Blackstone Mortgage Trust Third Quarter 2023 Investor Call
October 25, 2023 at 9:00am ET

Operator: Good day and welcome to the Blackstone Mortgage Trust Third Quarter 2023 Investor Call. Today's call is being recorded. At this time, all participants are in a listen-only mode. If you require Operator assistance at any time, please press star zero. If you would like to ask a question, please signal by pressing star one on your telephone keypad. If you're using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. At this time, I would like to turn the conference over to Tim Hayes, Vice President, Shareholder Relations, please go ahead.

Tim Hayes: Good morning and welcome everyone to Blackstone Mortgage Trust's Third Quarter 2023 Conference Call. I am joined today by Katie Keenan, Chief Executive Officer; Tony Marone, Chief Financial Officer; and Austin Peña, Executive Vice President of Investments. This morning 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 subject to risks, uncertainties and other factors outside 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. This audiocast is copyrighted material of Blackstone Mortgage Trust may not be duplicated without our consent. For the third quarter, we reported GAAP net income of $0.17 per share, while Distributable Earnings were $0.78 per share. A few weeks ago, we paid a dividend of $0.62 per share with respect to the third quarter. Please let me know if you have any questions following today's call. With that, I'll now turn things over to Katie.

Katie Keenan: Thanks, Tim. Since our last earnings call, geopolitical risk is more acute and interest rates have continued their march higher. The 10-year is 4.9%, up 100 basis points in the last three months, and SOFR is at 5.3%. We believe that higher rates are having the Fed's desired impact with inflation decelerating and economic growth slowing, but we take the Fed at their word and expect rates to persist at these levels and are managing the business accordingly. Rates impact our lending business in two critical and correlated ways. First, as a floating rate lender, we continue to recognize the pronounced benefit in our income from higher base rates, yielding yet another quarter of strong Distributable Earnings. At the same time, the sustained pressure of high rates and the attendant capital markets illiquidity is weighing on the overall credit environment.

Even so, BXMT remains well positioned for a higher-for-longer period. With our Distributable Earnings exceeding our dividend, we are able to bolster our book value and significantly offset increasing reserves. The steps we've taken on both sides of our balance sheet, including proactive asset management, a conservative liquidity posture, and a patient approach to new investments, leave us on strong footing to navigate this environment. This positioning is evident in our third quarter results, with DE of $0.78 per share covering our dividend by 126%, liquidity still at record levels, and a continued reduction in our leverage. On the credit side, our portfolio remains resilient – 95% performing, notwithstanding some negative credit migration, and a continued healthy pace of repayments. And over the first three quarters of the year, we contributed over $80 million of Distributable Earnings in excess of our dividend to book value, cushioning much of the impact of incremental reserves.

Delving deeper on credit, our challenged assets remain a small part of the overall portfolio with just 5% on cost recovery. Our watchlist represents an additional 13% of the portfolio – loans which are our focus of our asset management efforts but remain current and performing. We collected $1 billion of repayments this quarter, demonstrating liquidity and investor demand for the high-quality collateral backing our loans. We recognized partial paydowns on several large office loans and we strategically sold

a subordinate interest in a UK office loan, reducing our basis by 18%, generating $50 million of proceeds, and retaining a lower-LTV senior loan still earning a double-digit ROI. A separate UK office loan repaid post quarter-end, selling to an institutional fund at 50% above our basis.

While the office headwinds are well established, high-quality assets continue to outperform. In addition to physical quality, amenities, and location, tenants are increasingly focused on the capitalization of office assets when making leasing decisions – a clear advantage for our collateral. Notably, we saw several significant leases signed in our portfolio this quarter, including flagship deals in Chicago, West LA, Miami and New York. With the slow but steady march of RTO, tenants are transacting, and we expect the demand that exists in the market will continue to concentrate in the best assets. Our portfolio is far more weighted towards collateral built or substantially renovated since 2015 than the market, and is therefore well positioned to capture an outsized share of demand today and in the future, with very little new office development on the horizon.

