Safety, Income & Growth

First Quarter 2018 Earnings Conference Call

April 26, 2018

CORPORATE PARTICIPANTS

Jason Fooks, *Vice President of Investor Relations and Marketing*

Jay Sugarman, *Chairman and Chief Executive Officer*

Andrew Richardson, *Chief Financial Officer*

CONFERENCE CALL PARTICIPANTS

Collin Mings, *Raymond James*

John Massocca, *Ladenburg Thalmann*

Anthony Pallone, *JP Morgan*

Joshua Dennerlein, *Bank of America Merrill Lynch*

PRESENTATION

Operator:

Good day, and welcome to Safety Income & Growth's First Quarter 2018 Earnings Conference Call. If you should need assistance during today's call, please press star, zero. At this time, for opening remarks and introductions, I would like to turn the call over to Jason Fooks, Vice President of Investor Relations and Marketing. Please go ahead, sir.

Jason Fooks:

Good morning, everyone, and thank you for joining us today to review SAFE's first quarter 2018 earnings report. With me today are Jay Sugarman, Chairman and Chief Executive Officer, and Andy Richardson, our Chief Financial Officer. This morning we will plan to walk through a presentation that details our first quarter 2018 results. A corresponding presentation can be found on our website at safetyincomegrowth .com, in the Investor Relations section. There will be a replay of this conference call beginning at 1:00 pm Eastern Time today.

Before I turn it over to Jay, let me point you to our forward-looking statements disclaimer on Slide 1. I'd like to remind everyone that statements made on our conference 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 on this slide, as well as in our SEC reports. SAFE disclaims any intent or obligation to update these forward-looking statements except as expressly required by law.

With that, I'd like to turn it over to our Chairman and CEO Jay Sugarman. Jay?

Jay Sugarman:

Thanks, Jason. Thanks to those of you joining us today.

The first quarter continued our steady progress forward, as we modernize and reinvent the ground lease industry. Portfolio growth of 18% and Value Bank growth of 21% were both solid. We still believe we have just scratched the surface of what is possible in this space.

Earnings benefited from the strong year-over-year growth and the once a year percentage rent payments from our Park portfolio. We look forward to a solid bump in the coming quarter on the north complex in our Hollywood multi-family ground lease.

With significant dry powder still available and a growing dialogue with potential customers, we are well positioned to continue scaling the portfolio and establishing our unique value proposition for owners of high-quality real estate and for investors seeking safety, income, and growth.

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

Andrew Richardson:

Thank you, Jay. Good morning, everyone.

I'm very pleased to be joining you today. In the short time that I've been with the Company, I've seen SAFE gaining traction with property owners and building momentum in the market.

My remarks this morning will refer to the slides from our earnings deck that we posted on our website today.

Let me begin with Slide 3. To assess performance at SAFE, we look at GAAP net income along with non-GAAP financial measures such as funds from operations or FFO and adjusted funds from operations or AFFO. For the quarter, net income was $0.20 per share, FFO was $0.33 per share, and AFFO was $0.30 per share, including receipts of percentage rent from the Park Hotels portfolio, which is recognized annually during the first quarter.

Turning to Slide 4, I would like to highlight three themes from the quarter. We had meaningful revenue growth stemming from a larger asset base, and recognition of the annual Park Hotels percentage rents. Our quarterly portfolio cash rent, excluding the Park Hotels percentage rent, grew by 9% from the fourth quarter to $5.6 million, driven by our new investment activity. In addition, we were pleased to see annual percentage rent at our Park Hotels portfolio also grow by 11% to $3.3 million.

We've continued to build investment momentum, closing three new transactions totaling $91 million. Of note, all of our post-IPO customers for whom we've structured a SAFE Ground Lease have returned to explore further opportunities for ground leases with us.

Our portfolio grew by 18% during the first quarter, and now totals $588 million, which is up more than 70% from IPO. As the asset base grows, so does Value Bank, which is now $1.2 billion or $66 per share, representing 21% growth from the prior quarter and 173% growth from our IPO.

