold disclaims any intent or obligation to update these forward-looking statements except as expressly required by law.

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

Jay Sugarman

Chairman & Chief Executive Officer, Safehold, Inc.

Thanks, Jason. We kicked off 2019 with a strong quarter showing significant growth in all our core metrics. Revenue was up almost 90% year-over-year, earnings per share jumped 80% year-over-year and the unrealized capital appreciation embedded in our owned residual portfolio crossed the $2 billion mark. We entered three new target markets and grew the portfolio over 75% versus Q1 2018, while further cementing our powerful relationship with iStar and setting the stage for continued growth.

Our investment team is working across markets, property types and transaction structures to bring our more advanced, more efficient ground lease capital to an increasing number of building owners who want to generate higher returns, reduce transaction costs and eliminate debt maturity risk on a large part of their capital structure. Importantly, we've expanded our capabilities with our new SAFE/STAR program and can now offer a comprehensive capital solution for owners developing, recapitalizing or repositioning well located buildings, providing them with streamlined access to our lower cost capital and our flexible structuring options.

The first quarter saw the first two SAFE/STAR deals of the year and we now see this as a significant competitive advantage going forward. We also continue to make progress in our long-term financing structures that are matching our long-term effective yields with our long-term effective cost of debt. As our portfolio grows and diversifies, we continue to see opportunities to access attractive sources of capital that recognize the unique credit quality and stability of our assets. And we are pleased to see investors beginning to recognize the potential value of this misunderstood sector and look forward to further outreach to the many parts of the marketplace we think will find this relatively unique combination of principal safety, income growth and capital appreciation a perfect fit for their investment needs.

So, with that, let me turn it over to Andy to go through the quarter in more detail. Andy?

Andrew C. Richardson

Chief Financial Officer, Safehold, Inc.

Thank you, Jay, and good morning, everyone. Let me begin on slide 4. The first quarter of 2019 was highlighted by significant earnings growth year-over-year as we continue to increase our portfolio. This year, we also raised substantial liquidity to make new investments and closed on additional non-recourse long-term financings further solidifying our balance sheet.

On slide 5, we summarized our earnings results. Revenues for the first quarter of this year were $22 million, an 87% increase from the same period last year, while net income grew by nearly 200% to $11 million. On a per share basis, net income was $0.36 which includes, in our share count the 12.5 million LP units issued for $250 million on January 2.

As a reminder, the first quarter also includes the annual percentage rent from our Park Hotel portfolio. This year's percentage rent was $3.6 million or approximately $0.12 per share versus $3.3 million last year.

As we discussed in February, our earnings reflect the new lease accounting standards that became effective on January 1, which treat ground leases entered into after 2018 as [ph] bond like (00:05:01) investments rather than as real estate.

On our balance sheet, we are recording most new ground lease transactions as a net investment in leases and on our P&L, we are recording income on these new investments through interest income from sales-type leases based on the effective yield of our ground leases.

We believe that the new GAAP treatment of these leases captures many of the fixed income like aspects of our business. The GAAP yields recorded on our sales-type leases are now consistent with the accounting for our debt obligations. And as a – as a result, GAAP net income is more indicative of our operating performance as a high-grade fixed income investment business. Additional information on the impact of the new accounting standards can be found in the appendix on slide 19.

Let's turn to slide 6 to discuss this quarter's investment activity. During this first quarter, we closed six new investments for a $143 million, growing our aggregate portfolio to approximately $1.1 billion, a 76% increase year-over-year. You can see the key investment metrics on the transactions closed in Q1 towards the bottom half of the slide. We are earning a 5.86% effective yield with 4.61 times coverage and the gross book value equal to 37.7% of CPV or combined property value. These investments also include periodic CPI look-backs that could provide additional potential upside to our effective return.

Slide 7 shows this quarter's investments in some additional detail. It was a busy quarter as we introduced Safehold in three new markets during the quarter; San Antonio, Philadelphia and New York with our Jersey City transaction. In addition, half of the deals this quarter came from repeat customers, which continues to confirm to us that our capital solution is helping customers generate better returns and win more deals. We also closed two transactions through our SAFE/STAR one-stop capital program during the quarter.

Turning to slide 8, we have also enhanced the right side of our balance sheet to help facilitate our growth. After the end of the quarter, we closed a $122.5 million of 30-year secured non-recourse fixed rate financings that were custom structured to the unique characteristics of our ground leases. The financings are full term interest-only with a weighted average interest rate of debt of 4.25% and LTV of 64%. The ground leases that collateralized the financings have an unleveraged yield of 5.73% implying an ROE of over 8%.

