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KKR Real Estate Finance Trust, Inc. Second Quarter Financial Results

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CORPORATE PARTICIPANTS

Sasha Barenbaum – *Investor Relations*

Chris Lee – *Co-Chief Executive Officer*

Matt Salem – *Co-Chief Executive Officer*

Patrick Mattson – *Chief Operating Officer*

Will Miller – *Chief Financial Officer*

CONFERENCE CALL PARTICIPANTS

Jade Rahmani – *Keefe, Bruyette, & Woods, Inc., Research Division*

Rick Shane – *J.P. Morgan Securities, LLC, Research Division*

PRESENTATION

Operator
Good morning, and welcome to the KKR Real Estate Finance Trust Second Quarter 2017 Financial Results conference call. All participants will be in listen-only mode. 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 one on your telephone keypad. To withdraw your question, please press star then two. Please note this event is being recorded.

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

Sasha Barenbaum
Thank you. Welcome to the KKR Real Estate Finance Trust Earnings Call for the Second Quarter 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 our remarks and responses to your questions today may contain forward-looking statements that are based on current expectations of management and involve inherent risks and uncertainties that could cause actual results to differ materially from those indicated, including those identified in the Risk Factor section of our prospectus dated May 4, 2017 filed with the SEC on May 8, 2017. Such factors may be updated from time to time in our filings with the SEC, which are available on our website at kkrreit.com. We assume no obligation to update any forward-looking statements except as required by law.

In today's remarks we'll refer to certain non-GAAP financial measures. Reconciliations of these non-GAAP financial measures to the most comparable measures calculated and presented in accordance with GAAP are available in our earnings release and in the supplementary information, both of which are available on the Investor Relations portion of our website.

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 second quarter earnings call. As we discussed on our June 14th call, we had a very active second quarter. Since the IPO, we have been focused on responsibly investing our capital into floating rate senior loans. In the second quarter we originated $224 million of loans, and we have a pipeline with another $779 million of loans closed or under exclusivity since the end of the second quarter. The loans under exclusivity have not yet closed and are subject to customary closing conditions. We believe that all of them will close during the third quarter, and we will update you if and when that happens. Matt will provide more details on the investment activity shortly.

We believe that the market environment for senior floating rate loans continues to be favorable. The increase in transaction activity since the first quarter, combined with the need for refinancings to continue to progress business plans, have provided us with attractive lending opportunities. The heightened competition for light transitional lending opportunities has led to spread compression in this particular market segment. Despite a more competitive environment, we have been unwilling to sacrifice on credit quality, loan structure or asset quality, nor have we been willing to stretch on leverage to achieve incremental returns.

We continue to focus on high quality sponsors, well located institutional quality real estate and loan structures that create prudent alignment of interests with our borrowers. We have been able to compete in this environment and successfully secure transactions by utilizing our relationships with borrowers and sponsors in the market and by competing on creativity, flexibility and speed versus price and proceeds. Generally, we believe real estate fundamentals continue to remain healthy across most property types and markets. Supply is still relatively in check, and most of our borrowers are continuing to progress their business plans in line with the terms of their original underwriting.

Turning to our portfolio, as of June 30th, the currently funded portfolio totaled $1.3 billion, with another $257 million of future funding obligations. One hundred percent of our loans are performing, and our securities portfolio is performing as expected. Including the three loans that have closed post quarter end, our portfolio is 88% invested in senior loans, and the three largest exposures by property type are 36% office, 19% multi-family and 17% retail.

We've made a tremendous amount of progress deploying capital since the start of the year, with approximately $1.3 billion of loans closed or pending closing as of today. We're happy with our pace of deployment, portfolio performance to date, and the quality of our pipeline, and are looking forward to the remainder of 2017.

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

Matt Salem
Thank you, Chris, and good morning, everyone. Let me drill down on our recent capital deployment. In the second quarter we originated two floating rate senior loans totaling $224 million, secured by office properties. The weighted average LTV and coupon for these loans are 64% and LIBOR plus 3.9%, respectively. And on a levered basis, the two loans have a weighted average underwritten IRR of 11.5% at spot LIBOR, which is in line with our targeted returns.

Subsequent to quarter end, our origination pace has been particularly strong. We have already closed three loans totaling $405 million and are in the process of closing an additional three loans totaling approximately $374 million. This activity, assuming all the pending loans close, totals $1 billion of total originations over the two quarters, in line with our target pace of originations.

The loans we have already closed in the third quarter are collateralized by an industrial property in Queens, New York, a Class A multi-family property in Denver, and a luxury condo inventory loan in Manhattan. The three loans under exclusivity are secured by two Class A multi-family properties and an office property. All these loans are secured by properties located in dense, in-fill locations. The three loans that are already closed have metrics consistent with our existing portfolio, with a weighted average LTV and coupon of 71% and LIBOR plus 4.5%, respectively, and a weighted average underwritten IRR of 12.5%.

