

Blackstone

Mortgage Trust

Final Transcript

Blackstone Mortgage Trust, Inc.: 2Q 2019 Earnings Call

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SPEAKERS

Stephen D. Plavin – President and Chief Executive Officer

Anthony F. Marone – Chief Financial Officer

Douglas N. Armer – Executive Vice President, Capital Markets

Katie Keenan – Executive Vice President, Investments

Weston Tucker – Head of Investor Relations

ANALYSTS

Douglas Harter – Credit Suisse

Don Fandetti – Wells Fargo

Rick Shane – JP Morgan

Steve Delaney – JMP Securities

Steven Laws – Raymond James

George Bahamondes – Deutsche Bank

Jade Rahmani – KBW

Coordinator Good day, and welcome to the Blackstone Mortgage Trust Second Quarter 2019 Investor Call. [Operator Instructions] I would like to advise all parties that this call is being recorded for replay purposes.

And now I would like to hand over to your host for today, Weston Tucker, Head of Investor Relations. Please proceed.

W. Tucker Good morning everyone, and welcome to Blackstone Mortgage Trust's second quarter conference call. I'm joined today by 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 a 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 Factors 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.

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So, a quick recap of our results. We reported GAAP net income per share of \$0.59 for the second quarter, while Core Earnings were \$0.68 per share. Last week, we paid a dividend of \$0.62 with respect to the second quarter. If you have any questions following today's call, please let me know. And with that, I'll now turn things over to Steve.

S. Plavin

Thanks Weston and good morning, everyone.

Our second quarter results again reflect the earnings power of the high-quality senior loan portfolio that we've built. Our Core Earnings of \$0.68 generated 110% coverage of our dividend that yields an attractive 7% of the current share price.

On the call in April, we announced the Q2 pipeline of \$875 million. As the quarter progressed, the hangover from the Q4 volatility that slowed originations at the start of the year abated. Our originations accelerated and we ended up closing \$1.3 billion of loans in the quarter.

We continue to see an uptick in large loan opportunities and our forward pipeline has grown. We now have another \$3 billion of loans that closed post quarter-end or are in the closing process. So, we are well-positioned for a strong second half.

Our originations in Q2 exemplify our global capability. Our largest loan this quarter was a €192 million acquisition financing for an office portfolio in a very tight Berlin submarket. In the U.S., we made a \$210 million construction loan for a preleased asset in West L.A., another very strong market. We also closed loans secured by apartments in Arizona, a hotel in California, and office buildings in Florida and the U.K.

In addition, we closed six more loans totaling \$165 million in our partnership with Walker & Dunlop. The growth in our pipeline comprised of a broad international mix of larger loans, capitalizing

on the power of the Blackstone global real estate franchise and the strong relationships we've established.

Blackstone generally owns real estate everywhere BXMT lends and maintains geographic and sector focused teams of investment and asset management professionals that are hugely beneficial in the sourcing, underwriting, and asset management of our loans.

As we saw our pipeline expand, and to further optimize our capital structure, we issued a \$500 million corporate term loan that we mentioned in the last call. We also raised \$300 million of equity. Doug and our Capital Markets team did a great job on the execution and market timing for all of this new capital. The equity raised and our earnings in excess of the dividend also contributed to a nice pop in book value. Tony will take you through those details.

To keep pace with our portfolio and pipeline growth, we continue to expand our credit facility capacity in multiple currencies. Post quarter-end, we closed facilities with two new lenders for the company, and now have more than \$13 billion of capacity from 12 lenders with more in process.

The scale and quality of our capital markets initiative is well matched to our origination capability. It also benefits from the global Blackstone real estate platform and has a great track record as a borrower and banking client.

Improving credit profile continues to be a theme across our portfolio. We've upgraded the risk ratings on 18 loans in the first half, nine in each quarter, generally driven by improved leasing and cash flow as the collateral properties advance in their business plans, and transition to more stabilized operating performance. In the second quarter, we put three loans secured by New York City apartments on our watch-list, the only risk rating downgrades of the year.

