Blackstone

Mortgage Trust

Final Transcript

Blackstone Mortgage Trust, Inc.: 1Q 2019 Earnings Call

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SPEAKERS

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Michael Nash – Executive Chairman

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Katie Keenan – Executive Vice President, Investments

Weston Tucker – Head of Investor Relations

ANALYSTS

Douglas Harter - Credit Suisse

Rick Shane - JP Morgan

Steve Delaney - JMP Securities

Stephen Laws - Raymond James

Jade Rahmani – KBW

Ben Zucker - BTIG

Kylie Wong - Citi

Coordinator Good day, and welcome to the Blackstone Mortgage Trust First Quarter 2019 Investor Call. My name is Joanne, and I'm your event manager. [Operator Instructions] I would like to hand over to Weston Tucker, Presider of Investor Relations. Please proceed.

W. Tucker Thanks, Joanne. Good morning, and welcome to Blackstone Mortgage Trust's first quarter conference call. I'm joined today by Mike Nash, Executive Chairman; Steve Plavin, President and CEO; Tony Marone, Chief Financial Officer; Doug Armer, Executive Vice President, Capital Markets; and Katie Keenan, Executive Vice President, Investments.

Last night we filed our 10-Q and issued a press release with the presentation of our results, which are available on our website and have been filed with the SEC.

I'd like to remind everyone that today's call may include forward-looking statements, which are uncertain and outside of the company's control. Actual results may differ materially. For a discussion of some of the risks that could affect results, please see the Risk Factor section of our most recent 10-K.

We do not undertake any duty to update forward-looking statements, and we will also refer to certain non-GAAP measures on this call. For reconciliations, you should refer to the press release and our 10-Q.

So, a quick recap of our results. We reported GAAP net income per share of $0.62 for the first quarter, while Core Earnings were $0.71 per share. Last week we paid a dividend of $0.62 with respect to the first quarter. If you have any questions following today's call, please let me know.

S. Plavin Thanks, Weston. Good morning, everyone. Our 2018 portfolio growth provided very strong earnings momentum going into 2019. We started the year with our balance sheet heavily invested in loans, which provided robust earnings power and helped drive our $0.71 of Core Earnings for the quarter.

Our asset base remained well-positioned throughout the quarter. The capital markets volatility that started in December and carried over to early 1Q slowed transaction activity and limited lending opportunities in the market. But we still grew our loan portfolio, with $700 million of originations. Our performance this quarter further demonstrates the strength and stability of our floating rate senior mortgage lending business model, with the large portfolio that we've established.

The largest loan closed in the first quarter was NEC, a £240 million mortgage participation secured by the UK market leading convention and exposition center, and other complementary assets located in Birmingham and owned by a Blackstone equity fund. The 59% of cost loan is in participation with Starwood Property Trust. The NEC business caters to a primarily domestic client base, and has proven resilient over time, with very limited competition.

During the quarter we also originated low LTV transitional acquisition loans for office buildings in Canada and London, a New York City hotel, and apartments in San Antonio. We have another $875 million of loans either closed post quarter-end or with agreed terms and in the closing process.

Another origination I would like to specifically highlight is the upsize of an existing loan in California, because it exemplifies several of the virtues of BXMT, including our transitional loan origination strategy, active asset management, and the advantages of Blackstone management. The $195 million, 55% of cost loan was made by a west coast team in 2018 to a major institutional sponsor and repeat client secured by a vacant historic department store in downtown Oakland undergoing a conversion to creative office.

The market knowledge and investment conviction that comes from the Blackstone real estate ownership footprint were major advantages in this origination. As an owner of San Francisco office buildings in our equity funds, we agreed with the sponsor thesis that escalating requirements for space from tech tenants combined with virtually no large block availability in San Francisco, would generate strong leasing demand for this high quality, but pioneering Oakland asset.

This viewpoint was critical in our underwriting and successful pursuit of the loan, and five months post loan closing, our credit analysis was validated. A lease was signed for 100% of the office space with a major tech tenant on terms that exceeded our underwriting. With the lease in place, the property could attract a more efficiently priced bank or insurance company loan, but we worked to maintain the loan, and reached agreement on a modification, including an upsize to the loan amount, a reduction in rate, and an extension of call protection. Because of the low risk profile of the leased asset, our credit facility provider agreed to reduce its rate to us, so we were able to maintain an attractive ROI and a larger, more stable loan.

