KKR Real Estate Finance Trust Inc.

Q1 2024 Earnings Call

April 24, 2024, at 10:00 a.m. Eastern

CORPORATE PARTICIPANTS

Jack Switala – *Investor Relations*

Matt Salem – *Chief Executive Officer*

Patrick Mattson – *President and Chief Operating Officer*

Kendra Decious – *Chief Financial Officer and Treasurer*

PRESENTATION

Operator
Good morning and welcome to the KKR Real Estate Finance Trust Inc. First Quarter 2024 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 Jack Switala. Please go ahead.

Jack Switala
Great. Thanks, Operator, and welcome to the KKR Real Estate Finance Trust earnings call for the first quarter of 2024. As the Operator mentioned, this is Jack Switala. Today, I'm joined on the call by our CEO Matt Salem; our President and COO Patrick Mattson; and our CFO Kendra Decious.

I'd 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 certain forward-looking statements which do not guarantee future events or performance. Please refer to our most recently filed 10-Q for cautionary factors related to these statements.

Before I turn the call over to Matt, I'll provide a brief recap of our results. For the first quarter of 2024, we reported a GAAP net loss of $8.7 million or negative $0.13 per share. Distributable earnings this quarter were $26.7 million, or $0.39 per share. Book value per share as of March 31, 2024, was $15.18, a decline of approximately 2% quarter-over-quarter. Our CECL allowance increased to $3.54 per share from $3.06 per share last quarter. In mid-April, we paid a cash dividend of $0.25 per common share with respect to the first quarter.

With that, I'd now like to turn the call over to Matt.

Matt Salem
Thank you, Jack. Good morning, everyone, and thank you for joining us today. I'd like to begin with a brief update on the state of the market.

Despite the latest higher-than-expected CPI print, resulting in muted expectations for near-term interest rate cuts, the commercial real estate market continues to heal with increased transaction volume, price transparency and liquidity across most property types. Given narrowing views around interest rates and sustained economic growth, combined with valuation stability, we are beginning to see encouraging green shoots.

The lending environment is competitive as a significant amount of capital availability outweighs suppressed transaction volumes. Over the last 24 months, insurance companies, foreign banks and government agencies have been able to meet the needs of the market. In sympathy with broader macro strength, spreads are tightening with recent lending on stabilized real estate in the mid-100s. With US banks still largely on the sidelines and the increased market activity, our expectation is for this supply / demand imbalance to normalize and potentially reverse, creating an attractive opportunity for KREF to fill this void as we resume lending in the next few quarters.

Our team has not been dormant. Given KREF's large and diversified CRE credit platform, we have been actively originating loans throughout the cycle. Our bank, insurance and debt funds pools of capital across

the US and Europe are actively investing with a budget of approximately $10 billion this year. Our own pipeline demonstrates this return of transaction volumes with an existing pipeline of deals in review or in closing of approximately $20 billion totaling over 100 opportunities. This compares favorably to last year's weekly average pipeline of $14 billion.

While we expect CRE lending across the US banking activity to remain muted, we are seeing a notable shift of preference from direct mortgage origination to loan-on-loan facilities to institutions like ourselves. This change is driven by more efficient capital treatment, less intense resources and relative safety.

In terms of property type fundamentals, the Office sector remains challenged, though we are beginning to see more liquidity now than six months ago. In KREF’s portfolio, we continue to feel we have identified the potential office issues within our watch list and do not anticipate further negative ratings migration to the watch list from the Office sector.

In terms of Life Science, we remain positive on the sector given the long-term demand from innovations in science and technology, though the market has seen a decrease in funding. We downgraded one additional Life Science loan to our watch list this quarter as a result of challenges posed by the short-term leasing slowdown.

Multifamily fundamentals have slowed given new supply dynamics, but liquidity in the sector is very high. Market research suggests a 50% decline in Multifamily construction starts in 2024 versus 2022, leading many investors to look past the elevated rate environment and current rent pressures. Multifamily represents 43% of our portfolio and has performed well with weighted average rent increases of 3.4% year-over-year.