Slides 5 and 6 gives further details on our income statement, FFO and AFFO, which I previously discussed.

Moving ahead to Slide 7. Slide 7 shows the quarterly earnings impact of both the Park Hotels percentage rent recognition, as well as the waived portion of G&A expenses.

As I mentioned before, because percentage rent from the Park Hotels is recognized annually in the first quarter, we think it is helpful for comparative purposes to show the impact to our earnings as if we recognized it evenly over the year. Doing so would result in a $2.5 million or $0.13 per share reduction to our first quarter earnings.

Secondly, and as a reminder, iStar waives all management fees and reimbursable expenses through June 30, 2018. That said, under GAAP, both the management fee and reimbursables are still reported as G&A expenses during the waiver period, and as an increase to stockholders' equity in a like amount. In the first quarter, this amount represented $0.07 per share or a $1.3 million cash benefit to the Company.

Slide 8 provides more of the details behind the G&A breakdown I just discussed.

Moving ahead to Slide 9, which illustrates our dividend payments. We paid a $0.15 per share quarterly dividend for our first three quarters as a publicly traded Company. We expect to be able to grow the dividend over time as we continue to invest more capital in new ground leases.

Let's turn to our portfolio on Slide 11. Slide 11 gives metrics on three ground lease investments we originated during the quarter. We invested a total of $91 million during the quarter, at an average going in cap rate of 4.2%. These leases have an annualized fixed escalation of 2% over the life of the lease, and all three included CPI-based adjustments to provide periodic inflation protection. The deals also feature credit protection in line with our target, with a weighted average ground rent to property net operating income coverage of 4.4 times, and a weighted average basis as a percentage of combined property values of 33.5%.

Slide 12 highlights some of the features of the deals we closed during the quarter. The Onyx transaction is a 14-story 266-unit multi-family project in Washington, D.C. In this transaction our customer utilized the SAFE Ground Lease combined with agency financing to create a highly efficient capital solution that allowed them to submit the winning bid for the property. We are very pleased with this transaction, not only because it represents a solid investment for SAFE but also because it has opened the doors to the universe of agency-funded multi-family assets. Since closing this investment, we have received many reverse inquiries from other multi-family investors about how a SAFE Ground Lease structure can be potentially utilized for their benefit.

In February we also closed two other ground leases with a repeat customer, who also recognized the benefits of SAFE custom-tailored ground leases. This customer was able to successfully recapitalize Regency Lakeview, a 27-acre office campus located in Cary, North Carolina, as well as acquire Pershing Point, a seven-story office building located in midtown Atlanta, Georgia. These SAFE Ground Leases provide a low-cost long-duration solution to unlock value and achieve better returns for this customer at both of these properties.

Over all, the SAFE Ground Lease is designed to help our customers unlock value and maximize their return. This is why we have experienced strong repeat business. We've seen that once we overcome the initial education process and our clients understand the power of the SAFE Ground Lease, they are excited to bring us more opportunities.

On Slides 13 and 14, you can see some details on the diversification overall composition of our portfolio.

On Slide 15, we provide key metrics about our portfolio that we believe sets our brand of ground leases apart from other investment opportunities in terms of safety and relative value.

Just a few things that I would like to highlight. Our annualized cash rent, including percentage rent, is $27.4 million or a 4.7% current return on our basis. Our leases all have some form of rent escalators in them. Of the ones which have fixed rent bumps, the weighted average annualized bump is 1.7%. This excludes any leases whose escalators are solely based on percentage rent or CPI.

On the bottom part of this slide, I'd like to highlight that the annual cash flow of the properties sitting on top of our land covers our annual cash rents by 4.7 times, and our cost basis represents 33% of combined property value.