In addition, as we previously announced, we raised $250 million of cash equity from iStar at the beginning of the year. This investment provided us with fresh capital to pursue approximately $750 million of new deals assuming our targeted 2:1 debt-to-equity ratio. And we presently have approximately $585 million of asset purchasing power. We've also been pleased to see the stock react positively. SAFE is one of the top performing REITs over the past six months as more investors begin to recognize the opportunity, relative value and our growing momentum.

Slides 10 and 11 show the diversification in our portfolio. Washington D.C. remains our largest MSA and the map includes Safehold's expansion into the New York, Philadelphia and San Antonio MSAs. Our portfolio stratification continues to show attractive metrics, which we believe demonstrate the AAA credit quality of our ground leases.

Slide 12 details key metrics of our portfolio. Annualized GAAP rent after depreciation and amortization was $68 million or 6.7% yield on the portfolio. Annual cash flow of the buildings sitting on top of our land covers our annual cash rent by 4.52 times and our current portfolio gross book value represents 35% of the combined property value.

On slide 13, we have highlighted some metrics surrounding our owned residual portfolio. Our ground leases typically include a residual right to acquire the buildings and other improvements on our land for no consideration at the end of the lease. As of March 31, our owned residual portfolio had an estimated market value of $3.1

billion, comprised of nearly 9 million square feet of real estate, including 4 million square feet of office and industrial, 3,000 hotel rooms and over 2,700 multifamily units.

Moving to the next slide. We track changes in the excess of the current estimated value of our owned residual portfolio over our investment in the ground leases as a measure of unrealized capital appreciation in the portfolio, which we previously called Value Bank.

At March 31, our aggregate cost basis in the land was $1.1 billion, versus the estimated combined property value of $3.1 billion, indicating unrealized capital appreciation of approximately $2 billion. This unrealized capital appreciation grew by $245 million during the quarter when compared to $1.8 billion at the end of the year.

Moving to slide 16, I will review our debt and leverage. At the end of the quarter, we had $437 million of outstanding debt and an all-in effective rate of 3.94%. The figures on the slide are as of March 31. Pro forma for the new 30-year financings, which closed after the end of the quarter, we had $560 million of debt with a 3.6% weighted average cash interest rate and all-in weighted average effective rate of 4.17% and leverage of 0.9 times. Our leverage levels are down from year end and below our 2 times target due to the new equity raised at the beginning of the year. Slide 17 outlines our interest rate hedges, which are sufficient to provide protected 2 times leverage on the existing portfolio.

In conclusion, we remain confident that our Safehold ground leases provide a better, more efficient capital solution for customers that allow them to win more deals and make higher returns with less risk and that by helping create this efficiency, we believe that we will be able to continue to scale our portfolio. At the same time, we will continue to educate more investors across a broad spectrum of investment styles about the compelling combination of growth and excess returns embedded in our Ground Lease portfolio relative to other AAA quality investments.

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

Jay Sugarman

Chairman & Chief Executive Officer, Safehold, Inc.

Thanks, Andy. Couple of final comments. As I've said before, the true value of this business will only be apparent as we begin to reach scale. We believe we're making significant strides in providing our customers with better capital and see the impact most clearly in our growing portfolio and the number of repeat customers who continue to work with us on new opportunities.

We expect the value of our company become more fully recognized as we build a highly diversified portfolio across all 30 of our target markets and make our company unique value proposition, simple and understandable to investors well beyond the real estate world. Our goal over the next 12 months is to push forward aggressively and make our innovative Ground Lease business a growing part of the real estate world and Safehold shares a core investment for a wide range of investors.

Operator, let's go ahead and open up for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. Today's question-and-answer session will be conducted electronically. [Operator Instructions] Our first question comes from Nikita Bely of JPMorgan. Your line is open.

Nikita Bely
Analyst, JPMorgan Securities LLC

Q

Good morning, guys. Can you provide a little bit of color on who the lenders were on the 30-year debt at 4.25%? And also, more broadly, what is the depth of that pool as you go forward to pursue this kind of financing?

Andrew C. Richardson
Chief Financial Officer, Safehold, Inc.

A

The lenders on the long-term financings that we're doing are like company lenders. We're not going to give specific names as we've worked with – now working with several groups of that type to continue to work on 30-year and even potentially longer financings. But we think that with the announcement of the first deal a few months ago that we're getting more and more inquiries, and so we think the depth of that market we're just beginning to test it. But we think it is – it's becoming sort of once you do the first one, many others become more interested in it. So, we think there's a relatively deep market there.