Now, turning to KREF’s earning results for the first quarter of 2024. KREF comfortably covered our $0.25 per share dividend this quarter with distributable earnings of $0.39 per share. As we stated last quarter, we set our dividend at a level that we can cover with distributable earnings ex-losses with our performing loan portfolio under a number of different scenarios. Our expectation is that in the near term, DE ex-losses will continue to be significantly higher than our dividend.

With the help of KKR Capital Markets, KREF continues to maintain high levels of liquidity with $620 million of availability at quarter end, including $107 million of cash on hand and $450 million of undrawn corporate revolver capacity. We have diversified financing sources across a number of facilities totaling $8.7 billion with $2.9 billion of undrawn capacity.

Seventy-eight percent of our secured financing is completely non-mark-to-market, with the remaining balance mark-to-credit-only. KREF has no corporate debt or final facility maturities until 2026. The composition of KREF’s financing structure remains a true differentiator.

This quarter, we received $336 million in loan repayments, including full repayments of $173 million on our previously 4-rated DC office loan and $151 million on our previously 4-rated New York City condo loan. We funded $103 million for loans closed in previous years for a net reduction of $232 million. Repayments have now exceeded fundings in four of the last five quarters, and we expect this to continue with aggregated projected repayments throughout 2024 of over a billion dollars.

KREF, as an externally managed vehicle, benefits from access to the resources, relationships and expertise of KKR’s global real estate platform that manages nearly $70 billion of assets across both debt and equity. Our dedicated team of approximately 150 real estate professionals has a strong reputation as a full-service capital solutions provider. This integration provides us with an optimal toolkit to implement a variety of strategies, maximizing value across our portfolio.

In addition, K-Star, our affiliated rated special servicer, with a team of more than 45 professionals and over $45 billion of special servicing rights—representing over 5,000 properties—provides us with extensive access to an expert team with sizeable real time market information. We will continue to proactively and transparently navigate this challenged real estate market.

As we mentioned last quarter, we will patiently optimize our REO portfolio. And as we sell those assets, we believe we can reinvest the capital to generate an additional $0.12 per share in distributable earnings per quarter.

And with that, I'll turn the call over to Patrick.

Patrick Mattson
Thank you, Matt. Good morning, everyone. I'll begin with updates to our CECL allowance and watch list.

CECL reserves increased $33 million this quarter, driven primarily by collateral-dependent loan reserves, resulting in an aggregate $246 million of CECL. This was largely related to a further downgrade of our $37.5 million retained mezzanine loan backed by an office property located in Boston. As we mentioned last quarter, KREF is currently in modification discussions, and we anticipate subordination of a portion of our mezzanine loan to new equity contribution from the existing sponsor.

Regarding our risk-rated 5 Seattle Life Sciences loan and Mountain View Office loan, we are working with those respective sponsors to take ownership through a deed-in-lieu of foreclosure in Q2 as we explore the path of joint venture partners and continue to evaluate the go-forward business plans. Further details on these loans, as well as our existing REO portfolio, is reflected on page 13 of our Supplemental.

We experienced no realized losses in the first quarter of 2024; however, during the second quarter, as we anticipate taking title to the Mountain View and Seattle assets, we expect a significant portion of our collateral-dependent loan reserve to flow through distributable earnings. Coupled with the anticipated modification on our Boston Office loan, we project realized losses to total approximately $140 million in Q2, or approximately $2.00 per share, in line with our existing reserves across these three assets.

For our Philadelphia asset that became REO last quarter, we have an agreement in place to sell two of the four buildings with a closing date tracking for Q2. We're comfortable holding the remaining office building and parking garage longer term; however, we may have an opportunity to sell those properties as well, and we'll update everyone on the next call.

KREF is well capitalized with a debt-to-equity ratio of 2.1x, with a look-through leverage ratio of 4.1x as of Q1, slightly lower than year end. We expect deleveraging to continue through the remainder of 2024 as repayments are anticipated to outpace future funding obligations.

