Final Transcript

Blackstone Mortgage Trust, Inc.: 4Q 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

Don Fandetti – Wells Fargo

Douglas Harter – Credit Suisse

Jessica Ribner – B Riley FBR

Steve Delaney – JMP Securities

Jade Rahmani – KBW

Rick Shane – JPMorgan

Coordinator Great day ladies and gentlemen, and thank you for joining the Blackstone Mortgage Trust Fourth Quarter and Full Year 2017 Investor Call. My name is Latoya and I'll be the 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]. It is with great honor introducing our host for today, Weston Tucker, Head of Investor Relations. Please proceed.

W. Tucker Great. Thanks, Latoya. Good morning and welcome to Blackstone Mortgage Trust's Fourth 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-K 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 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-K. Any references to tax reform on this call do not constitute as tax advice, and you should consult with your own tax advisors regarding the consequences of investment in BXMT. 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: We reported GAAP net income per share of $0.59 for the fourth quarter and $2.27 for the year. Core Earnings were $0.65 per share for the quarter and $2.55 for the year. Last month we paid a dividend of $0.62 with respect to the fourth quarter, and based on today's stock price, that dividend reflects an attractive yield of over 8%. If you have any questions following today's call, please let me know. With that, I'll turn things over to Steve.

S. Plavin Thanks, Weston, and good morning everyone. In 2017, the benefits of BXMT's management by Blackstone, the leading real estate investment manager in the world, were evident on both sides of the balance sheet. We originated $4.8 billion of senior loans, up 37% from 2016, and grew our portfolio by $1.2 billion to over $11.0

billion. To support those originations and future growth, we sourced $4.2 billion of new, efficiently priced capital during 2017. That investment and funding activity drove full year Core Earnings to $2.55, which more than covered our dividends paid.

During the quarter, we originated $1.2 billion of loans. The originations were concentrated in the multifamily asset class and in major, coastal markets, matching two of the favorite investment themes of Blackstone Real Estate. Multifamily originations contributed about $520 million or 44% of our quarterly loan volume with the Walker Dunlop JV accounting for $110 million of that total. Loans secured by an industrial property in Boston, office buildings in Atlanta and Northern California and a hotel in Southern California comprised the rest of our quarterly originations - all of which remain consistent with our focus on the coastal markets where we see the highest quality sponsors and assets with the most enduring property values. We have an additional $1.5 billion of loans expected to close in the coming months and our pipeline of origination opportunities remains strong.

We work the right side of the balance sheet as hard as the left and had a truly extraordinary year funding our business. In December, we raised equity for the first time since 2015 - $396 million gross proceeds at 1.2x book value, primarily driving the $0.41 increase to book value per share. Earlier in the year, we issued $400 million of convertible debt with a 4.375% coupon and sponsored a securitization of a large loan that facilitated an $889 million origination. And, at year-end, we issued a $1.0 billion CLO, an innovative financing of participations in 31 of our loans and a new source of credit for our balance sheet assets. We also added $1.6 billion of additional credit facility capacity to fund continued growth in our loan portfolio.

In addition to increasing lending capacity, we have reduced our borrowing costs and added corporate leverage with the convert, enabling us compete more aggressively for less transitional origination opportunities that require lower loan spreads. Increased competition is also driving spreads tighter which has led to more refinance opportunities as property owners look to improve loan terms.

With interest rates ticking up, we have seen pressure on REIT share prices, including our own. But private asset values remain high and cap rates within the historic, healthy spread range to treasuries. There is still strong demand for top quality properties.

Corporate tax relief bodes well for US economic activity and for growth in property revenues to offset the impact of higher interest rates and expense inflation. And with a 94% floating rate portfolio, our performance benefits from increases in short term interest rates.

Tax reform also provides an additional benefit. Individual shareholders get a 20% deduction on REIT dividend income, effectively lowering their maximum federal tax rate from 37% to 29.6%. Our dividend produces an approximate 8.2% pre-tax yield on the current share price, and at that level, its tax deduction will provide most individual shareholders in the top bracket the pre-tax equivalent of another 90 basis points of yield.