We continue to enhance our brand and competitiveness in the market. We have direct relationships with the five sponsors on the loans closed in Q2 and Q3 to date. In addition, three of these loans were to repeat borrowers. We are focused on expanding our client base to further fuel these organic lending opportunities.

Now, I want to provide some color on our condo inventory loan, given it is a new property type to our portfolio. In the third quarter we originated a $239 million loan collateralized by the remaining inventory of a newly constructed luxury New York condominium. The sponsor is a top developer in the country, who, as I alluded to before, is a repeat borrower for us. The property has a total of 40 residential units, 10 of which have been sold, representing 18% of the total square footage, at a weighted average gross price per square foot of approximately $3,000. Our collateral is the remaining 30 units, with a weighted average loan per square foot of approximately $2,300 and includes four units already under contract, representing $39 million of allocated loan balance.

The loan represents a loan to net sell-out value of 69% and will pay down and de-lever periodically as units are sold. We will be opportunistic and flexible as we continue to invest and look for pockets of dislocation and relative value. In this case, the combination of collateral quality, basis, loan structure and sponsorship makes this an attractive risk-adjusted opportunity.

In summary, origination activity has been robust. We have a healthy pipeline and we're pleased with how our portfolio is evolving. Now, I'll turn the call over to Patrick.

Patrick Mattson
Thank you, Matt, and good morning. For the second quarter of 2017, our GAAP net income was $14.1 million, or $0.30 per share. Net core earnings, which is core earnings less incentive fees, were $13 million, or $0.28 per share. Book value per share was $19.83. Our portfolio, which totaled $1.3 billion at the end of the quarter, has a weighted average risk rating of 2.9 on a 5.0 point scale, a slight improvement from last quarter. The portfolio experienced no payoffs in the quarter and, as of June 30th, 89% 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 right-hand side of the balance sheet, we continue to scale our financing capacity. As we discussed on our June call, we upsized our Wells Fargo term credit facility from $500 million to $750 million and entered into a new $75 million secured corporate revolving facility, increasing our total financing capacity to $1.8 billion. During the second quarter we also syndicated a senior position with a current balance of $62 million, creating structural leverage on an $86 million loan we originated in the first quarter. Essentially, we've been able to optimize our cost of capital and risk management by utilizing both off-balance sheet and on-balance sheet financing sources, and as we grow the portfolio we will continue to focus on diversifying our financing channels to further optimize our overall financing strategy.

Looking at total leverage, we closed the quarter at 0.2x after temporarily paying down our facilities to minimize cash drag while we ramp our portfolio. As we continue to fund new originations we will re-draw capital from our term facilities to re-leverage the portfolio. Since quarter end we have re-drawn over $410 million. As a reminder, we generally target a 3x leverage ratio on new senior loans, so, as we ramp the portfolio, we expect the total leverage ratio to increase but remain at a prudent level.

Finally, I want to discuss our dividend. For the second quarter, we declared a dividend of $13.4 million, or $0.25 per share, which was paid on July 14th. Because the second quarter represented a stub dividend, given the increase in our equity capital base, we want to give one-time guidance on our expected dividend for the third quarter. We expect the dividend to be in the range of $0.35 to $0.37 per share. Any actual dividend is subject to the discretion of the Board, which is scheduled to meet in mid-September, and we will make an announcement of any dividends declared shortly thereafter. Going forward, we do not plan to provide specific guidance on our dividend, but expect to announce it when declared in the last month of each quarter, a practice consistent with many other market participants.

Thank you, again, for joining us today. We are pleased with our results and look forward to the second half of the year. And now, we are happy to take your questions.

QUESTIONS AND ANSWERS

Operator

We will now begin the question and answer session. To ask a question, you may press star then one on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star then two. At this time, we will pause momentarily to assemble our roster.

And our first question will come from Jade Rahmani of KBW.

Jade Rahmani
Thanks. How would you characterize the competitive environment? Do you think it's rational or overheated?

Matt Salem
Hey, Jade, it's Matt. Thanks for joining the call today. I think similar to what we discussed on our last call, we view the market environment as competitive but disciplined. We haven't seen a lot of new entrants in our particular space, but we have seen some spread tightening. I think some of that was caused by the slower transaction activity that we saw in the first quarter. It feels like activity is picking up into the second and third quarter, and I think you can see some of that coming through in our pipeline as well. But overall I'd say we feel it's a disciplined market, and most people are competing on price and not on structure or terms.

Jade Rahmani
Can you talk to what drove the higher LTVs on your new originations?

