KKR Real Estate Finance Trust Inc.

Q4 and Full Year 2017 Financial Results Conference Call

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CORPORATE PARTICIPANTS

Chris Lee - *Co-Chief Executive Officer*

Matt Salem - *Co-Chief Executive Officer*

Patrick Mattson - *Chief Operations Officer*

Will Miller - *Chief Financial Officer*

Sasha Hamilton - *Investor Relations*

CONFERENCE CALL PARTICIPANTS

Steve Debartolo – *Wells Fargo Securities, LLC, Research Division*

Ryan Tomasello – *Keefe, Bruyette, & Woods, Inc., Research Division*

PRESENTATION

Operator
Good morning and welcome to the KKR Real Estate Finance Trust Inc. Fourth Quarter and Full Year 2017 Financial Results Conference Call. All participants will be in listen-only mode today. Should you need assistance, please signal a conference specialist by pressing the star key followed by zero. After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star, then 1 on your telephone keypad. Please note this event is being recorded.

I would now like to turn the conference over to Sasha Hamilton. Please go ahead.

Sasha Hamilton
Thank you. Welcome to the KKR Real Estate Finance Trust earnings call for the fourth quarter and fiscal year 2017. I'm joined today by Chris Lee and Matt Salem, our Co-CEOs; Patrick Mattson, our COO; and Will Miller, our CFO.

Before we begin, I would like to remind everyone that we will refer to certain non-GAAP financial measures on the call, which are reconciled to GAAP figures in our earnings release and in the supplementary presentation, both of which are available on the Investor Relations portion of our website.

This call will also contain forward-looking statements, which do not guarantee future events or performance. Please refer to our most recent filed 10-K for cautionary factors related to these statements.

A quick recap of our results before I turn things over to Chris. For the full year 2017, our GAAP net income was $58.8 million, or $1.30 per share. Net core earnings were $55.5 million, or $1.22 per share. For the fourth quarter 2017, our GAAP net income was $17 million, or 32 cents per share, down slightly from the third quarter. Net core earnings were $17.1 million, or 32 cents per share, up 4% from 3Q.

Book value per share as of December 31st, was $19.73. In January, we paid a dividend of 37 cents per share with respect to the fourth quarter, and based on yesterday's closing stock price of $19.60, the dividend reflects an annualized yield of 7.6%.

With that, I would now like to turn the call over to Chris Lee.

Chris Lee
Thank you, Sasha. Good morning and thank you for joining us for our fourth quarter earnings call. 2017 was an important and exciting year in the evolution of KREF. In May 2017, we transitioned to a public company and increased our book value to over $1 billion. We originated $1.5 billion of senior floating-rate loans during the year, nearly 3 times our 2016 volume. This investment activity increased our total funded portfolio to $2.1 billion, a 2.5 times increase from 2016. And on the right side of the balance sheet, we increased our funding capacity by $325 million to $1.8 billion.

We've started off 2018 with strong investment activity. We closed a $76 million loan in January. We have also built up a robust pipeline of another $794 million of loans currently under exclusivity that we expect to close in the coming months, subject to customary closing conditions. Given we are still in the process of ramping our portfolio, earnings, and dividend yield, we will continue to provide periodic updates around capital deployment as loans close.

The macro-economic backdrop for our business remains favorable. There is still strong demand for real estate from global institutional investors. Robust job growth, strong corporate profits, and the recent changes to the tax code have provided additional economic stimulus, which should further drive positive underlying property fundamentals. Supply is still in check in most markets. In addition, cap rates remain at healthy spreads relative to interest rates.

The combination of reduced acquisition activity in the large loan segment, increased capital flows to the real estate credit space, and the near-term expectation of short-term rate hikes has continued to drive competition for high-quality transitional lending opportunities. An increase in refinancing activity has offset some of this dynamic. Despite the increased competition, we have been successful at identifying attractive opportunities to deploy capital. Our relationships with borrowers and intermediaries and access to information to quickly assess credit continue to differentiate us in the marketplace. In addition, we have been able to reduce our cost of liabilities to offset some of the spread compression and continue to deliver an attractive risk-adjusted return on equity to our shareholders.

In 2018, we are focused on a few key initiatives at KREF. First, we will continue to deploy capital in a prudent manner with a focus on lending on institutional-quality real estate owned by high-quality sponsors. We are encouraged by our recent deals and current pipeline and feel like we are able to secure our share of the highest-quality transitional lending opportunities.