BXMT has become a leading senior real estate lender, and our competitive positioning and recognition in the market have never been stronger. The majority of our loans are with repeat borrowers, the greatest endorsement of the way we do business and our differentiated, client-centric approach. Our loan portfolio has an overall, origination LTV of 61% and is 100% performing. With its very attractive yield, we believe the value proposition of investing in BXMT with Blackstone management remains highly compelling for shareholders. With that, I'd like to thank you for your interest and support and will now turn the call over to Tony.

T. Marone Thank you, Steve, and good morning everyone. Steve already covered our 2017 full year results, so I will jump right into the fourth quarter highlights.

We reported GAAP net income of $0.59 per share and generated Core Earnings of $0.65, both down slightly from the third quarter. This decrease was in-part due to $0.02 of additional prepayment income generated in 3Q, as well as the dilutive impact of our $392 million Class A common stock offering net proceeds in December. As with any of our stock offerings, we immediately used these equity proceeds to revolve down our credit facilities to manage our balance sheet and reduce the "J-curve" impact of the new equity on earnings per share. However, some decline in earnings is unavoidable until these proceeds are fully deployed into new loan originations. For context, all else equal, had we issued these shares on October 1st instead of December 5th, our Core Earnings for 4Q would have been $0.61 per share as a result of this dilution. As Steve mentioned, we have a robust pipeline of new investments and therefore anticipate the earnings dilution to taper over the first half of 2018.

Importantly, we are proud of executing this offering at 1.2x gross price-to-book, capturing a favorable price for our stock, and driving a $0.41 increase in book value per share during the fourth quarter. As we have mentioned on previous calls, our book value is not generally subject to significant fluctuation over time, as our loan portfolio is held for long-term investment and we do not own any mark-to-market securities or long-dated fixed rate assets. Accordingly, although we have seen some pressure on our share price following the broader market, and REITs in general, we do not anticipate this capital markets volatility to translate to our balance sheet given the floating rate nature of our business.

As Steve mentioned, our 4Q originations totaled $1.2 billion, bringing our total portfolio to a record $11.1 billion, up 14% from 2016. These loans are all floating rate, senior loans, with an average origination LTV of 63%, secured by institutional real estate in major markets.

Loan fundings during the quarter totaled $1.3 billion, outpacing $875 million of repayments, and benefiting from $227 million funded under previously originated loans. Our portfolio remains 100% performing, with an average origination LTV of 61%, and risk ratings largely unchanged at an average of 2.7 (on a scale of 1 to 5), with only one, $21 million , “4 rated” loan in our portfolio.

On the right-hand side of our balance sheet, we had an active quarter lead by our inaugural $1.0 billion CLO issuance, providing $818 million of non-recourse, term-matched financing for 31 of our loans, with a weighted average cash coupon of only LIBOR plus 1.21% on notes sold. This innovative structure includes a replenishment feature, which allows us to maintain the 82% advance rate as the initial 10 loans repay, reducing the effective cost of financing these loans. This CLO issuance, coupled with our $392 million net equity raise in December, reduced our debt-to-equity ratio to only 2.0x, down significantly from 2.6x as of September 30th. Available borrowings under our revolving credit facilities comprise the majority of our $681 million of liquidity at quarter-end, which amount is available to us for future investment activity.

Lastly, as Steve mentioned, we are excited to see the impact of the recently enacted federal tax reform on our business, and the REIT sector in general. Under the new laws, REIT dividends are entitled to a 20% deduction by individuals owning the stock, effectively reducing the top marginal tax rate on this income to 29.6% from 37% for bonds and other fixed income products not benefiting from the REIT structure. Accordingly, all else equal, on an after-tax basis our $0.62 dividend is equivalent to $0.69 of income from such non-REIT sources.

We are pleased with our results for the fourth quarter and full year 2017, and we look forward to generating continued value for our stockholders in the future. 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 Don Fandetti with Wells Fargo. Please proceed.

D. Fandetti Yes, hi Steve. Quick question on rates. The ten-year yields moved up obviously, and one of the things you're worried about is what the impact would be on the ground in terms of the real estate property markets. I guess my first part of the question is have you seen a slowdown in the velocity of transactions, and two, would you expect that to happen? So, that's my question.

S. Plavin I don't think we've seen a slowdown yet, Don. It depends upon how far back you want to go from a rate standpoint, but transaction activity is still solid in the market. I think what we're seeing now is the pickup in economic activity. I think the benefit of tax reform is already being felt as a corporate activity.

