Blackstone

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Blackstone Mortgage Trust, Inc.: 2Q 2017 Earnings Call

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SPEAKERS

Michael Nash – Executive Chairman

Stephen D. Plavin – Chief Executive Officer

Douglas N. Armer – Head of Capital Markets

Anthony F. Marone – Chief Financial Officer

Weston Tucker – Head of Investor Relations

ANALYSTS

Jessica Ribner – FBR

Doug Harter – Credit Suisse

Steve Delaney – JMP Securities

Jade Rahmani – KBW

Rick Shane – JPMorgan

George Bahamondes – Deutsche Bank

Coordinator Good day ladies and gentlemen and welcome to the Blackstone Mortgage Trust's Second Quarter 2017 Conference Call. My name is Tracy and I will be your operator for today. At this time, all participants are in a listen-only mode, and later we will conduct a Q&A session. (Operator Instructions) At this time I would like to turn the conference over to your host for today Mr. Weston Tucker, Head of Investor Relations. Please proceed.

W. Tucker Thanks, Tracy. Good morning and welcome to Blackstone Mortgage Trust's Second Quarter Conference Call. I'm joined today by Mike Nash, Executive Chairman; Steve Plavin, President and CEO; Tony Marone, Chief Financial Officer, and Doug Armer, Head of Capital Markets.

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

We will also refer to certain non-GAAP measures on this call and for reconciliations, you should refer to the press release and our 10-Q, both of which are posted on our website and have been filed with the SEC. This audio cast is copyrighted material of Blackstone Mortgage Trust and may not be duplicated without our consent.

So a quick recap of our results before I turn things over to Steve. We reported GAAP net income per share of $0.53 and Core Earnings per share of $0.60. Earlier this month we paid a dividend of $0.62 with respect to the second quarter and based on today's stock price, the dividend reflects an attractive yield of 8.0%. If you have any questions following today's call, please let me know. And with that, I'll turn things over to Steve.

S. Plavin Thanks Weston, and good morning everyone. With our second quarter performance, BXMT continued to demonstrate the strength of our loan origination and capital markets capabilities. BXMT originated $1.5 billion of loans in the quarter, taking total originations to $2.5 billion for the first half of the year, 44% ahead of the same time last year. And we have a healthy pipeline with another $875 million dollars of loans closed or in the closing process since quarter end.

The origination highlight of the quarter was the $889 million financing of a portfolio of office buildings in Rosslyn, Virginia, a Washington DC metro area submarket. The portfolio has strong sponsorship and a stable base of tenants with upside potential from additional leasing in an improving market. We utilized our ability to execute on larger deals as part of the Blackstone real estate platform as well as our strong relationship with the sponsors to successfully compete for this loan.

This origination was also driven by our capital markets execution. The majority of the properties were combined in a cross-collateralized portfolio loan. The large, pooled loan enabled us to capitalize on the strong demand for floating-rate, single borrower CMBS. We co-sponsored with Goldman Sachs a $500 million new CMBS issuance, our first time accessing this market for the balance sheet financing of a BXMT loan origination. The result of the CMBS transaction for BXMT was an efficiently priced, term- matched, non-recourse financing of the Rosslyn Portfolio loan.

In addition, a two building Rosslyn Portfolio with a long-term, major lease and very substantial future capital requirements was separated into an individual $136 million loan that we plan to syndicate – the most efficient senior execution for that loan.

We also originated three multifamily acquisition loans totaling $279 million during the quarter. Two are New York City deals and the third is in Southern California. We continue to like Class B multifamily in the major coastal markets and are excited about these new loans. We also closed on a $189 million refinancing of a 1.3 million square foot Chicago office building for one of our top clients. The low basis loan provides the sponsor with additional capital to complete the leasing of the property.