Moving to Slide 16, which presents our pipeline. Presently, we have $472 million of deals in our pipeline, comprised of $391 million of transactions, for which we are negotiating term sheets with our client, and $81 million of deals with signed LOIs. Of note, we narrowed our pipeline to two categories this quarter from the three previously discussed. We eliminated the category of in review, in order to focus the pipeline disclosure to just deals that are further along in the funnel. Note that the multi-family opportunity represents approximately half of our pipeline right now.

Slide 17 provides an update on our Value Bank. Our Value Bank grew 21% during the first quarter to $1.2 billion or $66 per share from $54 at year end. Recall, at the expiration of a ground lease, the building and all improvements revert back to SAFE. Since our initial investment was only the cost of the ground, the value of the building less our historical purchase price of the land is what we refer to as Value Bank. CBRE provides appraisals on all of our properties, and reappraises every asset annually.

In effect, Value Bank tracks the embedded capital appreciation potential at lease maturity, and it will grow with every ground lease we acquire.

On to Slide 19, let me discuss debt and leverage. Our debt is relatively straightforward: $227 million of fixed rate debt due in 2027, secured by our initial $340 million portfolio, and $71 million of asset-specific debt against our Hollywood investment. In addition, we have a $300 million revolver, of which $10 million was drawn at the end of the quarter. We continue to be conservatively leveraged at 0.9 times debt to equity, below our 2 times target, and our debt represents 17.3 of combined property value below our 25% target.

Finally, just a word on Slide 20. To mitigate the impact of interest rate fluctuation, we have put in place interest rate hedges for all of our ground leases that are not yet financed, or that are financed with floating rate debt. These hedges, which represent shorter-term hedges through October 2020 and longer-term forward starting hedges through October 2030, give us 12.5 years of protection.

In sum, this was a strong quarter for the Company, and the combination of customer response to our ground leases, compounded by how the pipeline is shaping up, makes us very optimistic about the future.

With that, I will turn it back to Jay.

Jay Sugarman:

Thanks, Andy.

I think it's fair to say we don't believe our share price comes close to reflecting the potential of the Company yet.

The two main components of value, the ultra-safe long duration growing rent streams we receive and the future potential for capital gains that we track via the Value Bank, should both generate significant value for Shareholders. We continue to work on ways to highlight and capture the true value of both components.

As our business grows and as we continue finding ways to demonstrate the size of this opportunity, we believe the market will reward our innovative approach to the real estate market, and we're focused on making that happen as soon as possible.

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

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 will pause just a moment to assemble the roster.

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

Collin Mings:

Hey, good morning.

Jay Sugarman:

Morning.

Collin Mings:

First question from me, just, in February you guys indicated your goal was to get to roughly a billion dollars of assets by year end. Is that still the goal, or has that come down a little bit, just given where things stand here at the end of April?

Jay Sugarman:

That's still the goal.

Collin Mings:

Okay. I guess maybe along those lines, maybe just expand a little bit more with the $81 million of deals under LOI, how close are those ones that you would expect here to close in the second quarter still, are you thinking it could drift a little bit to later in the year, and then just specifically when thinking about that bucket, maybe just put a little bit more color around that because I believe that slide depicts kind of the pipeline in aggregate.

Jay Sugarman:

I think we've got a number of deals in process that we feel good about. Always tricky on timing, given we're third into the quarter. We'd expect a good chunk of those to close, but right now we're still not exactly sure of the closing dates on a couple of them so I don't want to go too far in overstating that.

The dynamic we've seen, and this is probably the thing we've learned the most over the first eight months of our existence, is, we're making a lot of progress, because the logic of what we're doing is so compelling to owners. They understand that splitting the building, where the talents they bring to the table can earn very high returns, away from the much lower-risk but also lower-return piece of land, is definitely a smart trade for them. What we're finding is that first meeting where we sit with a deal person, an owner of real estate, we make that progress.