Nikita Bely
Analyst, JPMorgan Securities LLC

Q

And how likely that that will be the key funding source in the future, going to let companies...?

Andrew C. Richardson
Chief Financial Officer, Safehold, Inc.

A

We believe it's going to be a key funding source, particularly on the long end, but we continue to explore other sources of capital as well. But we're very thrilled with the interest level that we have from that type of lender.

Nikita Bely
Analyst, JPMorgan Securities LLC

Q

And how does that compare currently to [ph] equity issuance (00:15:03) given how the stock has valued recently?

Andrew C. Richardson
Chief Financial Officer, Safehold, Inc.

A

Our targeted leverage level in the company is about 2 times debt to equity, still have over a $500 million of buying power based on the liquidity that we have at the end of the quarter. So, we're pleased with our stock price, but we also want to make sure that we balance out dilution with the liquidity that we have.

Nikita Bely
Analyst, JPMorgan Securities LLC

Q

Any color you can provide on just with cash yields in the quarter? Just trying to [ph] back (00:15:44) into the number, I think it comes out to in and around about 3.7%. If you could maybe provide a little bit of details on that for the current deals...?

Andrew C. Richardson
Chief Financial Officer, Safehold, Inc.
A

The year-one cash yields are pretty consistent with we've seen in prior quarters. So, we're in the 3.5% to 4% range in general.

Nikita Bely
Analyst, JPMorgan Securities LLC
Q

And, are you able to provide a straight-line rents and intangible amortization for the quarter?

Andrew C. Richardson
Chief Financial Officer, Safehold, Inc.
A

That's in our – I think that's in the supplemental information in the back. So, we recognized about $1 million of income from the investments that we did in the first quarter, of which just less than $300,000 of it was non-cash income.

Nikita Bely
Analyst, JPMorgan Securities LLC
Q

And lastly, what can you give a little bit of deals on the pipeline of deals that you are looking at right now in the near future that maybe you've already closed?

Marcos Alvarado
President & Chief Investment Officer, Safety, Income & Growth, Inc.
A

Hi. It's Marcos Alvarado. We have two deals in contract, totaling approximately $81 million, and we have another approximately $255 million across six transactions under letter of intent, and in the pipeline, the quarter-over-quarter, so from Q4, it's substantially larger.

Nikita Bely
Analyst, JPMorgan Securities LLC
Q

And, you said $251 million?

Marcos Alvarado
President & Chief Investment Officer, Safety, Income & Growth, Inc.
A

$254 million under LOI.

Nikita Bely
Analyst, JPMorgan Securities LLC
Q

$254 million, so there is a likelihood that they might close before second quarter or in second quarter I should say.

Marcos Alvarado
President & Chief Investment Officer, Safety, Income & Growth, Inc.
A

Those transactions could close further into the year.

Nikita Bely
Analyst, JPMorgan Securities LLC
Q

Okay. So, it might not have to be second quarter, right?

Marcos Alvarado
President & Chief Investment Officer, Safety, Income & Growth, Inc.

A

Correct.

Nikita Bely
Analyst, JPMorgan Securities LLC

Q

Okay. Thank you.

Marcos Alvarado
President & Chief Investment Officer, Safety, Income & Growth, Inc.

A

Thanks.

Operator: Your next question comes from John Massocca of Ladenburg Thalmann. Your line is open.

John J. Massocca
Analyst, Ladenburg Thalmann & Co., Inc.

Q

Good morning.

Jay Sugarman
Chairman & Chief Executive Officer, Safehold, Inc.

A

Hey, John.

John J. Massocca
Analyst, Ladenburg Thalmann & Co., Inc.

Q

Just quickly kind of following up on that pipeline question, what percentage roughly of the pipeline today is SAFE/STAR?

Andrew C. Richardson
Chief Financial Officer, Safehold, Inc.

A

Roughly 20%.

John J. Massocca
Analyst, Ladenburg Thalmann & Co., Inc.

Q

Okay. And then maybe kind of switching gears a little bit on the equity front, obviously, I understand you guys have a decent runway to kind of continue to work through, but iStar obviously has viewed SAFE as kind of an attractive investment and with the financing in January has been kind of open to giving you guys capital, but as you kind of get to a price today where we have more attractively priced, I mean, how do you view additional equity from iStar versus equity from the public markets just as you kind of look out over the long term?

Jay Sugarman
Chairman & Chief Executive Officer, Safehold, Inc.