Our originations during the quarter, combined with a $146 million of advances under pre-existing commitments, led to $811 million of loan fundings net of repayments – our best net deployment quarter since the GE transaction. By comparison, the first quarter, even with its $1.0 billion of originations, had slightly net negative fundings because of repayments and construction loan originations not significantly funded at closing. The full impact of this quarter's positive fundings will be experienced in 3Q.

Because of our strong origination pace and attractive conditions in the convertible debt market, we raised $288 million of five-year unsecured, convertible notes during the quarter. The notes have a 4 and 3/8 percent coupon, with a conversion price of 1.35x book value per share.

Although the issuance negatively impacted our 2Q earnings, the increased leverage will ultimately enhance our ability to compete in a market where we have seen spreads compress for the high quality loans that we pursue. We do not compromise credit quality by reaching for yield, so improvement in our cost of capital from the convert is especially beneficial in the current environment.

As for new lending opportunities, we are seeing increased transaction activity in the market and a pick up in demand for floating-rate acquisition loans from our clients. Refinancing and construction loan volumes also continue to be robust. The market remains highly competitive overall, but the increased demand is very positive.

We continue to feel great about the credit quality of our portfolio. Our loans are 100% performing with an average origination LTV of 61%. Our focus on major markets and top sponsors is a strategy that we believe protects our shareholders. And as a reminder, our portfolio is now 92% floating rate, so we gain $0.23 of net interest income from a 1% increase in LIBOR.

During the quarter, three private equity platforms took their commercial mortgage lending vehicles public. These are not new players. All were lenders for a few years prior to their IPOs. We expect that their expansion of the public commercial mortgage REIT sector will be beneficial and lead to additional interest and overall investment. With the Blackstone backing of BXMT and our strong team, track record and high quality loan portfolio, I am confident that we will outperform. And with that, I will turn it over to Tony.

T. Marone Thank you Steve, and good morning everyone. This quarter we saw significant activity on both the left and right-hand sides of the balance sheet, with strong originations volume supported by a dynamic financing strategy.

As Steve mentioned, our 2Q originations totaled $1.5 billion, bringing year-to-date originations to $2.5 billion, up 44% from the first half of 2016. These loans are all floating-rate, senior loans, with an average origination LTV of 61%, and a focus on large projects in major markets with quality sponsors, consistent with our overall investment strategy. Our total loan portfolio of $10.6 billion, the largest since our 2Q 2015 acquisition of the GE portfolio, remains strong, with 100% performance, a stable risk rating and LTV profile, and 92% of our loans indexed to floating rates. This continued focus on net floating rate exposure positions us to realize significant benefits in the future as rates increase.

One note on construction loans in our portfolio. As we have mentioned on prior calls, loans with future funding commitments, and construction loans in particular, contribute to our earnings in the periods following their origination. These loans are funded over time as our borrowers complete their development or transition plans and request additional capital from us, effectively acting as organic portfolio growth over time. In 2Q, for example, we funded $146 million under previously originated loans, including $72 million under construction loans, roughly the equivalent of one additional new loan origination during the quarter.

On the right-hand side of the balance sheet, we had an active quarter on the capital markets front, issuing $288 million of convertible notes and closing our first balance sheet securitization financing. The convertible notes have a five-year term and initial conversion price of $35.67, with a coupon of 4 and 3/8, down from the 5 and 1/4 percent coupon of our 2013 convertible notes issuance. As with our existing convert, we view this as accretive balance sheet capital that can further enhance our regular way loan origination business. Our Rosslyn Portfolio securitization generated an incremental $475 million of stable, term-matched, financing for one of our newly originated loans at a coupon of only LIBOR plus 1.86%. The accounting for this transaction is all consolidated on our balance sheet, reflecting our origination of the total loan and a $475 million liability for the non-recourse notes sold into the market. Notwithstanding this gross presentation, the net impact on our stockholders' equity and net income reflect our economics as the subordinate investor in the securitization.