KREF's weighted average risk rating on the portfolio remains 3.2, and 85% of our portfolio is risk-rated 3 or better. KREF has built a fortified liability structure that is diversified across two CRE CLOs, a number of match-term lending agreements and asset-specific financing structures, as well as our corporate revolver. KREF's substantial liquidity position of over $600 million at quarter end, including $450 million of undrawn revolver capacity, is a key component of our ability to navigate this dynamic credit and interest rate environment. Coupled with our best-in-class financing, over 75% of which is fully non-mark-to-market, and our long-standing relationships with our financing partners and borrowers, KREF has the tools at its disposal to withstand the challenges of today's market environment.

Thank you for joining us today. Now we're happy to take your questions.

QUESTIONS AND ANSWERS

Operator
We will now begin our 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 the first question will come from Rick Shane from JP Morgan. Please go ahead.

Rick Shane
Hey, thanks for taking my question this morning. So, when we look at the reserve rate at the end of the first quarter and we take the charge-offs that you got into in the second quarter, it would imply a reserve rate ex-those expected losses of about 140 to 145 basis points. Does that seem appropriate? It's obviously well below what your reserve rate has been for the last year or two, but it is also reflecting the realized loss on specifically reserved assets. So how should we think about the reserve rate as you start to realize some of the bigger losses that you've held?

Patrick Mattson
Good morning. This is Patrick. Thanks for that question.

So, I think in terms of that number, it's around 150 to 160 basis points on the balance, so I think you're directionally correct there. I think what it is really reflective of is, as we've worked through some of these more challenged assets on the watch list, we're going to get down to a pool where we think we've got relatively clean composition, so I don't view that number as sort of high or low, it feels probably appropriate right now. I think in the longer term that could even feel a little bit high, but in this market, that's probably the right level.

Rick Shane
Look, you know that I love metaphors and I think that in some ways the reserve is a piggy bank that you've been depositing in for many quarters. I guess what you're saying is that we should expect it is now time to crack open the piggy bank and perhaps make some withdrawals.

Patrick Mattson
I think directionally that's what's happening when you think about the guidance that we're giving on the second quarter.

Rick Shane
Geez, Patrick, I couldn't get you to buy into my piggy bank metaphor?

Patrick Mattson
It wasn't bad, Rick. It wasn't bad.

Rick Shane
Thanks, guys.

Operator
And our next question will be from Stephen Laws from Raymond James. Please go ahead.

Stephen Laws
Good morning. First, I want to start, I guess, with a follow up on the reserve question, and I think you

appreciate the color on the 5-rated loans, but as you think about the 4-rated loans, three of which are Multifamily, how do you think about the next three to six months for those assets? What are the key things you're watching that may move them back to a 3 versus moving to a 5? And when you take a step back and look at the collateral values versus your attachment point with the loans, do you feel there's still good coverage there from a collateral standpoint? Or what is the risk that if they move to a 5, it'll drive incremental asset-specific reserves?

Matt Salem
I can jump in on that one. I appreciate you joining the call and asking the question.

I think on the 4-rated loans, I guess I would break it down a little bit, as you're suggesting, in terms of just by property type. We still believe that the Multifamily segment, while it's going to have noise, especially if you think about just a little bit higher rate environment for a little bit longer could put more pressure on some of the sponsors that don't have as much liquidity as others, but we don't feel like there's material loss content in that component of the portfolio. I think we stated that in previous earnings calls, and I think we still feel like that today. So, while certainly there's the ability to transition a Multifamily property from a 3 to a 4, or a 4 to a 5 over time, you're really looking through to what's the value of that asset versus our basis. I think we still feel pretty good about the overall positioning there.

When you start to think about some of the other assets, like Life Science or other things, there's a little bit more jump risk in terms of just what happens as those transition through. Of course, these loans aren't rated 5 for a reason; they're performing, paying current debt, etc. But at that moment, where you start to get into difficulty or monetary defaults, then those reserves can certainly increase.