Despite these bright spots, office overall remains challenging. We downgraded and recorded impairments on three of our previously watchlist loans this quarter – office assets in the Bay Area and Chicago. While these loans were current on interest through the quarter, we are taking a forward-looking approach as we anticipate potential deterioration ahead of maturity dates or other decision points. We continue to run a robust quarterly process around our risk ratings and reserve levels. We've increased our office reserves by more than 10x in the past year, with marks on our five-rated loans implying an average decline in asset value of over 50%. And collectively, we have now either impaired or watchlisted nearly 40% of our US office loans, as we continue to transparently identify risk within our portfolio. But away from our watchlisted assets, our 1-3 risk-rated office portfolio is generally stable. Nearly 60% is backed by new or substantially renovated assets where we are seeing stronger leasing momentum, like the Spiral in Hudson Yards or 545 Wyn in Miami. And another 16% benefit from substantial recent equity investments driven by our active asset management approach.

On the asset management side, we continue to leverage the resources of the Blackstone Real Estate platform to pursue the best outcomes for our shareholders across the portfolio. Last quarter, we highlighted the substantial progress we've made on this front, securing additional capital and improving our credit position. Over the past year we have secured a total of $1.5 billion of additional equity commitments subordinate to our loans, of which over $750 million relates to 3 and 4-rated office loans, as we continue to pursue proactive modifications to place deals on more stable footing in the current environment. These modifications typically exchange substantial additional borrower capital investment for time and in some cases, rate relief. Prioritizing credit protection over marginal return is a rationale trade in the current environment for our borrowers, and for us, especially given our substantial dividend coverage.

In more challenging situations, we are focused on ensuring we have maximum optionality to pursue recovery outcomes. With our robust liquidity and long duration balance sheet, we are never a forced seller. And as the largest owner of real estate in the world, we have a deep well of expertise to take ownership and drive value when appropriate. And at the same time, we will actively pursue sales of challenged assets when the opportunity cost of holding exceeds the return potential. We expect to execute on at least one such sale next quarter on a small multifamily loan where we are appropriately reserved.

In multifamily more generally, our second largest sector, fundamentals continue to support loan performance with all other multi loans current on interest. In the near term, a pocket of new supply is tempering rent growth. But looking past this year, the supply-demand dynamics are favorable. Multifamily housing starts are down 42% year-over-year and home mortgage rates are at a 23-year high, significantly impacting affordability for potential home buyers and supporting rental demand. And further,

our loans are typically set up with value-add business plans, allowing for rent and NOI growth beyond market trends.

For example, our largest multifamily asset – a newly constructed trophy building in Brooklyn – is nearing completion of its lease-up at rents well above our initial underwriting, resulting in a projected debt yield nearly 100 basis points higher than our base case. This quarter, we upgraded 6 multi loans seeing strong cash flow growth through successful execution of such value-add strategies.

The financing market for multifamily also remains liquid albeit impacted by rates pressuring DSCRs and loan sizing. With a shrinking universe of targeted asset classes, the sector remains squarely in the strike zone. We see this in our multifamily repayments so far this year – $550 million, through bank and agency refi's, as well as sales well above our basis.

We expect 2024 may bring further pressure across the sector as many 2021 originations face maturity. But the combination of robust, long-term fundamentals and continued institutional liquidity incentivizes Sponsors who have the wherewithal to bridge near-term NOI pressures and protect the substantial equity in their deals. As such, we believe our multifamily portfolio – 68% origination LTV on average – remains well positioned to perform.

In closing, there is no question that we are in a challenging period for the real estate market. Rising rates continue to weigh on credit performance but as a floating-rate lender, our earnings and dividend coverage also benefit. In this environment, current income is a critical component of investor returns. Since the beginning of the year, we have paid out $1.86 per share in dividends, while our book value has declined just $0.36. Our dividend, which we paid for 33 consecutive quarters and covered 130% for the past four, currently produces a 12.3% annualized yield on our share price.

We've intentionally constructed our business for resilience and performance over the long-term. And our approach has supported Distributable Earnings stability since the onset of the rate cycle. We continue to maintain a high bar for new investments, but we expect sustained rate pressure will spur the need for capital solutions for both borrowers and banks as we move into next year. With a well-structured balance sheet and $1.8 billion of liquidity, we are well positioned to capitalize as this opportunity unfolds. With that, I'll turn it over to Tony.