Second, we are very aligned with our shareholders and will continue to be good long-term stewards of shareholder capital. We are focused on improving the liquidity of our shares throughout 2018 and will look for ways to grow the company prudently and accretively when our share price supports it. In the meantime, we believe we have several avenues available to us to continue to deploy capital and grow KREF’s earnings capacity.

Lastly, our affiliation with KKR, one of the largest global asset managers in the world, gives us differentiated access to the capital markets. We have very attractive funding today; however, we are working closely with KKR Capital Markets to help us continue to improve the cost and structure of our liabilities.

Overall, 2017 was a great year for our business, and we are excited about the growth opportunities for KREF in 2018.

With that, I’ll turn the call over to Matt.

Matt Salem
Thanks, Chris, and good morning, everyone. I’ll start by discussing our recent investments. In the fourth quarter, we originated two floating-rate senior loans totaling $332 million. These loans include acquisition financing of a Class A luxury multifamily property located in New Jersey and the refinance of a Class A office property located in downtown Minneapolis. The weighted average LTV and coupon for these loans are 66% and LIBOR plus 4%, and on a levered basis, the two loans have a weighted average underwritten IRR of 11.8% at spot LIBOR, which is consistent with our existing portfolio.

In terms of repayments, we had a $20 million paydown of our condo inventory loan this quarter associated with the sale of units. Subsequent to quarter end, we received a $33 million repayment of a mezzanine loan secured by a hotel property. As a reminder, our portfolio has a weighted average seasoning of only 11 months. So while we will continue to see periodic repayments, we do not expect to see more consistent repayments until 2019.

Turning to our portfolio, as of year end, we had a funded portfolio totaling $2.1 billion, with another $316 million of future funding obligations. One hundred percent of our loans are performing, and our securities portfolio is performing as expected. The portfolio is 90% invested in senior loans and is diversified both geographically and across property types. The three largest exposures by property type are 40% office, 27% multifamily and 13% retail, which is down from 27% at the time of the IPO. Notably, the paydown of the mezzanine loan, which I mentioned before, decreased our hotel exposure to less than 5%.

We continue to concentrate our lending on institutional quality real estate in major population centers to the highest quality sponsors. From a property type perspective, multifamily and office properties made up more than 75% of our originations in 2017. Our origination efforts have focused on these because of their short term, light-transitional business plans. The average occupancy of the office properties in our portfolio was 64% at year end, which creates in-place cashflow and the possibility for near-term stabilization. We will continue to target the highest-quality opportunities, trading incremental yield for credit quality.

As Chris mentioned, our strong origination pace has continued into 2018. We have already closed a $76 million senior loan secured by a Class A office property located in St. Paul. This loan has an LTV of 73% and a coupon of LIBOR plus 3.6%. Similar to the previous discussion, the property is 86% leased with in-place debt yield of 11%. Our pipeline is particularly strong with six loans totaling approximately $794 million under exclusivity and scheduled to close over the next few months. As always, these are subject to customary closing conditions.

We have a best-in-class team, which we continue to grow. Our team's extensive relationships with owners and operators of real estate have been key to our origination activity. We made significant progress in enhancing our brand awareness, market presence, and competitiveness in 2017. The majority of the loans we originated in the year included a direct relationship with the property owner. We've been able to differentiate our platform with our borrowers through our—through the closing process and subsequent asset management. Nearly half of our 2016 borrowers have become repeat borrowers, which represented over 30% of our 2017 originations. We are highly focused on growing our existing relationships and creating new ones in 2018.

In summary, we have a defensively-positioned portfolio and our origination activity continues to meet our expectation in terms of credit, volume, and return.

Now, I'll turn the call over to Patrick.

Patrick Mattson
Thank you, Matt, and good morning, everyone.

Our portfolio, which totaled $2.1 billion at the end of the quarter, has a weighted average risk rating of 2.9 on a 5-point scale, a slight improvement over last quarter. And the portfolio has 100% credit performance. As of year end, 93%of the portfolio was invested in LIBOR-based, floating-rate loans, which positions us well to benefit from increases in short-term interest rates.