Matt Salem
I think that's largely a function of specific assets and what's closing that particular quarter. So, if you look at some of the activity that we've closed over the second and third quarter, some of this was a little bit more stabilized in nature, which obviously you can lend a little bit more on the more stabilized assets.

Jade Rahmani
Do you think any of the increased competition is seasonal, or related to capital deployment plans that have lagged targets, so the amount of competition could moderate somewhat in the second half of the year?

Matt Salem
I think that's difficult to predict. I don't view the competition as very seasonal. I think some of the transaction volumes you can see some seasonality to, but I think it's hard to predict the competition being seasonal.

Jade Rahmani
Do you anticipate any pickup in loan repayments as a result of the competitive environment?

Matt Salem
I think we can see a loan repayment or two. But I think for the most part, given the seasoning of our portfolio we wouldn't expect to see material repayments in the next year or 18 months, just given where our borrowers are in their business plan in executing that.

Jade Rahmani
And just lastly, can you comment on the outlook for B-piece investment, is that still an attractive place to deploy capital? How much in aggregate do you expect to allocate to that strategy? Thanks a lot for taking the questions.

Matt Salem
Sure. I'm happy to. So, specifically, as it relates to B-piece, if you recall, KREF made a side-by-side investment of $40 million next to an existing vehicle and fund that's managed by KKR. We've drawn down some of that $40 million commitment and have been actively investing in the market. We expect to deploy that remaining capital really over the next two years, which is the draw down period of the fund we're investing side-by-side with. But I'd say we've been a market leader in that space in terms of providing risk retention capital to the market, and we see that as, I'd say, a very attractive opportunity right now.

Operator
And our next question comes from Rick Shane of JP Morgan.

Rick Shane
Hey, guys. Thanks for taking my question this morning. Look, I think that what you described in terms of Q2 volume and Q3 volume and where you stand shows the lumpy nature of this business, and the insight into Q3 is very helpful. I am curious because presumably what you're really working on right now, or another group of folks is working on, is building that pipeline into Q4 and frankly into Q1 2018. How do you feel about that pipeline in the context of being able to deliver $400 million to $500 million on average per quarter? And I realize it's going to be a little bit lumpy, but do you feel like the funnel is appropriate right now to meet those objectives in Q4 and Q1?

Chris Lee
Hey Rick, this is Chris. Thanks for the question. I think our view on the pipeline is, as Matt mentioned, we're seeing a lot of activity from our borrowers, and when we look at the pipeline every week we're seeing several opportunities where we have relationships with existing borrowers or we can move quickly on acquisitions, etc., so, as we look forward, we expect that our pipeline will continue to be robust. While we can't give specifics or guidance on what happens in the fourth quarter, and as you mentioned, some of the closings can be relatively lumpy as we're deploying capital and building the portfolio, we're definitely encouraged by the conversations we're having in the market with borrowers, with brokers, and feel good about the pace going into the fourth quarter.

Rick Shane
Got it. Look, given the origination volumes that you're citing for Q3, and you essentially have $400 million already done and that's earning for probably, let's call it 60% or 70% of the quarter, and then you have another $400 million behind that that even if it does close probably won't contribute very much this quarter. I'd love to hear your thoughts about where the core earnings will be in light of that in context of the dividend. And again, I know you're not going to provide earnings guidance, but I'm curious if you think that that dividend policy reflects where you will be at the end of the quarter or what you will deliver during the quarter.

Patrick Mattson
Hey, Rick, it's Patrick. Good morning. So, the way I think about that is we're nearly halfway through the quarter here, if you looked on those loans, and we provide the months which we originated those loans, you'll see that two of them occurred in August, so you can think about that in that context. And then, obviously, the remainder we expect to close over the months of August and September. So, in terms of having an impact on this quarter, obviously, the later ones, it's going to be de minimis, but going forward from the fourth quarter on obviously we expect those loans to contribute fully.

Rick Shane
Yes. So, just to try to put a slightly finer point on it, when you think about your dividend policy, do you

think that that dividend policy reflects what you earned during the quarter or in this growth mode what you would have earned if everything had been in place on day one, so the exit velocity as opposed to the intra-quarter velocity?

Chris Lee
Hey, Rick, it's Chris. When we sit down with the Board, we do look at both. We look at what we have earned from a taxable income perspective in the quarter in which we're paying the dividend, and we're also thinking prospectively and looking at variables like pipeline, when deals have closed in the prior quarter, and it's an iterative process. So, I think, without going into a lot of details and giving guidance, those are all factors as we think about the dividend on an existing quarter but also on a prospective quarter basis.

Rick Shane
Got it. Okay. Thank you, guys.

CONCLUSION

Operator
And this concludes our question and answer session. I would like to turn the conference back over to Sasha Barenbaum for any closing remarks.

Sasha Barenbaum
Thank you again for joining our call. We look forward to speaking to everyone next quarter. Thanks.

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