There's a whole 'nother chain of people behind that, that we also need to really share with them how we're reinventing the business, why it's different than the historical ground lease business I think a lot of people think about when they hear this. So we've spent a lot of time trying to figure out how do we get past that first meeting, to the partners, the lieutenants, the lawyers, the mortgage brokers, all parties to transactions that I think, on first blush, are looking at ground leases in the way historically they've been used, which is really a value-destroying proposition for owners. They have to really see the merits of what we're talking about, which is a value-creating ground lease structure. I think, as Andy said, we've had a lot of repeat customers, which tells us, if we can touch all those parts of the puzzle, we're going to get a lot of business in the future but that lead-up time, that four or five meetings we have to have with all the parties involved to help explain that we are fundamentally reinventing this business, it has nothing to do with the old-fashioned ground lease business that they're probably used to, that's taking a little bit of time, so.

Again, we feel pretty optimistic that the more we do the more we'll be able to do, but getting through those first couple of points of resistance is taking quite a bit of time and effort on our part.

Collin Mings:

Okay. That's fair. I guess, switching back to just the Value Bank, the increase, obviously a big jump in that relative to year end, was that just reflecting kind of the deals completed in 1Q, or was there any other kind of moving pieces that drove that, or was it just, again, just largely reflecting the overall combined property value stepping up pretty big?

Jay Sugarman:

We like to split Value Bank into two pieces: these quantum jumps that happen each time we add a deal, that creates a quantum jump, and then we have the organic growth which is the underlying property values increasing. This quarter, because again we're still quite new and we haven't gone through a full cycle of reevaluation, it's almost all that quantum jump. We haven't really added in the organic growth that's taking place in the portfolio.

Collin Mings:

Okay. Last one from me and I'll turn it over. Just, Jay, maybe if you could comment on the search for a permanent CFO? I know obviously Andy's fulfilling that on an interim basis but maybe just talk about that, I recognize it's obviously relevant to both Safety and iStar but just any thoughts there?

Jay Sugarman:

As we suspected, Andy is doing an incredible job for us right out of the box, so we've got the luxury of having somebody who's really wonderful at it. Our first goal is really to build this business, and we'll turn our attention to the other pieces of the puzzle throughout the rest of the year, but right now we'd tell you, it's all hands on board to really get this business out into the marketplace, and Andy's certainly helping us do that.

Collin Mings:

Appreciate the color. Thank you.

Operator:

Your next question comes from the line of Jason Massocca with Ladenburg Thalmann. Your line is open.

John Massocca:

It's John, but okay. Kind of the first question, is it fair to say that the—when you look at the portfolio, the stuff that is now called "in discussion" is the same as what was "in ongoing negotiation" in the prior presentation?

Jay Sugarman:

We're trying to find a metric that's really useful for you and for us. I think we have a lot of deal dialogue going on, as I said, we get through the front door pretty easily with the compelling logic of what we're presenting and the long history of what we have done in working with customers and owners of real estate to find ways to help them do their business better. That can be a very productive meeting and we'll leave that meeting with a handshake that let's go work on some stuff together.

As we sort of tailor this pipeline and try to understand why things are happening and why things aren't happening, again, we think there is several layers that we have to win to really get a transaction all the way from that initial very compelling first meeting to a transaction. We think the LOIs obviously have made it through that path. But the "in discussion" I think is really our deal team's view of something where they go look, not only is the idea make sense and really does unlock value, but we also have buy-in from some key decision makers, and there seems to be a momentum to try to get a deal done.

The wider funnel, the "hey, we've had a good meeting", we're not going to highlight as much, because we still have a lot of work to move those into these two baskets, so, I think better for us at this point, and for you, frankly, to see the deals that we think we have traction on. Not all of them will happen. But we're making a deeper inroads into an organization or an owner's thought process where they're saying, yes, I want to do this. Still I think there's a lot of territory out there we haven't even touched, but it doesn't really make sense to tell you we're working on tons and tons of deals that frankly we've had one really good conversation with a decision maker, we've found that does not lead to a guaranteed deal. We're being a little more cautious about how we show you and how we think about ourselves, how this funnel really works.

John Massocca:

Okay. Those two categories are kind of comparable. Right? If so …

Jay Sugarman:

Yes.