Tony Marone: Thank you, Katie, and good morning, everyone. In the third quarter, BXMT reported Distributable Earnings or "DE" of $0.78 per share – our fourth consecutive quarter of exceptionally strong earnings as the tailwind of rising rates continued to benefit our floating-rate business model. Our 3Q earnings included a one-time $0.02 gain on extinguishment of debt, reflecting our repurchase of $33 million of our senior secured notes at 85% of face, which helped offset the impact from 2Q loan modifications, loans placed on cost recovery accounting, and net portfolio contraction. This quarter, we again posted net portfolio contraction and moved an additional three loans to cost recovery status as of 9/30, which we collectively expect will impact our go-forward quarterly earnings by $0.03 to $0.05 per share. Our debt repurchase this quarter allowed us to opportunistically deploy capital at an attractive yield, while also taking an additional step as part of our broader strategy to focus on the strength of our balance sheet and maintain a stable and dynamic posture as this credit cycle evolves.

To that end, we reported our second consecutive quarterly reduction in our debt-to-equity ratio, which is down to 3.6x as of 9/30 from 3.8x at the start of the year. At the same time, we maintained our record liquidity of $1.8 billion, up from $1.6 billion at the start of the year, despite a net repayment of $1.1 billion of debt so far in 2023. As we've highlighted on prior calls, our balance sheet continues to benefit from our stable capital structure, with no corporate debt maturities until 2026, no capital markets margin call provisions across our term-matched credit facilities, and fully non-mark to market provisions on the

majority of our liabilities. Our loan portfolio decreased to $22.1 billion as of 9/30 with $1 billion of repayments outpacing $440 million of loan fundings.

These incremental investments represent fundings on our existing loans, and our credit facility lenders continue to advance their share of ordinary course loan fundings, indicative of the strength of our banking relationships and the quality of our overall portfolio. Our 185 loans are diversified across geographies and property types, and only 5% of our total portfolio is characterized as nonperforming, which indicates a 5-risk rated loan with an asset specific CECL reserve. Our total asset specific CECL reserve increased $108 million to $323 million at quarter-end – a reserve equivalent to 23% of the related loans cost basis and implying a decline of over 50% in the underlying real estate collateral value. These incremental asset specific reserves were offset by a $12 million decline in our general CECL reserve, for a net reserve increase of $97 million during the quarter. These reserves do not impact DE until they are realized but do impact GAAP net income, which declined $0.42 this quarter to $0.17 per share as a result.

In addition, our aggregate CECL reserve of $477 million, does impact our book value. However, our ability to retain earnings in excess of our dividend has limited our book value decline to about 1% since January 1 of this year, despite the 39% increase in our total CECL reserve over the past three quarters. Looking at our risk ratings, as noted, we downgraded three office loans to a 5-risk rating this quarter. All these loans are on cost recovery status as of 9/30, which means that any cash interest received is applied as a reduction to our loan basis rather than recognized as income. Year-to-date, we have recorded $41 million of such cost recovery proceeds, representing about $0.19 per share of unrecognized net income. As I've highlighted in prior calls, this income will eventually be recognized as these loans recover or will otherwise reduce future realized losses should credit continue to deteriorate. Outside of our impaired loans, we only had two downgrades and reported seven upgrades as the majority of our portfolio continues to perform well and generate compelling returns with comparatively lower levels of risk. Overall, our portfolio average risk rating remains at 2.9 – the same level we have maintained over the past 4 quarters.

In closing, we remain steadfast in our focus on maintaining a strong balance sheet, finding opportunities to reduce risk in our portfolio, and managing our more challenging credits to maximize long-term shareholder value. Our $0.62 dividend is well covered by our Distributable Earnings and provides a highly attractive, reliable income stream for our stockholders, generating a 12% yield on yesterday's close. As a final note, we view our recent addition to the S&P SmallCap 600 as an endorsement of BXMT as a valuable long-term investment for our stockholders. The resulting incremental demand creates additional liquidity for our stock, which we believe will benefit our investors across market cycles.

Thank you for joining the call and I will now ask the Operator to open the call to questions.

Operator: Thank you. As a reminder, please press star one to ask a question. We ask you limit yourself to one question and a follow-up question so we may take as many questions as possible. We'll go first to Stephen Laws with Raymond James.

Stephen Laws: Hi, good morning. Katie, I guess to start, can you maybe talk a little bit about where you think you are evaluating the 1 to 3's. I know you talked about some performance metrics in your comments, what is the risk of additional negative ratings migration? How do you feel about the lead time into some of the loans that maybe have original maturity dates later next year as you'll start getting more color on in the coming quarters?