These properties will be impacted by newly enacted legislation related to rent-regulated units that will ultimately result in less revenue growth over time than what we originally underwrote. We believe our credit position in these assets is still protected, even under the new regulations, but we still decided to watch-list the loans due to the projected change in cash flow profile. The collateral properties are owned by strong, well-capitalized

sponsors, and the three loans together represent only 1% of our portfolio.

The lending market overall remains competitive with spreads stable in part because of anticipated declines in base rates in the U.S. Fundamentals are solid with real tenant demand in the major markets that we target. We continue to achieve our best results with repeat clients, larger loans, special situations where speed and certainty matter most, construction loans, and loans in European markets.

We've built a market leading, global senior mortgage lending business with a \$16 billion portfolio, almost \$5 billion of equity market cap, and a highly efficient match-funded liability structure. Our focus remains on dividend quality and stability. And with that, I'll turn the call over to Tony.

T. Marone

Thank you Steve; and good morning everyone.

This quarter BXMT again delivered compelling results for our stockholders with strong earnings, a well-covered dividend, and increased book value following an active capital-raising quarter.

We generated GAAP net income of \$0.59 per share and Core Earnings of \$0.68, providing 110% coverage of our stable \$0.62 dividend for the quarter. Our book value increased to \$27.85, up \$0.53 during the quarter and \$0.65 year-to-date, driven by our issuance of 8.6 million shares of common stock during the quarter, raising \$311 million of fresh capital at 1.3x our prior book value.

In addition to our common equity raise, we also closed our inaugural \$500 million Term Loan B in April, which priced at a market leading LIBOR + 2.50% with only 25bps of issue discount. Our term loan has limited amortization, a seven-year term, and flexibility to prepay after 6 months, further expanding the aperture of financing options for our business. The term loan and premium equity raised in 2Q will be used to fund the continued growth of our business in the 2nd half of the year, and allow us to continue managing our cost of capital and competing for the best investment opportunities for our stockholders. We also remain steadfast in our focus on balance sheet stability in terms of our asset-level credit facilities, which had an average cost of only LIBOR + 1.89% as of quarter-end, and remain insulated from any capital markets based mark-to-market provisions. We closed the quarter with a debt-to-equity ratio of only 2.5x, down from 2.8x as

of March 31st, and liquidity of \$962 million, available to fund our active investment pipeline Steve mentioned earlier.

Looking at 2Q originations, we closed \$1.3 billion dollars of new or upsized loans during the quarter, highlighted by our international and southern California loan originations, and funded \$1.1 billion dollars under these and existing commitments. Our fundings were roughly in-line with repayments of \$1.4 billion dollars, maintaining our total portfolio size of nearly \$16 billion dollars as of quarter-end. Asset yields on our total investment portfolio migrated modestly lower during the quarter, with spreads tightening about 7 basis points, as a handful of legacy assets with higher spreads happen to repay this quarter. As we have highlighted on previous calls, we look to manage the impact of spread tightening with offsetting reductions in our cost of capital through accretive equity issuance, negotiating asset-level pricing with our credit facility providers, and employing other sources of financing like the term loan we closed this quarter.

Our portfolio credit quality remains stable, with an unchanged weighted-average risk rating of 2.7 (on our scale of 1-5) as nine upgrades totaling \$703 million offset the three minor downgrades

Steve mentioned, totaling \$167 million. It is important to note that these loans are all fully performing and we continue to have no non-accrual or impaired loans in our portfolio. We felt flagging the risk rating on these loans was a prudent disclosure to our stockholders given the changes in the New York City rent control regulations, but we have no expectation of loss on these loans. As a reminder, we have had two loans with a risk rating of four in the past, both of which have fully repaid with zero losses, as we successfully resolved these loans with our borrowers.

In closing, we have previously highlighted the floating-rate focus of BXMT's portfolio, which was 97% 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 proceed Doug, you are live in the call.

D. Harter Can you just update us on where you would expect leverage to get to as the pipeline comes through, and how the term loan factors into that leverage calculation?

D. Armer That's a great question, we do have a very strong pipeline. We expect net growth in our balance sheet which will probably show up in increased leverage. We're down quarter-over-quarter from 2.8x to 2.5x at the end of the second quarter and we would expect that to increase inside of the range that's anchored right around 3x in terms of debt-to-equity. I think our expectations for the level of leverage remains consistent with where they have been for the last several quarters, in a range right around 3.0x in terms of debt-to-equity.