So, we expect leasing velocity to actually pick up, and the overall economic impact to be positive for net operating income. It's the scenario that you want to see with higher rates in that it's coinciding with economic growth, higher economic activity, and more operating income for real estate.

D. Fandetti Okay. Then, on the CLO, how should we think about the all-in cost of that issuance, let's say relative to your bank financing?

D. Armer Hi, Don. It's Doug. That's a great question. The all-in cost will ultimately be a function of the tenor of the CLO, and as Tony mentioned, we have some structural features in this transaction that will enable us to really maximize the efficiency of the financing. I think we expect the all-in cost to be below 200 over, so another 25 to 50 basis points of non-cash costs that will amortize over time on top of the cash coupon.

D. Fandetti Okay. Thank you.

Coordinator Your next question comes from Douglas Harter with Credit Suisse. Please proceed.

D. Harter Thanks, Doug. To follow up on that last question, how should we think about what the tenor is and how long you stay at that 82% leverage before it starts to pay down?

D. Armer That's a great question. Obviously, it's a function of the pre-payment speed of the loans that are the collateral in the pool, so it will be a little bit of a random walk. I think the important thing to understand is that we built in some structural features including replenishment and also some ability to maintain flexibility in terms of extensions and modifications of the underlying loans, to maximize that tenor.

So, a typical weighted average life for a BXMT loan is probably in the three year range, and so our expectation is that we'll be able to push the period out at least that long.

D. Harter Great. The all-in cost that you referenced to in Don's question, does that factor your expectations for how this CLO pays down?

D. Armer No. Well, it does in terms of the additional 25 to 50 basis points, but I think with regard to the potential for rate creep or deleveraging, we'd expect to refinance the portfolio as that comes to pass. Again, that's going to be several years out, so we'll make the decision at the time based on market conditions then. We do have the option to maintain the CLO as term financing, but I think in terms of optimizing the all-in cost, we'd be more likely to call the CLO than have it significantly delever or have the rate creep in the out years beyond the three to five year horizon that we foresee.

D. Harter Very helpful. Thank you.

Coordinator Your next question comes from Jessica Levi-Ribner with B. Riley FBR. Please proceed.

J. Levi-Ribner Good morning. Thanks so much for taking my question. In terms of the credit environment that you're seeing, I know, Steve, you made comments that there's still a strong demand for high quality properties. What kind of credit are you seeing in terms of just on the broader market? I know that your portfolio is still 100% performing, but is there anything that's concerning to you more so than last quarter with this rate increase? Can you talk a little bit about that?

S. Plavin Sure. Jessica, I would say not really. I don't think we've seen a change in any credit quality in our portfolio, and what we're seeing in general remains strong. I think we're still at a good point in the cycle. Property operations and overall leverage in the market are at healthy levels.

So, I haven't seen any impact yet, and I think if rates stay in the range they're expected to be in, then I don't foresee any impact from treasuries in the low threes. The fundamental backdrop is still very strong.

J. Levi-Ribner Have you seen any competitors fall out of the market because of the higher rates and maybe some of the spread timing?

S. Plavin No, we haven't seen it. The private loan market remains very competitive, and we haven't seen competitors fall away. We are, I think from a competitive standpoint, feeling very good about our cost of capital and our ability to compete, but not because anybody's leaving the market unfortunately.

J. Levi-Ribner One last one, just in terms of construction lending in 2018. You made some comments around participating in less transitional lending, but are you still thinking about construction lending as attractive? Has anything changed there?

S. Plavin No, I think we still see construction lending as attractive. We didn't close any construction loans in this past quarter. We sort of talked about it being plus or minus maybe 10% of what we do. We continue to look for unique construction loan opportunities that seem well priced and that don't fit the profile of the banks. The banks' reluctance to fund construction loans hasn't changed, so I do think we'll see opportunities to commit to new construction loans as we go forward in 2018.

J. Levi-Ribner Okay. Thank you. That's it for me.

Steve Thanks, Jess.

Coordinator Your next question comes from Steve Delaney with JMP Securities. Please proceed.