Looking at the righthand side of the balance sheet, we continue to enhance our liquidity. In the quarter, we successfully upsized our Goldman Sachs credit facility from $250 million to $400 million and extended the term maturity date. We also extended and upsized our Morgan Stanley credit facility from $500 million to $600 million, with an option at our election to further increase the facility by an additional $150 million. And we terminated our JP Morgan facility, which was unused during 2017. As part of our diversified funding strategy in 4Q, we sold an $82 million senior position in one of our loans, creating structural leverage and optimizing our cost of capital.

Turning to total leverage, we closed the quarter at 1 times, and we continue to releverage the portfolio as we fund new originations. We generally target a 3 times leverage ratio on new senior loans, so as we ramp the portfolio, we expect the total leverage to increase but remain at a prudent level.

In 2018, we remain focused on expanding our capital sources and optimizing the balance sheet in order to diversify our financing channels and reduce our cost of capital. As Chris mentioned, we're working closely with KKR Capital Markets to explore additional funding options. Last year this Capital Markets' team of approximately 40 investment professionals globally executed over 190 transactions. We believe having access to their expertise and relationships provides us with differentiated access to capital. Specifically, we're working with the team on creating non-mark-to-market term financing facilities. We will keep you updated as we make further progress.

One other note on the balance sheet, as a reminder, we have a $100 million share repurchase authorization in place. Fifty million dollars was available to repurchase stock when the market price traded below book value per share. And the remaining $50 million is generally available for repurchases during the authorization period.

During 2017, we repurchased 26,000 shares in the third quarter, at a weighted average price of $19.80 per share. Subsequent to year end, we repurchased an additional 497,000 shares at a weighted average price of $19.49 per share, leaving approximately $40 million in place for future stock repurchases below book value.

Finally, I want to discuss our dividend. For the fourth quarter, we declared a dividend of $19.9 million, or 37 cents per share, which was paid on January 12th. It should be noted that our dividend policy takes into account our taxable earnings on an annual basis. For the full year, we paid $1.27 per share in dividends compared to taxable income of approximately $1.35 per share and GAAP net income of $1.30 per share. As our portfolio fully ramps, we expect our taxable income on a quarterly basis to more closely correlate with GAAP net income and net core earnings.

In summary, another strong quarter to finish a very active year. Our pipeline remains robust, our portfolio is performing, and we continue to enhance our liquidity profile. We remain confident in our ability to continue to execute in this market and scale our portfolio.

Thank you again for joining us today. And now, we are happy to take your questions.

QUESTIONS AND ANSWERS

Operator
Thank you. We will now begin the question-and-answer session. To ask a question, you may press star, then 1 on your telephone keypad. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star, then 2.

At this time, we will pause momentarily to assemble our roster.

The first question will come from Donald Fandetti with Wells Fargo. Please go ahead.

Steve
Hi, good morning. This is Steve on the line for Don. You mentioned your $794 million pipeline. Can you talk about the timing on when you expect those loans to close and then discuss origination expectations more broadly for this year? Thanks.

Matt Salem
Sure. Hi, Steve, it's Matt. Appreciate you joining the call this morning. In terms of timing for the loans, I think we mentioned on the call earlier that that's really—we expect those to close over the next few months, and they're largely consistent with the strategies we've been originating over the last few quarters, comprised predominantly multifamily and office properties.

And then, in terms of our expectations, I think we've always mentioned a target of $2 billion for annual originations. So if you think about the loan we've closed already, you know, subsequent to quarter end, plus the forward pipeline, we feel pretty confident in meeting the expectation for our targeted annual originations. And also, if you think about that another way in terms of ramping up the portfolio and becoming fully ramped, we think that with this origination pace, it could take us to a fully ramped profile by the end of the second quarter.

Steve
Okay, great. Thank you.

Operator
Again, if you have a question, please press star, then 1.

Our next question comes from Jade Rahmani with KBW. Please go ahead.

Ryan Tomasello
Good morning. This is actually Ryan Tomasello on for Jade. I was hoping to start off with some additional color on the competitive environment. Would you say that competition continues to pick up, or perhaps has stabilized year to date. And, secondly, can you say how much loan spreads have trended over the past two quarters and what magnitude, if any, further spread compression you expect, say, in the first half of the year, given the $700-or-so million dollar pipeline that you laid out?