Operator Your next question comes from the line of Don Fandetti of Wells Fargo. Please proceed Don, you are live in the call.

D. Fandetti Steve, can you talk a little bit about the New York multifamily properties in terms of the risk rating change. What are the scenarios, how do you see that sort of playing out in a bull and bear case scenario?

K. Keenan It's 1% of our portfolio. So, our risk is relatively limited, and I think in the various scenarios, we expect that our loans are going to be well protected. These loans were 67% LTV on average when we originated them, so we had significant equity cushion, and while the rent regulations will affect the impact of cash flow growth going forward, we don't think that, ultimately, it's going to result in an impairment, as we have that equity cushion.

So, we've underwritten the loans today based on what the regulations are today. We're obviously closely monitoring any potential developments on the regulations, but we're basing the way that we're looking at the loans on the current regulations and we thought it was prudent to risk rate them 4, but again, they are performing and we don't expect impairments.

S. Plavin And Don, I think we feel good about the fact that, although we didn't fully anticipate this kind of regulatory change, we have

strong sponsors and 65% loans that any reasonable fluctuation in the business plans is at the risk of the equity and not the debt. I think this is another case of that.

Operator Your next question comes from the line of Rick Shane of J.P. Morgan. Please proceed Rick, you are live in the call.

R. Shane There's at least one other New York multifamily property in the portfolio that continues to be a 3 rating. I do note that the LTV is a little bit lower, 62%, is that the distinction there, or is there something more nuanced we should all be thinking about in terms of how we think about New York multi?

K. Keenan So, I think it's important to note that New York rent regulations affect different properties in different ways. There are a lot of multifamily in New York that are fair market, and not impacted at all by rent regulation, and then other assets maybe have a few rent regulated units and are less impacted.

So, we've taken the approach that we've looked at every loan in our portfolio and assess the impact and the ones that we have downgraded are the ones we think are impacted in a way that

would necessitate a downgrade, but the others we just don't think are materially impacted.

Operator Your next question comes from the line of Steve Delaney of JMP Securities. Please proceed Steve, you are live in the call.

S. Delaney Steve, you mentioned a \$3 billion pipeline, I am just curious if we could parse that a little bit, are all those loans under term sheets at this time, or is that just a visible number about what you're looking at? Can you just kind of clarify that for us?

S. Plavin It's a stat that we note on all of our earnings calls, and it's deals that have signed up. We've already signed term sheets with agreed terms that we're proceeding to closing. The expectations are to close.

S. Delaney So, some in 3Q and then some in 4Q as well, correct? I mean, that's a big number for one quarter, but are you thinking that all these might actually close before September?

S. Plavin No, I think you're right, some in 3Q, some in 4Q, but we will also continue originating more loans, Steve, which will likely close in

4Q, but the origination process is ongoing. That's what we have signed up at the moment.

S. Delaney

And a quick follow up if I may for Doug. Doug, there was an article on CMA Page One last week about an evolved warehouse credit product that could provide a lower cost alternative to CLO financing. They mentioned specifically Morgan Stanley and KREF. I read the article and the features that they were discussing about no mark-to-market, etc., it didn't sound like anything to me, it sounded like a lot of features that Blackstone already has. I just wondered if you were familiar with that article and if you could comment on that briefly?

D. Armer

We are familiar with that article, and I think we share your view that that the structure of those transactions, particularly in terms of those features, is very consistent with stuff that we've been doing for years. So, we're happy to see the activity in the marketplace, and we think it will ultimately accrue to our benefit in terms of validating our business model and the market's acceptance of the loan-on-loan financing strategy that we have.

Operator Your next question comes from the line of Steven Laws of Raymond James. Please proceed Steven, you are live in the call.

S. Laws Couple questions around CECL, one is what do you think is the best historical data set that you look at as far as historical performance versus the portfolio that you guys own? And a specific follow-up to that is a situation like the large Tishman large loan you guys did, \$1.8 billion, last April. You had mentioned that won't start funding until 2020, but my understanding is you will have to take the entire full CECL reserve even if the funding is at \$0. So, given that accounting treatment, does that change your willingness to do large loans that have a significant delay in funding going forward?