John Massocca:

… what kind of cause the—it's pretty big growth, right, it's almost $300 million. Is a lot of that just reverse inquiries from multi-family, per the Onyx deal, or is there something else maybe that drove the growth in that category?

Jay Sugarman:

Yes, I think—look, we continue to believe there's sort of the flow business in the multi-family space and some of the other property types and then there's some of these larger transactions in the gateway cities, and those are the ones that come in and out that we have a harder time sort of knowing whether they're going to happen. Obviously a ton of competition in those markets; we've seen finance markets get very very aggressive in certain circumstances, and we're being pretty disciplined about where we want to go.

Right now, I think the mix of the two feels pretty good, but I wouldn't read too much into the absolute dollar number, I'd look more at the number of deals, because that for us is really a sense of how fast we're getting traction with our customer base and with new customers that we're reaching out to.

John Massocca:

Understood; and then, within the current pipeline, how much, kind of roughly speaking, of those are existing ground leases and how many of those, kind of percentage-wise, are ground leases you would create?

Jay Sugarman:

The majority are things we're creating, but, again, don't look so much at the dollar value, because some of the things we're working on will skew that, but just in terms of the number of deals we're working on, the majority are things either we are creating directly or we are creating in conjunction with an acquisition or a new transaction.

John Massocca:

Then, kind of specifically on the three transactions you closed in the quarter, what was the term on those? Lease term?

Jay Sugarman:

Ninety-nine.

John Massocca:

On all of them?

Jay Sugarman:

All three, yes.

John Massocca:

That's it for me. Thank you guys very much.

Jay Sugarman:

Thank you.

Operator:

Your next question comes from the line of Anthony Pallone (phon) with JP Morgan. Your line is open.

Anthony Pallone:

Thank you. Can you talk about just yields and sensitivity around yields as you talk to folks in the market, given just what's happened in interest rates in this last month or so?

Jay Sugarman:

I think people are always testing their alternatives, and as LIBOR continues to move up I think the idea of longer-term no-maturity capital is becoming increasingly attractive. I think the market understands that there's likely significant future moves in LIBOR coming, so the idea that today's rate is tomorrow's rate I don't think holds any more, and people are looking out over the curve and saying, over the next two years, what are my real cost of funds and what risks am I taking? I think they like the idea of locking in at least a portion of their capital structure on a more stable basis, and not having a refi risk in the future where they really can't predict where interest rates are going to be. We think right now people are starting to rethink their assumptions given where at least the Fed has told us they are going to take short-term rates and any floating-rate debt right now has a material increase in cost built into it.

Anthony Pallone:

Okay, and then, so the deals in the quarter were at about a 4.2% but they were all basically office deals. If we look at your pipeline and you've got a decent amount of apartments in the mix, do you think those deals could dip back below 4%, or do you think those could stay above 4% as we look ahead?

Jay Sugarman:

I'd say the highest-quality deals in the best markets are kind of in that 4% range right now, and it can get wider than that for things that have some less positive dynamics in terms of the locations, but it's going to be hard to get much below 4% right now unless something changes.

Anthony Pallone:

Okay; and then, just a one-off on the quarter. The other income bounced up. What was in there and is that going to stay at that level?

Jay Sugarman:

You're talking about percentage rent, or a different line item?

Anthony Pallone:

No, the actual like other income number there is sort of 499.

Andrew Richardson:

Four hundred, just over $400,000?

Anthony Pallone:

Yes.

Andrew Richardson:

I think that's interest income on our cash. More efficiently than holding the cash.

Anthony Pallone:

Okay. Got it. Thank you.

Operator:

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

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

Joshua Dennerlein:

Hey, good morning, guys. All that land under the Lipstick building in New York City was for sale. Is that something you're looking at, or would consider looking at purchasing?

Jay Sugarman:

Unfortunately, that is a classic old-fashioned ground lease, probably represents 90% of the value of the overall building, so it's not really a ground lease. It's really a very high in the capital structure, very low coverage piece of paper, so probably not something we would pursue, although inside of it, there's probably a very good modern new ground lease that we'd love to put on the building. But the one that exists today is not—doesn't really fit our goal.