Improving credit profile was a theme across our portfolio in 1Q. During the quarter we upgraded nine loans, primarily from a risk rating of three, where most loans are originated, to a risk rating of two, without any downgrades. The upgrades were driven by improved leasing and cash flow, as the collateral properties transitioned to more stabilized operating performance.

On the capital markets front, we continue to optimize our debt financing. Yesterday we closed a new efficiently priced and innovatively structured $500 million corporate term loan that significantly adds to our firepower with very little J-curve.

Along with our CLO, CMBS, syndications in corporate credit facilities, we have a powerful array of debt execution options to maximize our efficiency. We also continued to tap our ATM during the quarter, raising equity capital at an average of 1.27 times our book value.

We built a market-leading pure play, global senior mortgage lending business with a $16 billion portfolio, over $4 billion of equity market cap, and a highly efficient match funded liability structure. Our focus remains on dividend quality and stability, and continuing to introduce investors to BXMT, and the opportunity to invest in this Blackstone-sponsored company with its very compelling 7.2% dividend yield.

And with that, I'll turn it over to Tony.

T. Marone Thank you Steve; and good morning everyone.

This quarter demonstrated the earnings power of the BXMT platform, with positive results in all of our key metrics. We generated GAAP net income of $0.62 cents per share and Core Earnings of $0.71 cents, both up from the fourth quarter. Our quarterly earnings were almost entirely “run-rate” with minimal contribution from one-time items, and our performance was really driven by the strong loan originations volume coming into 2019 and nearly full deployment of our balance sheet capital, which we have been efficiently raising via “just in time” equity from our ATM program. During the first quarter, we raised $66 million dollars under the ATM program at an average price of 1.27 times book value, driving an increase in our book value to $27.32 cents per share. Our $0.71 cents of Core Earnings is 115% of our consistent, $0.62 cent dividend, a further indication of the strength and stability of our platform.

During the quarter we originated $699 million dollars of new or upsized loans, and funded $806 million dollars under these and existing commitments. We saw limited repayment activity in our loan portfolio this quarter, at only $508 million dollars, which brought our total loan portfolio over $16 billion dollars for the first time, up nearly $4 billion dollars from this time last year. Our portfolio continues to exhibit strong credit characteristics, with 100% performance, an origination LTV of 62%, and risk rating of 2.7 (on our scale of 1-5), all consistent with prior quarters.

In addition to the equity issuance under our ATM program that Steve and I mentioned earlier, we financed our portfolio growth primarily through our balance sheet credit facilities, which continue to provide us with market-differentiated financing for our assets. We continue to manage our cost of capital and negotiate market-leading terms for these facilities, which had an average cost of only LIBOR + 1.90% as of quarter-end, and remain insulated from any capital markets based mark-to-market provisions. During the quarter, we also closed the $936 million dollar non-recourse financing of The Spiral, the Hudson Yards development loan we highlighted last year. This financing is effectively a syndication of a senior interest in our loan, with our lenders committed to fund their share of future advances under the loan, representing 30% of total unfunded loan commitments across our portfolio.

We close the quarter with a debt to equity ratio of only 2.8 times, unchanged from prior quarter, and liquidity of $487 million dollars. Post quarter-end, our liquidity grew significantly following the closing of our initial $500 million dollar term loan, which Steve mentioned earlier. This loan carries an attractive interest rate of LIBOR + 2.50%, and priced at 99.75% of par, with a covenant package in-line with that of our existing credit facilities. The loan has a seven-year term, with six-months of prepayment protection and limited amortization requirements, providing an additional source of flexible capital for our business.

In closing, we have previously highlighted the floating-rate focus of BXMT's portfolio, which was 96% floating-rate as of quarter-end, and how this positions us to capture incremental earnings as rates rise. In addition to that important benefit, we would also like to highlight that while higher rates will directly increase our earnings, we are partially protected from declining revenues should rates decrease, with LIBOR floors baked into the structure of many of our loans, which we believe is another example of the stability of the BXMT business model. Thank you for your support, and with that I will ask the operator to open the call to questions.