Stephen Laws
I appreciate the comments there. And, Matt, I wanted to follow up on your comments around originations. You guys have really been focused on asset management for the past year, and you mentioned that maybe the supply / demand balance is shifting possibly more in your favor over the next coming quarters. What is it that you're looking for before shifting back on offense? Is it getting these three resolutions in the second quarter behind you? Is it some segment of your existing portfolio that you want to monitor performance before returning to offense? Or is it really the returns available that seem pretty tight on stabilized assets that you don't think is an attractive time to put money to work? Maybe a little more clarity on what you're looking for to resume new originations.

Matt Salem
Yes, happy to jump in. I think it's more internal to KREF what we're looking at within our own portfolio than a comment on the market environment, because as I mentioned, through our various pools of capital away from KREF, we actively like the market there. We just think it's going to get better over time.

So, what are we looking for within KREF? I would say a couple of things. Number one, just consistent repayments. So, we're starting to see that. Obviously, you want velocity in your portfolio before you start lending new capital and I think that velocity is coming back. Certainly, four of the five last quarters, we've had repayments offset future fundings. We think we'll get $1 billion dollars of repayments this year. So certainly, that's starting to move in the kind of green zone in terms of how we're looking at it.

The second thing would just be portfolio migration, in terms of what are we seeing from a credit perspective? That feels like it's slowing down. Now, this isn't a market I particularly want to predict the future of, but certainly when we look at the velocity of where things are going from 3 to 4, or 4 to 5, that wave of Office feels like we've dealt with a lot of that already. And there's other things that have come in recently, but it feels like it's slowing down. So I think just some stability around that in the portfolio migration.

And then finally, just leverage ratios, just make sure we get back to where we historically have operated, which has been in more of that high 3s context versus very low 4s where we are today, and that's migrating in the right way. And certainly, when we look through our projections, we expect that to continue to go in the right direction. So those are probably the three things we're watching most closely.

From a liquidity perspective, we have lots of liquidity. So certainly, we can go out and make another loan or two, but I think we really want to see those other areas firm up before we move in that direction.

Stephen Laws
Great. Appreciate the comments this morning. Thank you.

Operator
And the next question will be from Sarah Barcomb from BTIG. Please go ahead.

Sarah Barcomb
Hi, good morning, everyone. So, my first question is related to the Life Science portfolio. Could you talk about the leasing outlook for assets that are still 3-rated that may be close to delivering the project, but potentially remain vacant? Could you give us any insight into leasing for Life Science in your portfolio in general? Thank you.

Matt Salem
Happy to answer that. As you identified, we've got a couple—two—Life Science loans on the watch list today. When you look at the properties outside of those two that have been identified, about 70% of the remaining exposure there is new build, as you're suggesting. So, by definition, very, very high quality, trophy in some cases. And these are extremely well-located assets in the best life science markets in the country. So, I think we feel very good about where those stand currently.

Some are kind of lease ready, and some are still in the process of finishing construction and waiting for that moment to really have an opportunity to attract a tenant in. But I think what we've seen is that the velocity, and it's early days, but certainly with the LOIs, and to some extent leases, that are getting signed at these assets, there's a little bit more velocity in these newer build, purpose-built assets and new construction than we've seen in maybe some of the conversion plays.

Sarah Barcomb
Okay, great. And then my follow up question is related to the REO portfolio. Could you walk us through expectations for potential CapEx spend on these assets and maybe some commentary on your expectations for foreclosures going forward beyond your expected REO disclosures?

Matt Salem
Let me start on the CapEx side. I would say we're still finalizing these business plans. And as we go, REO, we'll develop those. I guess we think about it in a couple of ways. Number one, we were perfectly committed to spending CapEx to position these assets in absolutely the best way possible to attract really high-quality tenants and to stabilize the property. So that is our mindset that we will spend money to create value.