Matt Salem
Yes, let me take the first part in terms of just the competition. I would say the competition is largely the same over the last few quarters. That being said, we've seen a little bit of spread tightening. I would probably characterize that in the context of 25 to 50 basis points of tightening. I think what the difference is this time, you know, versus last year is that most of the spread tightening feels like it's in—is really stemming from where some of the senior financing is

pricing for our positions. So whether that's in the CLO market or on private facilities, it feels like that is—has largely driven some of the pricing in our market at this point in time.

Ryan Tomasello
And then, in terms of target leverage, including structured financing, you mentioned the target of being fully ramped by the end of the second quarter. So can you just remind us what target leverage is, and I realize that can vary depending on the mix of first mortgages you're doing.

Patrick Mattson
Sure. Hi, Ryan, it's Patrick. Thanks for the question. So in target—in terms of target leverage, yeah, generally, it's three times on senior loans. I think we look at it, though, on an asset-by-asset basis. And so where we have an opportunity to create, let's say, non-mark-to-market financing, and if you look at page 9 of our Supplemental and look at our senior loan interest there, you know when we do the calc, you know, effectively, we're at an 83% advance rate on those positions. And so overall, though, I think we're still consistently targeting at the corporate level, that 1.75 to 2 times leverage. And so I think that hasn't changed much.

Ryan Tomasello
And just regarding the ramp in earnings, given the large sequential growth in the average portfolio on the sequential basis from the third quarter, which we estimate was over 20%, the 4% sequential growth in earnings seems low, so perhaps you can comment on what factors might be driving that and how you're thinking about the dividends going into the first quarter.

Chris Lee
Hi, Ryan, this is Chris. I think some of that is just timing of closings, and when you look at the timing of closings, sometimes those happen at the end of quarters. And I think if you look at our sequential growth last quarter, these were definitely weighted towards the latter half of the fourth quarter.

And there's also the fact that we have, you know—we're also ramping the—you know, ramping the portfolio from a cash perspective. We also were holding cash in anticipation of another closing at year end, so there's a little bit of noise on an inter-quarter basis based on timing of closings, cash drag associated with just managing the liquidity profile on the balance sheet, so I think you'll continue to see a little bit of that noise as we ramp, but to Matt's point, once we get to later in the second quarter, we think a lot of that noise will be mostly mitigated.

Ryan Tomasello
And then, just one last one if I could squeeze it in. I was hoping you can comment on your appetite for M&A, notably homebuilder Lennar is reportedly marketing Rialto for sale, and given management's ties with that business, I was wondering if this would be something that KREF could potentially evaluate.

Chris Lee
Yes, this is Chris again. I think we're not going to comment on specific transactions, but I think that given our expertise in M&A and in capital market transactions, we're always open to things that we think could be accretive, but also have to be in line with our kind of core strategy. So right now we think that we have a very strong core business, and we'll be opportunistic in

responding to things, but we don't think of, you know, M&A as something that's kind of top of the list right now. We think of it as more we'll respond opportunistically.

Ryan Tomasello
Thanks for taking the questions.

Chris Lee
Yes, thank you.

Operator
Once again, if you have a question, please press star, then 1. All right, it looks like we have a follow-up from the location of Jade Rahmani with KBW. Please go ahead.

Ryan Tomasello
Hi, guys, thanks for the follow-up. But it's Ryan again. You know, you mentioned the CLO market being strong and your peers driving their costs of capital down. Given the lighter transitional and higher cash flowing collateral in your portfolio relative to peers, is the CLO market something that you could potentially execute on in the near term?

Patrick Mattson
Hi, Ryan, Patrick. I'll take that question. I mean, yeah, I think we're exploring kind of a number of financing alternatives, including CLOs, and there's no question we've seen a lot of activity and demand pick up in that space, but overall our key focus is, as we mentioned, on creating just non-mark-to-market match term financing solutions. And we believe there are both private and sort of publicly marketed alternatives that are available to us as we continue to scale. And so, yeah, we'll continue to actively monitor that space and, like we said, we'll come back with further updates.

Ryan Tomasello
Thanks for taking the follow-up.

Operator
Ladies and gentlemen, this concludes our question-and-answer session. I would like to turn the conference back over to Sasha Hamilton for any closing remarks.

CONCLUSION

Sasha Hamilton
Thank you, everyone, for joining the call. If you have any additional questions, feel free to follow up with us directly. Thanks again.

Operator
The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.