Coordinator [Operator Instructions]. Our first question will come from the line of Douglas Harter of Credit Suisse. Please go ahead.

D. Harter You mentioned that your earnings were mostly run rate this quarter, can you talk about how you're thinking about the dividend, given that 115% coverage and the high level of run rate earnings?

S. Plavin Thanks for the question. As I mentioned in my script, we're really focused on the quality of the dividend, and we really like the coverage and the fact that we're able to retain earnings. The retained earnings have been beneficial adding to book value, and you've seen a steady progression in our book value per share over time.

We'll continue to evaluate the dividend, and obviously we're proud of the strong coverage, but right now we like $0.62. Again, we'll continue to evaluate it quarter by quarter, but what we're trying to do now is get investors to appreciate the $0.62, how well it's covered, and have the multiple and the dividend yield reflect that.

D. Harter I appreciate that. When you're thinking about the new loan that you guys just closed, how should we think about your willingness to lever that capital and the impact on leverage for the company as a whole going forward?

D. Armer I think it's worth saying at the outset that the term loan is really a great deal for BXMT. It's floating rate, it's flexible capital, it's very efficiently priced, and it will allow us to maintain moderate balance sheet leverage as we continue to grow our capital base.

I think of it as providing very efficiently priced working capital for our business. As we deploy that capital and continue to grow the balance sheet, I'd expect leverage to increase somewhat from where it is today. We are very well deployed at 3/31 with a 2.8 times debt to equity ratio. New capital in the capital structure in the form of debt would imply a slight increase to it, but a large part of that capital will be used as working capital. So, I think the amount of leverage on our balance sheet will remain in the range that you've seen it in over the last several quarters, in that 2.5 to 3.5 range ultimately in terms of debt to equity.

Operator Our next question comes from the line of Rick Shane of JPMC. Please go ahead.

R. Shane A couple of things, as we look to the inflection point in rates, and again, I guess none of us really know which way we're going to go, but I appreciate the increased disclosure around lower rates. I'm curious about two things from a business impact. One, given relatively tight spreads, would we expect that repayments might actually slow a little bit as rates decline? The reason I ask that is, and the other part of this question is, could we expect spreads on originations to widen a little bit as you regain some pricing power versus LIBOR?

S. Plavin I certainly hope that's the case. I think a lot of the spread compression that we saw was as a result of increases in the index. When the index was low, spreads were historically wide, and now they've tightened a lot with LIBOR having increased. It's hard to say what will happen to spreads if rates do decline, but I think it's certainly a possibility that we could see spreads stabilize and potentially move wider.

R. Shane Got it. Again, this is a huge difference between what you do and what we do. We look at this on a spread basis, I know you guys do as well, but when you're really engaged in conversations with borrowers, is the conversation focused on spread, or is it really focused on all-in yield?

S. Plavin The conversation with us and our borrowers [includes] a lot of economic and non-economic elements that become part of the negotiation. I think it is all-in yield. The rate is the primary focus around economics, but there are origination fees and extension fees, and sometimes other fees, depending upon the nature of the loan. Rate floors are an important part of the negotiation as well.

So, all those factors, economic and the non-economic factors around loan structure and other important elements as it relates to how our loan matches the business plan and how we look compared to our competitors, they all come into play. But ultimately, we're seeing most of the competition around economics, and so I think, and we've seen a little bit of rate compression as a result, but with our repeat clients and the experience they've had with us, a lot of times we're able to win on the total package that we're able to deliver to the client, not just loan rate.

Operator Your next question is from the line of Steve Delaney of JMP Securities. Please go ahead.

S. Delaney Steve, I guess the best place to start and the thing that caught our eye right away when we saw the release, was the origination volume. Just based on how significant your originations have been over the last couple of years, so $700 million compared to about a $2.5 billion average last year, can you just comment—obviously the last year was chaotic, but can you roughly in your mind weigh the lighter number in originations, how much is just the timing lag as clients tried to react to the market, and how much may reflect some greater selectivity on your part as your portfolio tends to reach optimal leverage, as was commented on? Thank you.

S. Plavin I think all of those factors in terms of our originations in the first quarter come into play. We are highly selective on a credit basis in our new originations.