In addition to these two transactions, we continue to actively manage our mainline credit facilities, extending $1.5 billion of maturities during 2Q and closing the initial $450 million of credit facilities to finance loan originations in our new joint venture with Walker & Dunlop in July. We closed the quarter with a debt-to-equity ratio of only 2.5x, up slightly from 2.4x as of 3/31 following our convertible notes issuance during the quarter. Available borrowings under our revolving credit facilities comprise the majority of our $530 million of liquidity at quarter end, which amount is available to us to capitalize future investment activity.

Looking at second quarter operating results, we reported GAAP net income of $0.53 per share and generated Core Earnings of $0.60, both down $0.01 from the 1st quarter. This decline was due in part to the natural earnings drag as we deployed the capital raised in our May 5th convertible notes offering, as well as other quarterly timing and operational differences. We have maintained our 2Q dividend at $0.62

per share, reflecting our estimation of the consistent earnings power of our platform over the medium term as we continue to deploy capital under new and existing loans. Our book value of $26.38 is up $0.10 per share driven by appreciation in the Pound Sterling and Euro during the quarter. As we mentioned on previous calls, our book value is not generally subject to fluctuation over time, as our loan portfolio is held for long-term investment and we do not own any mark-to-market securities or other volatile assets.

In closing, we are pleased to conclude another strong quarter of originating senior floating-rate loans and our position in the current credit and rate environments. We are happy to add our first balance sheet securitization to our arsenal of financing strategies, and look forward to the continued growth of our lending platform.

Thank you for your support and with that I will ask the operator to open the call to questions.

Coordinator (Operator instructions) Your first question comes from the line of Jessica Levi-Ribner with FBR. Please proceed.

J. Ribner Good morning. Thanks for taking my questions. Steve, you mentioned that the full impact of this quarter's funding will be felt in the third quarter. Can you put some numbers around that in terms of how additive it could be to EPS?

D. Armer The $800 million or so of net fundings were basically originated in the middle of the second quarter. You have the average spreads, so you can run the numbers on what that earnings impact would be if you assume those outstandings for a full quarter as opposed to, essentially, half a quarter. That's roughly what we expect the impact to be, all else equal.

There are a couple of other dynamics. Obviously, LIBOR is going to be a little bit higher in the third quarter than it was in the second quarter, and we think deployment will increase during the third quarter as well. So, I think the wind is at our backs in terms of earnings. With regard to specific numbers, what we point to is the $0.62 dividend. We think that's supportable over the long term and earnings will be in and around that $0.62 dividend given our current model.

J. Ribner Okay. And then, can you also speak to the pipeline for Walker & Dunlop loans, for the loans that you're partnering with Walker & Dunlop on?

S. Plavin Sure. We reported that we did our initial closings under the Walker & Dunlop JV subsequent to quarter end. I think we're off to a great start in the program; we had $133 million worth of deals that closed right away. The program is in its evolutionary phase, but we're working great with Walker & Dunlop and we're seeing a lot of deal flow. We have a very active pipeline.

It will take a while for the portfolio to build because the marketing of the product really began in earnest when the deal was closed and our financing lines were put into place. But, we see a lot of opportunity, we think they're a great partner, and we love the multifamily space, so we're excited about what we're going to see going forward.

J. Ribner Okay. Thanks, that's it for me.

Coordinator Your next question comes from the line of Doug Harter with Credit Suisse. Please proceed.

D. Harter Thanks. Can you talk about your liquidity position as of June 30th following the strong growth in the quarter and the ability to fund the pipeline you talked about with that existing liquidity?

D. Armer Liquidity at quarter end was $530 million. That's down a little bit from last quarter given the strong net fundings we had during the period. I think it's adequate if you look at a maximum number, to fund approximately $1.9 billion of new originations, so it's in line with where we want to be, having a quarter or two of dry powder in reserve. That's after raising $288 million of capital in convertible notes, so we feel pretty good about our liquidity position and capital markets access overall with regard to growing the balance sheet going forward.

D. Harter Just with that $530 million, can you remind me of what you think of excess liquidity and how much excess liquidity you want to keep on hand?