Katie Keenan: Yeah. Thanks, Stephen. Thanks for joining us. So it's a great question and I think that we go through our 1-3's and really the entire portfolio and a lot of depth every quarter. I think you can see the proactive approach we are taking, both in terms of how we have treated the 4's and 5's, which really are

in many cases, or really in almost all cases, downgrades in anticipation of challenge. And then also the proactive modifications that we have taken across our office portfolio and anywhere where we see that there may potentially be stress ahead. So, when we look at our 3's and 4's in our office, we've really done proactive mods on many of those loans over the last year, and as a result, we put those loans in much better position.

So, we're not waiting around to sort of deal with a 2024 maturity and see what happens then. We've been having conversations with our sponsors about those loans for many months and that is sort of the result – is the $750 million of equity on our 3 and 4-rated office loans that we have brought in over the last year. So I think when we look at the overall credit environment, we have 200 loans across the portfolio, there's obviously going to be movements in both directions on the margin, but we are very in-depth in how we look at these deals and we're running out multiple year projections in terms of looking at decision points and risk areas, and so our risk ratings really reflect what we see over the future in addition to what we're seeing today.

Stephen Laws: Great, thanks Katie, and then as a quick follow-up, can you talk about the repayment outlook – not doing any new originations, similar to most peers – where do you think leverage trends or maybe troughs, how do you see that? And then appetite for more loan sales, not a lot in Q3 I don't think, but maybe could you touch on that please? Thank you.

Katie Keenan: Yeah, so I think that we're really proud of the reduction in leverage that we've had, that's really been a factor of the overall conservative approach we've taken with the business. We've had a very healthy pace of repayments so far this year – $1 billion in the quarter. And I think that's really a result of the quality of the portfolio and the institutional liquidity of the assets that underlie our loans, and we've seen that continue even this quarter obviously when rates ticked up. I think the pace of repayments could possibly slow down as rates are higher, but as I mentioned in the call script, we literally just had an office loan repay this week. So, the facts are with these loans is that they reach the end of their business plans, our Sponsors are ready to sell, they're ready to refi, and because our portfolio as a whole is low leverage and we're lending on high-quality assets that have business plans that are generally working, we do see that continued liquidity.

So we expect repayments to continue, and I think that as far as looking at – and the leverage will sort of continue in the range it is as a result of that – looking at new investments we are actively looking at new investments we have plenty of liquidity, our balance sheet is in great shape, and it's really a factor of overall transaction volume and making sure the investment opportunity is clear the high bar that we've set for ourselves, both from a return perspective and from a credit perspective. So with overall transaction volumes down 40% to 60% across the market, the addressable universe is smaller, but we're very actively out there with our big origination team looking for deals and I think that as the market continues to persist through this period and reaches more potential decision points coming into next year, I think there will be more opportunities and we'll certainly be looking for them.

Stephen Laws: Great, thanks for your comments this morning Katie.

Operator: We'll go next to Steve DeLaney with JMP Securities.

Steve DeLaney: Thanks, good morning everyone. So, I know a lot of focus probably today on the three new office downgrades – I'd like to flip it over though and ask the question about the seven upgrades. Were they mostly loans that were moved from a 4 to a 3, are there any large loans in there, and is there a common theme in those seven situations? I know every loan is unique, but what is allowing, what is improving generally on those seven loans that is causing you to upgrade them? Thank you.

Katie Keenan: Thanks, Steve. Great question. So those loans really primarily fall into the category of multifamily and they're primarily two, sorry, 3-risk rated to 2-risk rated loans, and I would say generally our risk ratings have been pretty sticky over time, we have a lot of loans in the 3 category that continue to perform on their business plans, but with some situations where we just see really continued outperformance, strong debt yields getting into the zone where we feel very good about the execution on the credit – we move those types of loans to 2's and in some cases 1's if it's sort of another leg up from that. So, these are multifamily assets, business plans completed, strong rent growth, strong debt yields, and really just working in terms of their business plans and benefiting from the leverage level that we have on them. There's also one select service hotel, which I didn't talk as much about hotels this quarter, but we have seen continued strength on the hotel side, especially in the sectors that we're focused on. I think that, like everything, will see some deceleration over time, but select service in good markets, resorts in good markets, those assets are performing as well. And so, one of our upgrades was a select service hotel.