T. Marone I could jump in on the CECL point. So, I'd say couple of things, one is we are still going through our adoption of CECL, as is everyone in the mortgage REIT space and, frankly, a lot of the folks in the banking and specialty finance space overall. So, I can't get into too much specific on exactly where we expect it to land. We think that the important reference data is a mix of looking at our loans, which has a great track record, as well as seeing what data is available in the market that we can leverage.

So, I can't really speak to definitively what our record set is going to be that we will use at this time, but we'll have more detail on that as we finalize our process and put those disclosures out more formally. I would say that we're being very thoughtful about ensuring that the reference data that we do use is as analogous to our loans as possible and not picking up data that may have lower credit quality loans that are not comparable to the high quality loans that we make here.

As for Tishman loan example, kudos to your reading of the FASB rules. You're right, CECL does require picking up a reserve on unfunded, not just on a deal like Tishman that's fully unfunded, but even if the loan is 90% funded, the 10% unfunded has to be taken into account. Without getting into a ton of the nuanced math, the way CECL looks at that, it does take into account the size of the loan over time. So, there is a timing element to those fundings in terms of how you look at how impactful that will be. We think that overall, the credit quality of the loans that we make is very high. And so, whatever the loan structure, our CECL reserve will be appropriately low and we'll take that into account.

I don't expect that's going to influence our decision-making in terms of our investments. We make good loans to quality real estate with quality sponsors and that will continue, but you are right, there could be a one-off loan here or there that may have a little larger CECL reserve, but we don't think that's going to move the reserve way out of a reasonable range.

Operator Your next question comes from the line of George Bahamondes of Deutsche Bank. Please proceed George, you are live in the call.

G. Bahamondes Do you have any thoughts on what the potential impacts on the incremental attractiveness of borrowing as LIBOR declines, assuming that we do see some Fed rate cuts in the back half of 2019 and into 2020? Just want to get a general sense, if you think that becomes incrementally more attractive to borrowers and maybe that impacts origination volumes. Generally, what are your thoughts on what the landscape could look like, should we see some Fed rate cuts?

The second question is, tied to that, do we see spreads maybe widen out a bit, given that LIBOR would decline, to ensure that the returns on these loans are similar to what they have been more

recently. I just wanted to get your general thoughts on that if possible?

S. Plavin

I think as it relates to the impact on loan demand of lower LIBOR, I mean it's certainly beneficial. Most of our borrowers are just floating rate borrowers not because they're guessing interest rates, but because they want to maintain flexibility in the real estate ownership. They don't want to lose a sale window; they have some ongoing capital needs they need loans that accommodate future advances and floating rate loans do that much better than fixed rate loans.

So, I think on the margin, it's beneficial having lower floating rates as it relates to loan demand, but our loan demand has been very strong throughout. When LIBOR was at a lower range and also when LIBOR is at the current range.

And I'll start off with the spread question, Doug, if you have anything you want to contribute. We've seen spreads begin to moderate in the market already. I think that's in part because people just have minimum returns, and business models that can't withstand continually compressing spreads.

But also, I do think there is, with the expectation of lower base rates, that spreads have moderated and I think there certainly is a possibility that spreads could increase as base rates go down, because, again, a lot of business models or investors are looking at their total return even on floating rate loans.

D. Armer

I think it's a great point, it's another illustration of how the LIBOR analysis is an all-else equal analysis, and by definition, all else will not be equal as we move forward into a different rate environment. There may be headwinds coming from spread compression or decrease in LIBOR, but there a lot of tailwinds coming from other directions albeit increased deployment or demand for our loans, potential moderation in spreads, and also, all of the capital market initiatives that Tony referred to – reductions in our funding cost optimizing corporate level leverage, raising premium equity. So, I think with regard to the capacity to offset those headwinds and maintain our earnings power, we feel very good about our asset-sensitive floating rate business model.

Operator

Your next question comes from the line of Jade Rahmani of KBW. Please proceed Jade, you are live in the call.

J. Rahmani What drove the surge in repayments in the second quarter, was anything surprising there, and what do you expect for the balance of the year?