D. Armer I would say it's about half of that, or $250 million which you could consider defensive liquidity and $250 million that you could consider working capital or offensive liquidity. It's a dynamic picture since we do experience repayments. We didn't experience tons of them during the second quarter, but we will during the second half. There are several different inputs into that number on the go-forward, but $250 million is probably what you could assume we reserve for purely defensive purposes.

D. Harter Thanks. Then thinking about the makeup of your capital structure going forward, how should we think about the mix of converts, common equity, any other structures that you might consider to make up that capital base?

D. Armer That's a great question. During the second quarter, we added some convertible debt to the capital structure. We also added some securitized debt to the capital structure. So, if you look at the leverage on our balance sheet in terms of recourse debt, it's actually flat although leverage and deployment was up during the quarter.

That kind of mix of financing techniques in order to optimize our capital structure is what we're going to continue to do going forward. It will involve a mix of our credit facilities with limited recourse, non-recourse securitized debt, convertible notes, potentially high-yield debt, and some corporate debt as well. Obviously, we didn't have a lot of outstanding on our revolver at quarter end, but that's another tool in the tool shed for us.

We're going to continue to target 3x recourse leverage and we're going to continue to optimize the cost of capital which I think is ultimately the most important factor for us, particularly in this market environment.

D. Harter Great. Thank you, Doug.

Coordinator Your next question comes from the line of Steve DeLaney with JMP. Please proceed.

S. Delaney Good morning. Certainly, the CMBS transaction was noteworthy and as Doug had mentioned, over the years, that was a market that you were following. I'm just curious, the loan, at least the $753 million piece was priced at about 340 basis points, a little bit lower than what you normally would do. So, the question is how critical, in terms of meeting your return hurdles, that financing which I think was an all-in around LIBOR plus 1.95%—was that the critical piece, that financing at that level, the critical piece that allowed you to competitively price and win that piece of business?

S. Plavin Hey Steve, good question. I think LIBOR plus 3.40% today, given where we see loan pricing, is in the range of where we're seeing the market. So, I think the profile of the deal and its pricing is very consistent with what we do. What was really the differentiating factor was just how large it was, and the fact that it was large enabled us to economically access the strength of the floating rate single-borrower CMBS market, something we wouldn't have been able to access on a smaller loan.

The key to getting this efficient financing was loan size. And, as you know, given our profile, we're always focused on trying to do things bigger and in top markets. So, it really felt good from a strategic standpoint: this loan and all of its qualities.

S. Delaney You mentioned some new players in the public arena and it seems to me that with your balance sheet and capital base you sort of have the ability, if you choose, to play in a much bigger ballpark. Now that you've had the success with the initial CMBS your name's out there in that market. Is it possible that we would see other large financings like this in the future, and, Steve, what would be a maximum? Is there an upper limit that you would commit in terms of a loan size to one transaction?

S. Plavin I wouldn't put an upper limit on what we would do. I think that we have the ability to do large size and the creativity to capitalize it. It is an important differentiator between us and some of the newer platforms which are smaller and can't compete on the larger deals that we pursue. So, we think it's an important competitive dynamic and something that really does distinguish us from some of the smaller platforms.

S. Delaney Okay. Thanks.

D. Armer Steve, I'll just add to that. I think you can expect to see us do more securitized financings in the CMBS or CLO market. As you mentioned, we've been following that market for a long time. We had a very successful execution and I think securitization will be the third leg in the stool in terms of our financing strategy on the go-forward.

S. Delaney I appreciate that, Doug. Tony, you mentioned construction loans and funding schedules. In your portfolio, you have 102 loans, $10.6 billion outstanding. How many construction loans are within that loan count and dollars outstanding, roughly?

S. Plavin Steve, I have that statistic. We have five construction loans. A couple of them were early construction loans where the construction is now complete. It's about 7% of our commitments and about 3% of our outstanding loan balance; the difference between those two being the unfunded portions of the loans that we intend to fund over time. We are seeing more opportunities to originate very attractive construction loans, so we have some more in the pipeline that you'll see in the coming quarters.