Steve Delaney: Got it. So, on the multifamily, really just strong leasing, solid year-over-year rent increases, and basically just achieving at plan or even better than plan expectation? So leads you to think that at the basis you're in, the owner will probably comfortably be able to refinance. Is that the right way to think about that? That loan is probably going to be off your books in a year or so?

Katie Keenan: Yeah, it's a good question. I would say our 2's and 1's are easily refinanceable in this market. I think the question for our borrowers, and what we've seen over the course of the last year, it really comes down to their business plan. So, if they have reached the end of their business plan and their next capital markets activity is selling, it's likely that they're just going to keep our loan in place for longer. It's unusual for someone to go out and refi if they think they're going to sell in a year or 18 months. The costs just don't really make sense. So we have a lot of borrowers that are sort of just waiting for a window in terms of sale. And in the meantime, we have these very high quality, stabilized assets sticking around in our portfolio because people aren't going to try – if they have a good quality deal, they've done a good job on – they're not going to sell into a more challenging market, they'll just wait. These assets have decent cash on cash, the spreads on the loans in the portfolio generally are probably lower than where they can achieve elsewhere in the market, but the capital structures are set up the right way because they've created value, and so I think these loans will stick around for longer and that's certainly what we've seen so far.

Steve Delaney: Thanks for the color, Katie.

Operator: We'll go next to Sarah Barcomb with BTIG.

Sarah Barcomb: Hey, everyone. Thanks for taking the question. So I would just like to talk about office color generally. So, from where we sit, post-Labor Day 2023, do you think the weakness in office fundamentals and refinanceability are more entrenched in work-from-home policy or overall economic weakness at this point? And if the latter worsens next year as more pre-COVID office leases expire at the same time, should we expect to see additional reserves taken on that asset class, and at what point do you think we would start to see REO come onto the books? Or would we see more modifications like we saw this quarter? Can you talk about that balance as we head further into next year?

Katie Keenan: Sure. That's a lot of questions, I'll try and hit all of them, and let me know if I miss anything. I think as far as the broader outlook on office, it's pretty interesting because there are two sort of counter balancing effects. There's certainly the risk of cyclical downturn, although the economy has been remarkably resilient to date, and if you look at the main users for the types of office buildings that we make loans on – whether it's the FIRE tenants, sort of creative marketing, content creation, even the tech industry, which is obviously pulling back from office a lot right now but the business itself actually in

recent earnings looks to be doing pretty well – those industries seem to be pretty resilient in the face of the overall macro. And we've seen job growth there as well, which historically has been a leading indicator of demand growth. Now, of course, there is also the countervailing factor of return-to-office, which has marched along sort of slow and steady, positively, but of course it's still below pre-COVID levels, and overall sort of space rationalization.

I would say when we look at the statistics – and there have been a number of third-party market reports out there this quarter – you can see that tenants are making space decisions, return to office continues. There's a lot of tenants out there that have instituted new return-to-office policies this quarter or starting next year. Sort of every quarter there's more of that. But I think that there's certainly still a question as to where that ultimately settles out. For our portfolio, I think the big question is the concentration of demand in which office buildings and how does that overlay with what we have? And 60% of our 1-3 rated office is sort of post-2015 vintage which is much higher than the market as a whole, and one of the statistics I saw recently, which I thought was really interesting, was that 90% of office vacancy is in like 30% of office buildings. And so, when you think about that relative to the concentrationt of where demand is going and there's lots of statistics like that in terms of net demand, et cetera, we just have to make sure that our office buildings are well positioned in the market to capture a disproportionate share of demand, because there's going to be the sort of broader market dynamics in terms of demand and I think it's candidly very hard to predict where those level out.

I think as far as more reserves and mods as we look forward to next year, every single one of our assets is a facts and circumstances, like bottoms-up deal decision. So when we approach each loan and each conversation with a borrower, whether it's proactive a year ahead of time trying to get capital in the door, whether it's looking at making sure the asset is appropriately capitalized to capture those leases in the market which is something we're very focused on, or whether it's thinking that we may be in a better position to maximize value for the asset in an REO situation than our borrowers for various reasons, we're really looking at each one of those and just using all the tools we have whether it's our expertise, our capital, the strength of our balance sheet to just make sure that we're maximizing value over time.