I'd say number two, in most cases, from just a pure CapEx perspective, we don't think there's large, large outlays. I think a lot of the capital is going to come from good news from tenant improvements and leasing commissions as we sign tenants there. And I guess the two ways you could think about it is like from an earnings perspective and from a liquidity perspective. Certainly from a liquidity perspective, not worried about it at all. Again, it's not a big number, we have ample liquidity to implement any strategy we wanted to and from an earnings perspective a lot of the CapEx, by definition, is going to get capitalized into the

asset, so it's not going to come through earnings. And we'll have a little bit of just expenses that will certainly impact earnings. And when we thought about resetting the dividend, clearly, that was kind of factored into some of the scenario analysis as we think about that. So hopefully that helps address a little bit of your CapEx questions.

And then, from an REO perspective, or foreclosure perspective, I think we've identified everything at this point in time in terms of what's in the watch list that we're kind of proceeding down that path. And, of course, we'll keep that transparency on a quarterly basis, and if that changes, we can update it, but there's nothing left right now that we haven't identified that we plan to go to title on.

Sarah Barcomb
Great. Thank you.

Operator
The next question is from Steve Delaney with JMP Securities. Please go ahead.

Steve Delaney
Good morning, everyone. Listen, first, just really applaud the forward disclosure about the losses, the projected REO, and the realized losses in the second quarter. I think it'll certainly make their life easier, and it will yours, and I think shareholders as well, just to kind of not have the uncertainty about Q2.

So, I'm looking at page 11 now, given that perspective, and should we think about this—after those projected REOs—that as far as 5-ratings, as you see things right now, that you're basically left with the Minneapolis and Boston Office properties? Is that the way to look at it sort of post the REO actions?

Matt Salem
That's right. I mean, absent any other changes, that's the way to think about it. And keep in mind that Minneapolis, we have modified that loan, so that's gone through restructuring. And then, as Patrick mentioned in his remarks, the Boston Office is currently under modification discussion, and we've tried to reflect that in the reserves for this quarter.

Steve Delaney
Got it. And with Boston, a little unusual there, because of the retained mezz. Is the $38 million your exposure at KREF and the difference between the total $188 million is with other KKR entities, is that the way to view that?

Matt Salem
There's a little bit of nuance there. I would say the $38 million is—$37.5 million to be direct—but is KREF's total exposure. The debt –

Steve Delaney
That's where I was going.

Matt Salem
That's right. So that's our maximum exposure, $37.5 million. The mortgage debt senior to us, which the two together comprise $188 million, is held by a third party.

Steve Delaney
And obviously you're subordinate of course there. So, you need to focus on that when you look into property value for sure.
So not to get ahead of things, obviously you're aggressively trying to get through these problems in the

workouts, I thought it was a pretty bold but strong move by the Board to make the meaningful cut in the dividend ahead of these resolutions. And obviously, $0.39 in this quarter for reported DE will be offset by the big number next quarter, but it does appear by the time we get into early 2025 that your run rate DE, I would expect, I'll just have to update our models, would be in excess of your $0.25 current dividend. So, I guess psychologically, at the Board level, what does the Board and what does management want to see in the portfolio before it would be reasonable to reconsider the dividend for a possible increase?

Matt Salem
Thanks, I can jump in again. I guess a couple of things. First of all, unfortunately, we just reduced the dividend. I don't think we're increasing it in the near term here. And I think most of the uplift is generally going to come from the recycling of REO assets into performing loans or earning assets effectively. And that's why we keep referencing back to the $0.12 per share where, okay, we're going to take title, we're going to be patient, we're going to lease these. I think that's the best thing for our shareholders, the best thing for our balance sheet over time and not paying out a higher short-term dividend. But if we optimize those outcomes and we repatriate that capital, then we'll be able to, we think, increase earnings by at least $0.12 a share. So that's really what we're focused on is that optimization and implementation of that REO strategy.

We'll see what the world looks like in six months, nine months, maybe other things that have a material impact on that. Obviously, the interest rate environment will be a big driver given we're a floating rate portfolio, but that's what I'd say we're mostly focused on is what is the path and the timeline to get REO assets.

Steve Delaney
Got it. Well, congrats on the resolutions and appreciate the color. Thank you.

Operator
And the next question is from Jade Rahmani with KBW. Please go ahead.