Joshua Dennerlein:

Okay; and then, just kind of a follow-up, for the multi-family, how it's 56% of your pipeline, what do you think makes multi-family be more attractive to folks to put a ground lease under? Or is that just—you think you just got more traction with developers on that front?

Jay Sugarman:

A great question. There's two things, I think when we first started two years ago looking at this, there was a question mark of, is this just financial moment in time and, really, I think we've redirected a lot of folks to the idea. They are trying to make low teens, mid teens, high teens or higher returns on the things they do well, the leasing, the marketing, the design, construction, and ultimately the sale. That business should generate mid-teens returns.

The business that they shouldn't be in is trying to own very long-duration 4% instruments like a ground lease. We've seen the take-up really be less about this financial difference between their cost today and their cost tomorrow, as much as it is just psychologically a, "Yeah, I want to use my money most efficiently, my capital most efficiently, I want to make the highest returns for the skill set I have," and that actually works really well in multi-family. It's a competitive market, cap rates have been driven down where absolute returns are difficult to make unless you're really efficient as a buyer, as an owner, as a manager, and as a seller, and we think we've touched a nerve on a couple transactions in the pipeline where people are seeing very explicitly they can do their business better, make better returns, by not having to own this long-term piece of ground lease. That's one big component is just the psychological understanding of what they do really well, and what they can make the most returns on, is benefitted by what we do well.

Secondly, I'd say, and this goes to the point I made earlier is, because the agencies are relatively consistent in how they view the financing piece of the puzzle, we can move very quickly through that process. The idea that we have to convince sort of the "can you borrow on a leasehold at certain rates," is taken off the table. We've already done it, they've already seen it, the agencies have already blessed it, so it suddenly becomes a very straightforward opportunity for them to look at their alternatives of, "do I do a ground lease with a leasehold financing or do I do a straight de-financing?" More and more we're seeing people gravitate to the former and say, "it's a lot more efficient for my capital; it allows me to do what I do best and generate the maximum returns possible for my success," and lets us do what we do well at Safety Income & Growth, which is own these very long-duration ultra-safe ground positions.

I think that's one of the exciting things we've seen over the first six months here is just a mental shift from the old-fashioned ground lease, "Why would I ever do this," to, "Wow this actually makes more sense, generates higher returns, takes my refinancing risk on a big chunk of my capital off the table." In a lot of ways this is just superior and a smarter way for them to capitalize their deals. That's what we're really going to press on here as we go forward is finding more and more owners who see what we've already done and say, "Yeah, why aren't I doing that? Why isn't that a lot better way for me to invest in the things I do really well, which is leasing, managing, designing, constructing and selling?"

We think we haven't reached a tipping point, I don't want to go too far out, but I think more and more meetings we have, the more aggressive, we've been able to reach out to people and say, "Don't think about the old-fashioned ones, they really aren't what we're talking about. Let us walk you through how we're going to help you make more money, how one plus one equals more than two." That's starting to sink in. I think the fact that we can do it in multi-family should have a positive impact on owners of other property types.

Joshua Dennerlein:

Great. Thank you. I'll yield the floor.

Operator:

There are no further questions.

Jason Fooks:

Thank you, Jack, and thanks to everyone for joining us this morning. As a reminder we have our annual meeting of Shareholders coming up on May 9 at the Harvard Club of New York City at 9:00 a.m., and all shareholders are welcome to join us. Otherwise if you should have any additional question on today's earnings release please feel free to contact me directly.

Would you please give the conference call replay instructions once again?

Operator:

Certainly. Today's call will be available for replay from 1:00 p.m. Eastern standard time today to 11:59 p.m. Eastern standard time May 10, 2018. The number to contact is 855-859-2056, and the conference ID number is 5688969.

This concludes today's call. Thank you for your participation, you may now disconnect.