The biggest factor was really the volatility. And what happens in periods of volatility is that buyers and sellers, and again buyers are the primary driver of demand for our loans, they tend to go the sidelines in periods of volatility waiting for the markets to resettle. And so although the period of volatility was relatively short, it ended relatively early in 1Q, but it takes another 60 or 90 days for regular way transaction activity to resume, for deals to start closing after their regular way gestation period.

We are seeing a pickup in pipeline activity now relative to where it was earlier in the year. Again, I think we feel very good about our origination pace, and if you look you can see that repayments in the first quarter were still below our originations. So, it's a little bit of a natural hedge in that when the origination environment isn't as potent we see fewer repayments. The fact that we were able to grow our portfolio in 1Q was really positive, and we remain very well positioned at the end of the quarter, just like we were at the beginning of the quarter, in terms of earnings power on a go forward basis.

S. Delaney That's helpful. Thank you for clarifying that. If we look out a year or two years out, the on balance sheet portfolio today is $14.5 billion, and I think I heard a combination of $487 million liquidity and $500 million term loan. Is it reasonable to think that, and let's just say market conditions, real estate conditions, lending, profitability, etc., are stable, is it reasonable for us to expect some portfolio growth, but maybe not at the pace seen over, say, the last two or three years? Can you give some color on where the portfolio may trend over the next year or two? That will take care of me. Thanks.

S. Plavin Sure. I expect over an extended period of time that we'll continue to grow the portfolio. It can vary from quarter to quarter, and a little bit of what you saw in 1Q was the fact that we had a lot of 4Q deals that just closed in December, some of which we thought might roll over into 1Q. So, I think our 4Q was extraordinary and that did impact a little bit the spillover in terms of 1Q. We had a little bit less than we otherwise would because we closed over 20 loans in the fourth quarter.

So, I still think that we have a great product. We have a great client base. We continue to see large opportunities to originate and to grow the portfolio. That is my expectation going forward. I'm not sure that we'll match 2018, I think that was an extraordinary year, but I think you'll see a steady trend with us of strong originations.

Operator Our next question comes from the line of Steven Laws from Raymond James. Please go ahead.

S. Laws I guess first looking at the financing side, from looking at the Q it looks like the asset specific financing declined quite a bit. I believe, from looking back historically, a good bit of that was a loan on the European portfolio, but can you maybe talk about what drove the asset specific financing from up to $1.5 billion down to $100 million, please?

D. Armer That was largely the result of a re-categorization of some of those financing. A big piece of what we had previously categorized as asset specific financing was the GE portfolio acquisition financing from Wells Fargo. That portfolio has really been fully turned over and it is, in essence, cross-collateralized and part of our regular way credit facility with Wells Fargo in effect. So, as that situation evolved, we re-categorized some of that financing. So the actual borrowings outstanding aren't reduced, we're re-defining how we categorize those in the Q.

S. Laws That's helpful, Doug. The next question, Doug, if you could comment on CECL. Your credit performance has been exceptional. You mentioned during the prepared remarks that there were some upgrades this quarter in loan performance, but how do you expect

CECL to impact the results? How will you think about reporting a book value number or some adjusted number? Can you comment on that, I guess as we're about six months away.

T. Marone With respect to CECL, I'd say a couple of things. One is, we don't have any specific numbers we can share yet. We're still going through our analysis. We do expect that we will have to book some reserve, everyone is effectively required to. We think given the credit quality of our portfolio that that reserve will be perhaps on the lower end of the range, but that remains to be concluded.

As it relates to its impact on the financials, the day one adoption is a balance sheet only, so it doesn't go through earnings. It reduces your loan portfolio and your equity, and then it changes in that reserve as loans come on or off, go through the income statement in the future. Our expectation is that there will be an adjustment for Core Earnings because this is not a realized expense. So, from a GAAP earnings perspective you'll see some noise, but Core Earnings will remain consistent with what we've seen.

You asked specifically about book value, I think we have a decision to make if we are going to adjust our book value. I think we'll have to wait and see how the final analysis comes out on that one.

Operator Your next question is from the line of Jade Rahmani from KBW. Please go ahead.