Jade Rahmani
Thank you very much. Just stepping away from the transitional CRE space and looking more broadly, can you give any sense as to what's happening to CRE loans at maturity? What are you seeing for most lenders in terms of loans that come up for maturity, the percentage that get refinanced, get modified, get extended? How would you characterize it from your broader vantage point?

Matt Salem
Thank you for the question. I would say, first of all, I don't have exact numbers at my fingertips in terms of how much is repaying versus getting extended. Certainly, we're in an environment now where there's a lot more extensions than normal payoffs. And I think lenders are more than willing to work with borrowers on an extension scenario if they need a little bit more time to get into an interest rate environment that's more accepting, I guess, of property values. And I think just everyone looks at the maturity wall, maybe that's a little bit of a question embedded in your question. I never look at that maturity wall as like something that's a real sign of imminent danger or issues. I think that if it makes sense and the borrowers are willing to put in a little bit of money, I think almost all lenders are willing to kind of give another six months, twelve months to go down the road. Very few instances are lenders that really need that capital back and force people out of the portfolio. So that'd be a little bit of how we think about it.

Jade Rahmani
Thank you. And on the flip side, from a borrower standpoint, and I know KREF has some large real estate equity holdings, how are borrowers contemplating the outlook now? It seems that there has been a material shift in the interest rate outlook, higher for longer versus earlier in the year. Any color you could

provide there?

Matt Salem
Sure. What we're seeing, and embedded in my comments is like the return to transaction volumes, and of course, when that inflation print hit and we got that rate move and that, I think there was a little bit of uncertainty in the market around how will this impact real estate equity participants, how will they think about acquisitions? How will they think about their ownership of assets?

And what we saw, and it's early days, but I think what we're seeing today is a materially different outlook than perhaps we saw in the fall where we had, obviously, a backup in rates, as well, which is a view that I'm not going to necessarily change how I think about terminal interest rates, terminal cap rates. I may have a little bit higher cost of capital in the interim here; however, my views around growth are more solidified today than they were six months ago. So, people are like leaning into growth a little bit more than they had been and really kind of leaving exit caps around the same from what we can tell. And, therefore, this print has been relatively, I think, immaterial to the mindset of institutional real estate investors. Again, early, but that's certainly what we're seeing right now and there's a lot of big transactions in the market that are pricing, and that's what we're witnessing.

Jade Rahmani
Thanks. And if I could ask a follow up. Could you give a range of what your views of the exit cap rates are, touching on property type? You could leave aside Office.

Matt Salem
So, I think Multifamily right now, I would say entry caps for Class A are somewhere around 5%. Very high 4s to low 5s I'd say is kind of where those entry cap rates are. I think Industrial is very hard to put—and these are all market dependent—I think Industrial is very hard to put a pin on just because: what’s the embedded gain to lease? How long are the lease terms? What market are you in? What's your box size? There's so much variation there. But I do think that a lot of those assets are trading call it high 5s, low 6s, type of context. And then people running exit caps either at or slightly inside those levels to adjust for, obviously, rallies in the treasury over the next couple of years.

Jade Rahmani
Thanks. That's helpful.

Operator
And as a reminder, if you'd like to ask a question, please press star that one. The next question is from Don Fandetti from Wells Fargo. Please go ahead.

Don Fandetti
Patrick, the two remaining Philly assets that you said you could possibly announce a sale, is that indicative of more capital coming in for real estate? Or is that more you just saying this make sense, let's clear the deck?

Patrick Mattson
I think it's a couple of things. I think there are signs in certain markets where, when real estate gets to a certain value, that there's interest. Those two assets that we were and obviously have the ability to hold longer term, one is a well occupied office, and the other is a parking garage. And I think when you talk about that profile of deal, even in this market there's interest. And so, I think as we indicated, we'll see how that transpires over the quarter, but we do think there is some possibility to sell both of those properties.

CONCLUSION

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

Jack Switala
Great. Thanks, Operator. And thanks, everyone, for joining today. Please reach out to me or the team here if you have any questions. Take care.

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

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