S. Delaney Thanks. Good morning, everyone. You've provided us with a great chart on page six of your deck on the strong execution of FL-1. When you look at that and the carving off of about 30% of the loans into an A2 participation, is there a structural reason why you couldn't take another 30% of the whole loan and create an A3 and then look to do another CLO? Thanks.

D. Armer Steve, hi, it's Doug. That's a great question. Maybe a little bit of a leading question, but no, there's no structural reason why we couldn't do that. The one thing we do keep in mind is the point that we were making previously with regard to the expected life of the CLO and the amortization of the upfront costs. So, I think looking at that static pool of 31 loans, we'd make an evaluation about what the expected life of those would be.

One other thing to keep in mind is that it's not an all or nothing decision. So, we can carve a couple of A3 notes off of half of the pool and combine them with some new loans and collateralize a new CLO with that kind of a pool. So, I think you'll see the technology used very efficiently in future financings for the company.

S. Delaney Understood. That's very helpful. The relative increase in multifamily, I understand Steve, your view that that's just an attractive asset class in general. I'm just curious when you start talking to CLO investors, is the mix of multifamily important to those investors versus other property types, and is that in some way making multifamily that much more attractive to you because of the financing? Thanks.

S. Plavin I think we really have pursued the multifamily asset class because we just like the fundamentals of housing in this country, so that's really what's driving our efforts to increase our loans in the sector. It's nice to see that we have some success.

Multifamily does actually perform well in these secured type structures. I also look at that as an added benefit, not the reason for it. The reason for it is the fundamental belief in how the real estate will perform.

S. Delaney Thanks. One final thing from me on loan spreads. Looking at page 12, it looks to me like the 5.38% cash coupon is based on where one month LIBOR was at year end and puts your average spread at about 380 basis points. As all of the commercial mortgage REITs have commented over the past year, as spreads were tightening in, we heard ranges anywhere from 50 points to 75.

I'm just curious if you can give us some insight as to how your current originations, whether it was the fourth quarter loans or where you're pricing loans now, how that compares to the portfolio average of LIBOR spread above 3.80%. Thanks.

S. Plavin I would say in general that spreads are tightening, and if I had to throw a number out there, I would say we've seen 50 basis points or so of tightening in the last sort of 6 to 12 months. In our case, we've had the benefit of offsetting much of that with improved funding cost and a little bit of corporate leverage, so we've been able to maintain our competitive ability despite the compressing spreads.

S. Delaney Okay. Thanks for the color.

Coordinator Your next question comes from Jade Rahmani with KBW. Please proceed.

J. Rahmani Thanks very much. A follow-up to Steve's question on spread tightening, what about year-to-date? Have you seen continued pressure on spreads? And on the fixed rate side where I believe there's been spread widening, is there any origination potential there?

S. Plavin I think the spread trend recently has begun to slow. We saw a lot of spread tightening coming into the first quarter, so I do think the level of spread tightening is beginning to moderate.

As it relates to fixed rate lending, I think over a longer period of time if we could find a way to add some fixed rate loans to our portfolio that would be really beneficial. Floating rate loans work better in our model and are better matched to how we finance ourselves, but we're constantly looking at how we can expand our lending envelope. If there's an opportunity for us to create shareholder value with fixed rate loans, then we'll add fixed rate loans to the mix.

J. Rahmani In terms of current financing capacity, can you comment on your appetite for additional CLO issuance as well as the $1.5 billion of loans in the pipeline if you believe current financing capacity is adequate to close those loans?

D. Armer Hey, Jade, it's Doug. Great question. We do have over $2.0 billion of current financing capacity on our credit facilities, which would accommodate the $1.5 billion in the pipeline, and we also have the ability obviously to do another CLO transaction. The CLO that we did in December generated $800 million plus of capacity. We took those collateral interests off of our revolving credit facilities to open some room there, and we can do that again.

The other thing I'd note is that we have almost $2.5 billion of upsizes and new facilities currently in process, so we're continuing to generate capacity within the credit facilities space. We're continuing to work the CLO angle, and we're very confident about our ability to fund growth in the balance sheet to the tune of even $3.0 billion and $4.0 billion.

J. Rahmani The cost of issuance on the CLO, I think we estimated it was around $10 million or perhaps a little bit higher. Was that outsized due to the inaugural CLO and the size of this CLO so that subsequent financing costs or those issuance costs would moderate?