S. Plavin I think, Jade, it's hard to look at repayments in any one quarter. So, I think those repayments that maybe we thought would come last year and just ends up coming in the first quarter. So, we think we're sort of in a stabilized repayment mode. Again, the repayments tend to be correlated over longer periods with our originations. When the market is more liquid, we would expect to see more repayments. But, as we go forward, we feel very good about achieving portfolio growth again like we have in most of the past quarters. So, it's a \$3 billion pipeline, we do expect to see portfolio growth in the second half.

J. Rahmani Just turning to the New York multifamily issue, can you give any sense, any insights, into the borrower mindset on these loans? Are they taking a wait-and-see mode and sort of hunkering down focusing on maximizing cash flows, reducing expenses? Have there been any comps, any transactions in the market? I don't believe there have – so there hasn't been much price discovery as yet. And over what kind of time period do you expect this to play out? Is it

over the next six months or are you thinking much longer than that?

S. Plavin

Great questions Jade, I think the answer on a lot of them is it's too early to say. Our sponsors are very committed to their assets, to their New York City multifamily strategy. And so, again, we spend a lot of time getting sponsors to feel great about the sponsorship on the loans that we've been talking about.

I do expect to see relatively few transactions in the near-term. Typically, in periods of volatility, transaction volumes slows, and I would assume that's what will happen here as well. And then over time, as things stabilize, we'll see transaction activity resume in the market. It can take a long time for the impact of this to play through, it really relates to future rents. So, it's not an adjustment of our in-price cash flow, it's really just an impact on what the future cash flow what might be. And typically, these deals have gradual increases of cash flow over time, depending upon how capital was spent and how units turn over. And so that's what's been impacted here, and we think that again, the underlying assets are still strong. We have a lot of confidence in our borrowers, so

we'll have to wait and see in terms of the market adjust, and what the long-term prognosis is here.

Operator Your next question comes from the line of Rick Shane of J.P. Morgan. Please proceed Rick, you are live in the call.

R. Shane It's largely been explored, but I just want to ask related to the three New York multifamily properties, is there any commonality among the sponsors or are they different sponsors?

K. Keenan We have different sponsors on various assets, they all are very well capitalized. So, the commonality in the assets is really the business plans, which was investment of capital over time for gradual increases of rents. As we have said, we expect that will moderate going forward.

R. Shane Is it three discrete sponsors for those properties?

S. Plavin It's two discrete sponsors, three loans.

Operator Your final question comes from the line of Doug Harter of Credit Suisse. Please proceed Doug, you are live in the call.

D. Harter Just following up on the term loan. Do you view, since it's a seven-year term, that as leverageable capital in any way, and does that presence kind of give you some ability to kind of be north of 3x?

D. Armer Doug, thanks for the follow-up. I think that, post term loan, the range that we will be able to achieve in terms of our debt-to-equity ratio is higher, and I think the long-term outlook for being above 3x, as opposed to below 3x where we've historically been is significantly greater.

Again, it'll relate quarter-to-quarter to the amount of deployment that were able to achieve in a given quarter, but yes, I think with the term loan being as well-structured as it is, floating rate, and as you point out a seven-year maturity, that's capital that we're very comfortable leveraging and results in the capital structure that we're very confident operating on a slightly higher leveraged basis than we have been historically. I think that'll be in a range around 3x, and more likely above 3x, as opposed to below 3x compared to prior to the term loan issuance.

D. Harter And then as you think about constructing the capital structure over the long term, how much term loan could we expect in the capital

structure, or more broadly, how much non-common equity could you expect to make-up that leverageable capital base?

D. Armer

I think the ratio that we have now, and we think about the convertible debt together with the term loan in connection with this question, is close to our target range. The amount of common equity is also in flux, and we'll continue to grow the balance sheet and we will continue to fund that through a mix of debt and equity.

I think that you would expect to see that mix stay roughly where it is today in terms of proportions, but again, I think with the term loan in the picture, that proportion is higher than it was previous to the term loan.

Operator

Thank you. There are no questions and I'll turn the call back to Weston for closing remarks. Thank you.

W. Tucker

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

Operator Thank you to all speakers. That concludes your conference call for today. You may now disconnect. Thank you for joining and enjoy the rest of your day.