J. Rahmani On the NEC deal, I was wondering if you can give any further color. Is this a Starwood originated loan that you participated in? What drove pricing? What kind of approvals are necessary, since, as you mentioned, Blackstone owns the company?

K. Keenan This was a Starwood originated loan that we then had the opportunity to participate in 49% of, as Steve mentioned in his script. The asset itself is pretty attractive. This is a 59% loan to cost loan secured by the dominant exposition center business in the UK, which includes five very large conference facilities totaling over 2 million square feet, and a strong in place cash flow. The performance of the business has been quite stable, with good forward visibility. So, we like the business and we think our loan basis is very well protected.

As far as the rate, because the business is, in large part owned real estate, but also some operating business, then that overlaid with the geographic location and the Brexit considerations, that combined with the deal size we think impacted the general competitiveness of the loan and drove a little bit of a higher rate. But again, that rate was established by Starwood as part of their origination. Then, because of the deal size and affiliated nature, we do talk to our board about these types of deals and get their approval from our independent directors.

J. Rahmani Thanks very much. Is there a transitional element to the business plan? You mentioned strong in place cash flow.

K. Keenan The sponsor does intend to continue investing in the business, improving the facilities, and we expect to see some cash flow improvement from that. But again, this is a very stable business and the cash flows are already good, so it would be great to see continued improvement in performance. But even at current levels, because of our basis and the stability of the business and also the fact that most of the contracts in the business are three to five years in length. So there is good visibility as far as the next couple of years. Our protection as far as our loan is well-established, depending on the business plan.

J. Rahmani Thanks. Separately, Steve, I wanted to ask if you could comment on how prepayments are trending quarter-to-date. Should we expect a similar range that we've seen over the last few quarters, in the $500 million to $600 million range, or with a more liquid market should we anticipate an acceleration?

D. Armer We don't disclose forward-looking statements, particularly with regard to portfolio activity, other than the pipeline numbers that were in the script. So, we'll have to wait until next quarter's disclosures for detail on that.

J. Rahmani Lastly, I wanted to ask if you guys could share your thoughts on the co-working and flex office trend that we're seeing contributed an outside share of leasing growth. I think JLL cited a statistic of about 20% of total leasings were to co-working. What are your thoughts there, and also does BXMT have any WeWork exposure?

K. Keenan We are seeing WeWork and other co-working as an increasing force in the market; in terms of their leasing activity, they're certainly quite active. I think from our perspective, we generally think that a small co-working space can be additive in certain types of buildings as an amenity for tenants and also a source of potentially incubating new tenants that can grow in the building. But in our portfolio specifically we have very little exposure to WeWork and co-working in general. It's just not really a factor as far as the tenancy in our office buildings.

J. Rahmani And by order of magnitude, are you talking a couple percent, or less than that?

K. Keenan Yes, it's approximately 2.5%.

S. Plavin Jade, it certainly is a force in the market, and something that we're very mindful of when we look at recent take-up and also the impact of demand going forward. But for a lot of buildings it's positive. We're certainly mindful of our exposures and ultimately prefer tenants that have strong underlying credit, so sort of a traditional approach in terms of how we look for credit. But for us in our portfolio co-working, I think, has been positive.

J. Rahmani Are you seeing it change any capex assumptions on the part of existing owners, because they are dramatically improving property and making old buildings a lot more modern and full of amenities. Is that causing any changes in your capex assumptions?

S. Plavin Well, you're right in that the co-working tenants tend to get large amounts of TI, and they usually invest some of their own as well to improve their space and create whatever the environment is that they're trying to establish in a particular market. So, yes, it's usually beneficial, in that the space gets significantly improved, and as Katie mentioned, it can create a tenant amenity in the building. It just adds a different vibe. It gives tenants who are expanding or thinking about coming into the building a place to go. But they do tend to spend very heavily on their space.

W. Tucker Great. Thanks, Jade. Next question, please, Joanne.

Operator Your final question is from the line of Don Fandetti from Wells Fargo. Please go ahead.

D. Fandetti Steve, I was on the CIT call yesterday and they were talking about being a little more careful in commercial real estate, and it seems like we continue to hear that from banks. If I'm talking to an investor, what are your key points on why you guys would continue to grow pretty aggressively while the banks are pulling back? I guess they obviously have some regulatory hurdles, but outside of that. Then secondarily, what are your thoughts on real estate asset pricing, let's say office CBD, in general?