So, do I think that we could potentially have some assets come onto REO or some more of those conversations over time? Of course, in this market that's definitely or very likely to happen. But I think that we have the tools and we've really been ahead of the game in terms of reducing our basis in these deals and making sure that they are appropriately capitalized, and also coming up with our contingency plans, our business plans, putting the right team in place to make sure that if we end up in those situations, we'll be ready to hit the ground running and maximize our potential recovery.

Sarah Barcomb: Okay, great, thanks for all the detail there. And then just one more from me, you mentioned during Q&A that you guys are actively looking at new investments given how strong liquidity is, so I was just curious if you could give a bit more color on what's looking interesting right now – whether credit or equity? I know we're focused on BXMT right now, but maybe some perspective from the broader Blackstone platform – just maybe some detail on what looks interesting from a sector or a geography perspective?

Katie Keenan: Yeah, absolutely. I think it is a really interesting time to invest and as a whole at Blackstone, we are really focused on the credit opportunity. We think it is a tremendously interesting time to be a credit investor – you're inherently investing at a discount to asset value, that creates a defensive position. And the returns available, you can see it in our results and really across the board in credit, especially floating-rate credit, are just historically attractive in terms of the risk-return you can achieve. So, we think credit is really interesting. That's certainly a posture of our business and across the firm. And I think on the real estate side, as far as sectors we're excited about, the demand growth in data centers has been phenomenal. That's an area we've been very active in, on the equity side as well as on the debt side.

Student housing continues to be very strong. Certain lodging and leisure sectors and obviously on the credit side, multifamily continues to be a good area at the right basis, and we'll be focused there too. And I should say industrial obviously continues to be a good sector.

Sarah Barcomb: Great.

Operator: We'll go next to Jade Rahmani with KBW.

Jade Rahmani: Thank you very much. I was wondering about asset management and loan resolutions. Are you seeing any sponsors take an interest in buying into some of your debt position in order to reduce their leverage and hence their basis? I noticed you sold a $51 million junior loan interest and I was thinking that this could be a way to facilitate modifications, workouts, loan resolutions.

Katie Keenan: Yeah, Jade. I think you're really on point and really a lot of the capital we brought in a lot of the mods we've done so far this year, have been exactly that. So, sponsors who look at deals, continue to believe in their business plans, but effectively want to pay off the bottom of their debt capital structure or effectively buy back the mezzanine portion of our loan. So what we'll do is they'll effectively buy the bottom 10% or 15% of the loan, they buy it at a double-digit 12%, 13% IRR, whatever we think is appropriate for that for the deal – they're effectively paying off the most expensive part of their debt capital structure, reducing the debt balance, reducing the carry cost, putting the asset on stronger footing in terms of deleveraging the asset going forward and enhancing their return potential. And for us, we're reducing our basis – we have so much built-in earnings in the portfolio because base rates are 500 basis points higher than when we set up these deals, so we're earning much more on these loans than we set them up to than we expected – so for us, making the trade of reducing our basis, reducing the overall gross coupon of the loan, but still earning more than what we expected to when we set the loan up. That's a very rational trade and a lot of our borrowers are taking advantage of that.

Jade Rahmani: Thank you. I also wanted to ask on cash flow performance. Something I've been focused on and I know investors are too. Cash flow from operations declined quarter-over-quarter. However, it looks like there was a working capital headwind to the tune of around $21 million. Wondering if there are any specific seasonal items to point out and your overall thoughts on cash flow performance?

Tony Marone: Hey Jade, it's Tony. I wouldn't say there's anything particularly notable in terms of cash flow from operations that I would flag as far as seasonality. As we've mentioned, we're getting paid generally speaking, on all of our loans, and we have plenty of cash flow to cover our dividend, not just from an earnings perspective, but importantly there is not a significant amount of PIK interest on deferred interest that's elevating our net income relative to our cash flow. So, I think what you're probably seeing is just some inherent lumpiness in cash flow from operations that's ordinary course in any business, but no issues there or anything that I would flag. I think we're very comfortable at the level of cash flow from operations we're generating.

Jade Rahmani: Thank you.