S. Delaney Thank you. I hate to ask one more but I want some clarity for model purposes. The Walker & Dunlop JV, 85/15 split, should we assume that's going to be, given that you're 85% that those loans are going to be consolidated into your portfolio and you'll simply show a minority interest to Walker & Dunlop? Is that the plan?

T. Marone That's exactly right. We consolidate, as you'll see in the third quarter financials, the venture. So, the loans will be in our loans, the financings will be in our financings, and then the 15% will come out of the bottom of the balance sheet and the bottom of the income statement. It will look exactly the same as the way we previously were presenting our CT legacy portfolio, with that bottom line adjustment.

S. Delaney Great. Thank you for the time and the comments.

Coordinator (Operator instructions) Your next question comes from the line of Jade Rahmani with KBW. Please proceed.

J. Rahmani Thanks. Can you comment on loan spreads in the quarter comparing this quarter's originations versus last quarter? How much of the decline in spread was the result of mix since you did more construction loans last quarter?

S. Plavin Good question. Let me answer that more in the trend that we're seeing in loan spreads. I think your observation is right and that the loan spreads we show in any one quarter will depend upon the composition of those loans. The construction loans that we do and the more deeply transitional loans will have higher spreads and the more stabilized, maybe multifamily, assets that we do will have lower spreads. So, I think that's what you see when you look at any one quarter. In general, spreads are trending tighter. We have seen a pickup in loan demand which is great, but spreads are tightening. We have a very competitive cost of capital, so I think we win relative to our competitors in this marketplace. But I think you'll see spreads growing a little bit tighter on the go-forward.

J. Rahmani And, can you quantify the magnitude of tightness that you've seen? Is it north of 50 basis points?

S. Plavin No. I would say, again, it varies. The construction loans really haven't tightened and the more stabilized product has tightened, I would say, 25 to 50 basis points this year.

J. Rahmani What do you think is driving that?

S. Plavin Good question. I think some new competition is driving that. There are some new private equity funds with senior lending strategies, some new separate accounts. Until recently, I had talked about this on prior calls, loan demand was off. Our fund sponsors, which comprise the majority of our client base, were less active buying properties, so there's just less demand for acquisition loans and the market had pushed a little bit more towards refinancings and construction loans, and refinancings, in particular, are very competitive.

We have seen in the last couple months a pickup in demand for acquisition loans, a little bit more acquisition activity on the part of the funds, and our pipeline reflects that. I think a lot of them are behind in their deployment dating back to the slowdown in the first quarter of last year, so it's nice to see the pickup in demand and the pickup in the volume of our pipeline.

J. Rahmani Do you anticipate a pickup in repayments as a result of the increased competition?

S. Plavin We work very hard to maintain the loans in our portfolio. Our asset management approach is one where we're very interactive with the borrowers and we'll right size the loans and reshape the loans to make sure that they match the borrower's objectives and business plans over time, which helps to mitigate the repayments.

In a more liquid market, like the one we're in now, we will get more repayments than in a market that's a little less liquid, but as you saw in the current quarter, we got way ahead of the repayments to the tune of about $800 million. I think that is an unusually high level, but we feel good about, on a longer-term basis, having our originations keep ahead of repayments in our portfolio.

J. Rahmani And, just touching on the credit performance, can you comment on how borrower business plans are generally coming in? Are there any trends you could point to with respect to either geography or property types that would explain either whether business plans are lagging or coming in line or ahead of expectations?

S. Plavin I think we've been pleased with the performance of business plans in our portfolio. We've stuck with the markets that we've been focused on: a lot of California, which is a very, very strong market, and New York, which is also a stable, and in many cases, a strong market. It's really helped us in terms of seeing business plans realized. A lot of the multifamily that we've done has been Class B multifamily as it's a really strong sector.