A

Yeah. I think we've publicly stated iStar wants to continue to be a significant investor in and around the ground lease innovation. So, they will continue to provide capital as a meaningful ownership, but I think we also recognize that building liquidity in the shareholder base is important as well. We think, as Andy said, we still have about $0.5

billion of firepower to deploy. So, we haven't really begun thinking about the next capital raise, but certainly, we would expect iStar to participate and to help increase the liquidity of the public shares out there.

John J. Massocca
Analyst, Ladenburg Thalmann & Co., Inc.

Q

And, one last one on the debt. I mean, do you think kind of future kind of debt issuance is going to be more typical of what you did here in 2Q or the other piece of debt you raised, I believe, it was late last year, maybe earlier this year, where you had kind of bumps on the interest expense side of things or are they both kind of on the table?

Andrew C. Richardson
Chief Financial Officer, Safehold, Inc.

A

Those two pieces of debt were structured very similarly. So, both of them have bumps on the cash interest rate that closely mirror the bumps on the underlying collateral.

John J. Massocca
Analyst, Ladenburg Thalmann & Co., Inc.

Q

Okay. So, they're very similar in their structuring in that they both have bumps. All right.

Andrew C. Richardson
Chief Financial Officer, Safehold, Inc.

A

Yes.

John J. Massocca
Analyst, Ladenburg Thalmann & Co., Inc.

Q

Okay. That's it from me. Thank you very much.

Jay Sugarman
Chairman & Chief Executive Officer, Safehold, Inc.

A

Thanks.

Operator: Your next question comes from Paul Puryear of Raymond James. Your line is open.

Paul D. Puryear
Analyst, Raymond James & Associates, Inc.

Q

Thanks. Good morning. Collin is traveling today, but a couple of questions from us here. Could you just give us some thoughts on really looking at slide 13, your thoughts on allocating capital among the different asset classes, and where you see the greatest build in your pipeline and how you're thinking about escalation of land values across those different asset classes?

Jay Sugarman
Chairman & Chief Executive Officer, Safehold, Inc.

A

Sure. I think one of the things we set out to do was show that this is simply better capital, more efficient capital, and it really applies to almost all markets and all property types. And I think you see that as the portfolio continues to scale, a significant increase in multifamily, significant increase in office and continued interest from the hospitality sector.

So, I think we start with the premise that the top 30 markets that we target have a lot of target-rich property types that we continue to work with customers on. So, we haven't really seen sort of a hard move one way or the other. We still see a relatively strong interest across the board. What I would say, we also stress that it works across the lifecycle of these properties. So, during development, we can be a very effective and cost effective source of capital at the moment of recapitalization or at the moment of sale or purchase.

Those are the three big moments where we think when you look at building a capital stack most efficiently most cost effective to really generate the highest returns with the least risk, the ground lease solution really stands out. And so, I think we are working across all those markets, all those moments, all these property types. And today, I wouldn't tell you we see a hard move one way or the other. It's a big open marketplace. We're introducing almost a revolutionary new way to look at the capitalization of these buildings in a way more effective, cost effective way. And so, the take-up has been, I would say, pretty much across the board.

As the portfolio gets bigger, as we see what's most effective for us to work on, where we can be most efficient with our time and our effort and our folks, you'll see us really try to be better and better at spending our time on things we know and we have a competitive advantage in. But right now, it's just a big open playing field and across all the property types you see here, we're seeing opportunities.

Marcos Alvarado
President & Chief Investment Officer, Safety, Income & Growth, Inc.
A

Just to add two other things to that, as I think about the pipeline, it's two more of our core markets that we're not in today, so we're excited about that. And then, the quality of our customer base has dramatically improved over the last 12 months, so the traction we're getting across the entire market [ph] is good (00:23:46).

Paul D. Puryear
Analyst, Raymond James & Associates, Inc.
Q

And then, one more question. So, is the land lease market just more active or the way you're going about it and sort of the financing solution that you're providing is just creating more activity? And then, I guess, it's part of that question, we continue to hear and track the inflation, the cost to build which of course is driving up values in several markets. And I'm curious how you view that as it relates to the underlying land value because it's the construction cost that's putting pressure and the permitting cost that's putting pressure on the development pipelines today? So, really, if you could respond to both of those would be helpful. Thank you.

Jay Sugarman
Chairman & Chief Executive Officer, Safehold, Inc.
A

Sure. Look, I think, as you see in our public materials, we actually think we're revolutionizing the ground lease sector. So this is not an investment that's out there and just got a lot of people executing it. We're the first and only public company doing it. We're doing most of the pioneering work in the brokerage community and with our customers. So, I would say, we still believe we are inventing this business or reinventing the business, but we don't see a lot of similar types of ground leases being executed. And, we have relatively little-to-no competition when we're doing this.