D. Armer I wouldn't describe it as outsized. That number isn't a number that we've disclosed, so I'm not sure where that comes from, but I think you are right that future CLOs will be more efficient, in particular, with regard to the legal costs that sort of relate to developing the technology. So, we think that both the cash coupons will come down given market dynamics, and we also think the upfront costs will be lesser going forward.

J. Rahmani Thanks. The number we calculated was just looking at the cash flow statement disclosure. The last thing I wanted to find out is if there are any other business lines you view as interesting or complementary to the current model, or is it with respect to primarily the floating rate transitional space?

S. Plavin We continue to see great opportunity, Jade, in our bread and butter business. You saw that it grew by 37% from a top line standpoint in portfolio growth last year. We have really good momentum going into 2018. We still think that what we do is really the best use of the capital that we have and provides really great returns for our shareholders. So, we love our core business.

We continue to evaluate anything that we think we could add onto it that would increase shareholder value and continue to create growth and liquidity for shareholders. That won't change, but for the time being, we really like our core business and think it's really hitting on all cylinders.

J. Rahmani Thanks very much.

S. Plavin You're welcome.

Coordinator Your final question comes from Rick Shane with JP Morgan. Please proceed.

R. Shane Hi, guys. Thanks for taking my questions this morning. Most have been asked and answered, but I would like to talk a little bit. This is the first quarter that we've seen in a while where fundings exceeded originations. In the last several quarters, there's been a pretty significant gap. I'm assuming that this is a function of the construction lending starting to come through the portfolio, but I'd like to think about how we should see that relationship going forward.

S. Plavin We've mentioned it a little bit on our prior calls, but what we have seen is meaningful fundings in each of the recent quarters from loans that were originated in the prior quarters. You're right, Rick, it is primarily the construction loans, so it was about $200 million in this quarter of advances that we made on loans that were originated in prior periods.

It's the impact of that one or two loans without having to actually originate them in real time at the quarter, so it is nice. We've talked about it for a while and it's nice to see it come to pass. We didn't originate any new construction loans in 4Q, so we didn't originate loans that had a lot of unfunded commitments, which in part explains the fundings exceeding the originations.

The positive funding balance that's on the quarter is really beneficial, and with our old unfunded commitments funding and the new pipeline being very strong, we expect to see some meaningful positive balance in fundings.

R. Shane Got it. That makes sense actually in terms of the relationship with no new originations in construction. As we move into 2018, you just mentioned about $200 million of funding related to draws on the construction loans. What's a reasonable number to think about? Let's not worry about a quarterly number, but let's think about an annual number. How much do you think could be drawn or is remaining to draw on those facilities?

S. Plavin Doug, do we have a number?

D. Armer Well, the total of unfunded commitments is over a billion. I think during 2017, the number was $486 million as the year's whole. It was a little bit skewed towards the fourth quarter, as you pointed out that $227 million. So, with the construction loans fundings sort of in full swing, I think you'd expect to see a number similar to that in 2018.

S. Plavin Rick, one other thing to add is that it's not just construction loans that provide the future funding for loans previously originated. A lot of the transitional loans that we make also have unfunded commitments for renovation and lease up when they close. It's a meaningful component of the transitional lending space. So, really it's a combination of those two, and it really is a nice feature added to the portfolio as with those fundings roll in.

R. Shane Got it. We assume, though, that the construction loans are much more likely to draw closer to the maximum capacity versus the transitional loans, where that's basically cushion for them.

S. Plavin Well, the construction loans funding is based upon the progress of construction, at least initially, and then maybe ultimately on the leasing and the funding of tenant improvements and leasing conditions. For the renovation loans, some of it is construction, the buildings, and a portion of it really relates to future leasing. We do expect a meaningful amount of that to be drawn as well, so I think the future fundings on previous commitments will be significant and something you should be definitely taking a look at.

R. Shane Terrific. Thanks, guys.

Coordinator I will now hand the call over to Weston Tucker for closing remarks.

Weston Thanks, everyone, for joining us this morning. If you have any follow up questions, please reach out. Thank you.

Coordinator Ladies and gentlemen, thank you for your participation. This concludes today's conference. You may now disconnect. Enjoy the rest of your day.