So, from a business plan standpoint we've been pleased. It's a little bit of a two-edged sword. As the business plans mature, the loans become more likely to be repaid, but again, we have a good and focused effort on maintaining our portfolio.

We're seeing a healthy progression through the business plans, what I would consider to be a normalized level of repayments, all things considered. I think you want to see repayments in our portfolio; it would be problematic if you weren't seeing any, and it's the nature of our business. The loans get repaid, we make new ones, and we feel great about the new ones. Hopefully, that will continue to be the case as we roll forward.

J. Rahmani Thanks very much for taking the questions.

Coordinator Your next question comes from the line of Rick Shane with JP Morgan. Please proceed.

R. Shane Thanks, guys, for taking my question. When we think about the puts and takes on a year-over-year basis, LIBOR's up, portfolio size is down, and presumably spreads are compressing, 2Q represents an inflection point where the portfolio has started to grow again. Should we see this as the inflection point in terms of earnings growth as well?

D. Armer I think you have a good point. I think 2Q is an inflection point. We did see material portfolio growth as we put the GE repayments more or less behind us last quarter. The portfolio is up 10% and deployment is coming closer in line with what we would consider a steady state, and as you point out, LIBOR is on the way up. Those are going to be big drivers of earnings and of earnings growth going forward.

R. Shane One question and one request. When we look at the LIBOR sensitivity chart, a year ago it was a little bit non-linear in that once you hit a certain level in LIBOR the sensitivity started to increase. If we look at that LIBOR sensitivity chart now, it's much more linear. Every 25 basis points has a more consistent impact on NII per share. Is that just a function of coming off the floors or is that a function of something on the right side of the balance sheet either in terms of funding or hedges?

D. Armer It's the former. The floors were primarily in the GE portfolio and were either on loans that have since repaid or are no longer in the money with LIBOR at 1.30% as opposed to close to 100 basis points less than that.

R. Shane Got it. This is more of a request. If I look back though the historical slides there was, I think, more disclosure each quarter around spreads on the floating rate portfolio both in terms of the overall portfolio you used to show what the LIBOR float was on the floating rate portfolio, spreads on the floating rate portfolio specifically, and you also would show each quarter what the spread was on originations.

Given controversy or concerns in the space about spread compression, can you continue to provide that? It would be really helpful so we can look at it on a year-over-year basis.

D. Armer Point taken. One thing we always pointed to was the stability in terms of the ROIs as we adjusted leverage and our cost of debt, and so as spreads have moved around a little bit, we didn't necessarily want to over emphasize the volatility in spreads, particularly as the loan mix changes and construction loans came into the picture. Each quarter's originations are pretty chunky, so we want to avoid reading too much into any one quarter's metrics, but, I think you have a very valid request and we'll certainly take that under consideration and figure out how to get that information clearly disclosed going forward.

R. Shane Terrific. Again, I realize that things like the large loan deals that you're doing come with tighter spreads, but it will just really be helpful to us as we think about our models and able to track the impact of that.

D. Armer Understood.

R. Shane Thanks, guys.

Coordinator Our final question comes from the line of George Bahamondes with Deutsche Bank. Please proceed.

G. Bahamondes Good morning. I'm sorry if I missed this, but did you disclose originations done post June 30th in your prepared remarks?

S. Plavin Yes. I referred to $875 million of loans that have either closed or are now in closing since quarter end.

G. Bahamondes Great.

S. Plavin The pipeline activity is good. I think that's a good number.

G. Bahamondes I know you guys usually disclose that on your call. I just missed it this time. I appreciate you guys answering that question. All my questions have been answered at this point.

S. Plavin Thanks, George.

Coordinator I will now like to turn the call back over to Weston Tucker for closing remarks.

Weston Thanks, everyone, for joining us this morning. If you have any follow-up questions, let me know.

Coordinator Ladies and gentlemen, that concludes today's conference. Thank you for your participation. You may now disconnect. Have a great day.