When you think about the land component of projects whether they be new developments or recapitalization, we think there is a slice of the capital structure that the land represents typically in our deals. It's somewhere in the third of the entire capital structure. The individual markets, I can't speak to, definitely price pressures, but what it all points to is you need to be very, very efficient with your capital. You can't afford in a market where costs are rising and return expectations are still important to limited partners and capital providers to not take advantage of a much more efficient way to build a capital structure.

And that's what we're seeing across markets, whether it's a Nashville or New York or San Diego, our customers are looking to build the most efficient capital structure, generate the highest returns and minimize inefficiencies and maturity risk as much as possible. Look, some projects still won't pencil out, but what we're finding is they have a much better profile when they use all the efficiencies we can bring to them.

And one of the things that SAFE/STAR program has done for us is allow us to move very quickly to really provide these comprehensive capital solutions. So, look, we're still figuring out exactly how to explain the benefits, but as you can hear, we're starting to see customers really gravitate to: it's more efficient, it's more cost effective, it's less friction. Those are all good things in a market that people are competing for capital.

Paul D. Puryear
Analyst, Raymond James & Associates, Inc.
Q

Okay. Thank you. That's all for us.

Jay Sugarman
Chairman & Chief Executive Officer, Safehold, Inc.
A

Thanks.

Operator: Your next question comes from Jade Rahmani of KBW. Your line is open.

Jade Rahmani
Analyst, Keefe, Bruyette & Woods, Inc.
Q

Thanks very much. I apologize if you've already answered this, but can you give an update on the Park Hotel's portfolio and any discussions about potential extension of those leases?

Jay Sugarman
Chairman & Chief Executive Officer, Safehold, Inc.
A

Hi, Jade. Yeah. Look, that portfolio continues to perform while you see the percentage rent continues to increase nicely. Again, we think those are attractive assets, but we have not engaged in any substantive conversations with Park at this point.

[indiscernible] (00:28:00)

Jade Rahmani
Analyst, Keefe, Bruyette & Woods, Inc.
Q

Is there a timeframe in which...?

Jay Sugarman
Chairman & Chief Executive Officer, Safehold, Inc.
A

Yeah. The lease has about six years on to primary term and has 10 years of extension, so it's 16 years fully extended at this point.

Jade Rahmani
Analyst, Keefe, Bruyette & Woods, Inc.
Q

Is there a timeframe in which it would be reasonable to expect discussions to heat up?

Jay Sugarman
Chairman & Chief Executive Officer, Safehold, Inc.
A

Look, we're delighted with their performance and certainly remain open and willing to have a conversation. But to-date, that just hasn't taken place.

Jade Rahmani
Analyst, Keefe, Bruyette & Woods, Inc.
Q

And in terms of the other assets in the portfolio that have extensions or maturities within, say, over the next 16 years, are there any other sort of near-term kind of low-hanging fruit that could be a means of establishing the Value Bank that you talked about?

Jay Sugarman
Chairman & Chief Executive Officer, Safehold, Inc.
A

There's nothing certainly on the magnitude of the Park Hotel's portfolio. But again, I would stress to you that we think we can demonstrate the value without having actual executed transaction. You'll see us as we continue to scale this portfolio, help folks understand why that value is concrete and tangible.

We do have CBRE go out every – annually and make sure that we have current marks on all of the properties where we have a ground lease and we think that demonstration of value is quite tangible and quite transparent and as the portfolio grows, will become easier for people to see.

Jade Rahmani
Analyst, Keefe, Bruyette & Woods, Inc.
Q

Thanks for taking the questions.

Jay Sugarman
Chairman & Chief Executive Officer, Safehold, Inc.
A

Thanks, Jade.

Operator: [Operator Instructions] Your next question comes from Mike Levine of Wells Fargo. Your line is open.

Michael Levine
Analyst, Wells Fargo Advisors
Q

Yeah. Hi, thanks. My question was around pipelines. It's been answered. Thank you.

Jay Sugarman
Chairman & Chief Executive Officer, Safehold, Inc.
A

Thanks, Mike.

Operator: And Mr. Fooks, we have no further questions.

Jason Fooks

Senior Vice President-Investor Relations & Marketing, Safehold, Inc.

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

Operator: Yes, sir. In order to listen to a replay of this conference call beginning at 2:00 PM Eastern Time today, the dial-in for that replay is 800-585-8367 with the confirmation code of 7664015. This concludes today's conference. You may now disconnect.