Operator: We'll go next to Don Fandetti with Wells Fargo.

Don Fandetti: Yes, good morning. Of the three office loans that were downgraded, can you provide a little context in terms of fundamentals at the property level, and also what sort of brought things to a head from a reserving perspective?

Katie Keenan: Yeah, absolutely. So obviously each deal is specific, but I would say generally, really the two factors are rates, not surprisingly, and then two of the three assets – the two larger ones – are in the

San Francisco Bay Area. And so we have one in San Jose, one in Silicon Valley, both very nicely, recently renovated, very high-quality assets. But as I think I mentioned in the Q&A, tech, which is 40% of the market in San Francisco, has just been really challenged in terms of office use – it's by far the biggest driver of negative net absorption across the country. If you look sort of more sector specific there is a pretty big difference between tech in any other industry, and San Francisco has just always been kind of a company town. So, we see historically in San Francisco, it's sort of a boom and bust cycle. When tech is working, it's extremely positive for the market and when it's pulling back, it's an overhang. And so you have that now, and you also have some quality-of-life issues that I think there's a lot of focus on addressing but will take time because of the way the sort of political system works in San Francisco and the Bay Area. So that's really what was driving most of the challenges with those assets, we do feel good about the long-term performance of that market.

As I said, it's really been a very cyclical market and tech as a whole we believe in, and we believe in San Francisco. But it's going to take time, and in the meantime, those are assets that have higher carry cost today because of where rates are. So, it's really the confluence of those two factors. The third 5-rated loan is just a very small office deal in Chicago, where we've been pretty successful over time reducing our basis, but it's sort of a small deal in a relatively old fund and it's hitting it's maturity, so we'll evaluate the best option there.

Don Fandetti: Got it. Thank you.

Operator: We'll take our next question from Rick Shane with JP Morgan.

Rick Shane: Thanks everybody for taking my questions. Look, the difference between Distributable Earnings, dividend and GAAP earnings really highlights some of the timing differentials inherent in the business model in terms of recognition of credit expenses, both from a Distributable and a taxable perspective, versus the sort of implicit or assumed credit expenses over time. We can look back and basically the dividend on any sort of one-year basis or two-year basis, splits GAAP net income and Distributable. The question really becomes twofold – one, when you think about the reserves, presumably, you believe that they conservative – how conservative or how much cushion do you think you have in them? But more importantly, when do we expect to really see some of those realized losses come through, is it a one-year horizon or is it a five year horizon, so we can start to reconcile that differential?

Katie Keenan: Thanks Rick. I think that it's hard to say, because it really depends on the individual assets, right? So, we have a hotel deal, for example, that we took a reserve on in the COVID period that has continued to perform at its reserve level, recover in performance – that's continued for a while. We have other assets, as I mentioned, where we are looking for more of a near-term sales situation. So, the timing really could extend over quite a prolonged period of time, there may very well be assets where we think the right answer is to take them over REO and operate them for the foreseeable future. So I think it's hard to peg sort of a definitive time period and certainly we'll be fighting for value recovery in those types of situations. I think the other very important dynamic is that every passing quarter our earnings of the majority of the portfolio – the 95% of the portfolio that is performing and that is earning a very strong amount of net income relative to what we expected and relative to the overall portfolio – we continue to see the benefit of that earnings on a quarterly basis, both in terms of the dividends, we pay out to our shareholders and in terms of our ability to accrete the excess into our book value. So, I do think that this is all going to take time to play out, we are going to want to implement the best recovery strategy. The capital markets are moving very slowly in all cases, and so all of this is going to take time to play out. And in the meantime, we are going to continue earning the very strong Distributable Earnings profile we have from the portfolio that allows us to cushion a lot of the impact here.

Tony Marone: The other thing that I would add – sorry, just to add one further thought as you were correlating DE, dividends and GAAP, and everything that Katie was just discussing, gets into the timing of how some of these reserves are recognized. As it relates to the dividend, that's driven by our requirements as a REIT, as it relates to taxable income, which is also influenced by the timing. But it's important to recognize that our dividend level is very stable in that at the moment, we're well out-earning the dividend, so there's no downward pressure for us to have to cut it – we're far, far away from that. But on the other hand, we do have some different tax attributes that is allowing us to retain those earnings and so we don't expect to have to add to our dividend and make a special dividend. So, I would view the dividend as very solid at $0.62, where it is for the near term, and then you're going to see the variability in GAAP and DE as those different timing elements that Katie mentioned earlier play through those metrics, but the dividend, you could think of as pretty solid.