S. Plavin Thanks for your question, Don. We are really careful on credit. We have a great credit infrastructure here, given our ownership footprint, how well managed the company is and how information is shared across the platform. So we feel like we have a much better ability to assess real estate risk as a huge owner and investor across the globe and, frankly, an investor in properties just like the ones that we finance. So, we feel like we have better insight and a better ability to make assessments on the margin than some of the banks do. But we continue to be very cautious in our growth, and whatever we do from a credit standpoint does reflect an investment committee process, and an analytical model that's highly focused on risk and I think exercises great caution.

The second part of your question about office building pricing, I think we're still seeing strong pricing for major market assets in markets where there's real growth. So, the coasts are still very strong. We like the innovation cities where there's dynamic sources of demand, where you've seen tech take up and biotech along with the traditional office uses. So, we're seeing positive fundamentals still in those markets and a lot of demand for those properties, and I think the pricing has held.

The secondary markets where the tenant demand is less robust and there are fewer new economy tenants, those markets are much more challenged. But we tend to not participate in those.

Operator Our next question comes from the line of Ben Zucker from BTIG. Please go ahead.

B. Zucker Good morning, guys. Thanks for taking my questions. Most of what I had was asked and answered, so just real quickly, I think I missed in your prepared remarks, but what did you call out as your origination pipeline right now?

S. Plavin $875 million.

B. Zucker Great. Thanks. Then just one for me: given the change in the posture at the Fed and what we're looking at now, would you happen to know offhand what percent of your loan book does, in fact, have LIBOR floors in place?

D. Armer Let me answer that a little bit in a roundabout way. Our business is very well positioned in terms of rates. We have a lot more upside than downside in our floating rate business model, and that's because of precisely the point that you bring up, our loans do have LIBOR floors, which provide significant protection for our earnings in a lower LIBOR environment. More than you might think, because the floors themselves are levered in the same way that our loan book is levered, so there's a range of strike prices for the floors. Most of our loans do in fact have LIBOR floors, and the impact of those floors is levered and provides significant protection to us.

We don't disclose the precise percentages or range of strike prices, as that's ultimately a confidential and business sensitive matter with our borrowers. What we do disclose, and it's in our earnings release, is the impact of that given our overall capital structure and portfolio, and you can see that it provides very significant protection, particularly for big moves in rates. And we're obviously very well positioned in terms of benefiting from big moves in rates on the upside.

Operator Our final question comes from the line of Arren Cyganovich from Citi. Please go ahead.

K. Wong This is Kylie Wong dialing in for Arren today. Maybe if you could give an update on what you're seeing with international investment opportunities, and what are the risks and benefits of investing outside the U.S.? Are you still expecting it to remain at about 20% of the total portfolio?

S. Plavin Thanks for your question. We see great opportunity in markets outside the U.S., I think it's one of the advantages of BXMT, and like in the U.S., everywhere we're making loans, we also own real estate, so it's true in Europe, it's true in Australia, and it's true in Canada. So, we have the same platform benefits we have outside the U.S. that we have inside the U.S. Europe is about 20% of our portfolio. We are seeing a very attractive spread environment in

Europe. Europe hasn't had as much spread compression as has the U.S., so on a relative basis from a rate standpoint it's more attractive.

But the deal flow is a little bit more episodic there relative to the U.S., it's more regular way demand in the U.S., and so our ability to grow further in Europe is just a function of how much loan demand there will be. We've seen a pretty good pace in recent quarters, and we have some good opportunities in our pipeline as we look forward, so we're optimistic.

I can't tell you what the percentage will be, because that's a reflection of not only what we originate in Europe, but also what we originate elsewhere. But I expect our global originations, our originations outside the U.S., to continue to be a very meaningful part of the overall BXMT loan portfolio as we go forward.

Operator I'd like to turn the call back to Weston Tucker for final remarks.

W. Tucker Thanks, everyone, for joining us this morning. And please let me know if you have any follow-up questions.

Operator Thank you, everyone, for joining us this morning. That concludes your conference call today everyone, you may now disconnect. Thank you very much for joining today.