Rick Shane: I think that's totally fair. I'm going to try to frame my follow-up question and get two in. Interestingly enough, with all of the headwinds in terms of office, it's going to be multifamily where you guys have cited you're going to take your next potential realized loss – is that because those are easier to exit in this environment because the market is more robust?

Katie Keenan: Thanks, Rick. I think that there is potentially some element of that, although as I mentioned, we've gotten $800 million of multifamily repayments so far this year – I mean, sorry $800 million for office repayments so far this year, so we are seeing decent liquidity in office. And I think that really there, it's a question of spot pricing versus recovery when we think about our long-term plan for our office assets and of course, liquidity is worse in office. This deal is a multifamily deal, it's small, it's one of the very few rent stabilized exposed assets in our portfolio, it's gone through sort of a storied history and it's just an asset that we have been looking to move on from for a long time. So I think it's a little bit idiosyncratic and we're hopeful that we can execute on the transaction with a good buyer there.

Rick Shane: Got it. And then last question, I couldn't read my own handwriting so thanks for your help, but I wanted to ask you – but when you, if you take REO, would you take write-offs immediately associated with them based upon revised appraised values?

Tony Marone: I think under our DE definition it would depend. The way we characterize Distributable Earnings, it's reduced by a realized loss. So that would typically be an actual contractual change in loan terms, or at the point of a sale of a property. However, we do have the ability, if we think that that loss – I think the language we have in our Q is nearly certain or all but certain – to take it. So I'd say it's more facts and circumstances and not something that I would say is programmatic based on appraisal at the time of foreclosure.

Rick Shane: Okay, thank you guys.

Operator: We'll take our final question from Arren Cyganovich with Citi.

Kaili Wang: Thanks, this is Kaili on for Arren today. Maybe if you could give an update on the risk-rated five loans that are coming due for the next couple of quarters, it looks like you have the Orange County and New York office loans due in 3Q and the Chicago office loans due early next year – do you expect to do additional maturity extension with the loans or should we just model a near term write-off related to the loans?

Katie Keenan: Yeah. So I think as far as the 5-rated loans, those are the ones I mentioned we're really focused on maximizing recovery. I would say the maturity dates, they really are what's driven the downgrades – the one you mentioned, the Chicago loan, is the one I was mentioning earlier that we've downgraded ahead of a conversation around that maturity date. For some of the other ones, we're engaged

in active discussion with our borrowers in terms of modifications or creating the best plan for recovery there. I think the maturity dates are a factor, but not the primary factor. We're really just focused on how we get to the best path for recovery for those assets over time or with sales if we think that's the right thing, but we'll really evaluate that just based on the ability to create the most value and with also thinking about opportunity cost over time.

Kaili Wang: Got it, okay. It looks like you have one mixed-use and one hospitality loan in Spain that are on risk-rated 4 as well. So maybe if you could talk about what you're seeing, how was the domestic market versus outside the US?

Katie Keenan: Yeah, I would say that what we're seeing generally in Europe is pretty stable. And I mentioned that we've had some good liquidity on UK office loans, or Europe office loans even this quarter. I would say, we see the macro there in terms of fundamentals for our real estate is pretty positive. The Spanish hotel market has really recovered very strongly – that particular asset is doing quite well. So, I think that what we've observed over time and what we really liked about the market in Europe is leverage has always been lower, so I would say, by and large, the leverage on our assets there is just at a lower LTV to start. The macro demand picture for the assets that we've lent on has been pretty stable notwithstanding some of the pressures more broadly in the market. And we've obviously been quite selective there over time as we have in the US too, but very selective in terms of sponsorship quality of assets, et cetera. So, I would say that Europe, both from a capital markets perspective and from a fundamentals perspective, has performed really quite well over the last year and we see those dynamics continuing.

Kaili Wang: Thank you.

Operator: That will conclude our question-and-answer session. I'd like to turn the call back over to Tim Hayes for any additional or closing remarks.

Tim Hayes: Thank you Operator and to everyone joining today's call, please reach out with any questions.