KKR Real Estate Finance Trust, Inc.

Q1 2022 Earnings Conference Call

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CORPORATE PARTICIPANTS

Jack Switala – *Head of 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 2022 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
Thank you, operator. Welcome to the KKR Real Estate Finance Trust earnings call for the first quarter of 2022. 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 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 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 2022, we reported GAAP net income of $29.8 million or $0.47 per basic share, and $0.46 per diluted share. Distributable earnings this quarter were $29.8 million, or $0.47 per share, covering our $0.43 per share Q1 dividend.

Book value per share as of March 31, 2022, increased to $19.46, which includes the cumulative CECL impact of $0.33 per share, as compared to $19.37 as of December 31st. This increase in book value was driven by strong portfolio performance, coupled with an accretive equity offering in the first quarter. This is the eighth consecutive quarter in which we have grown book value per share.

Finally, in mid April, we paid a cash dividend of $0.43 per common share with respect to the first quarter. Based on yesterday's closing price, the dividend reflects an annualized yield of 8.7%.

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

Matt Salem
Thanks, Jack. Good morning, everyone. Thank you for joining us today. Let me start today's call by welcoming Kendra Decious to the KREF team as our Chief Financial Officer. Kendra is a KKR veteran, having joined the firm in 2006 and most recently served as a Managing Director in KKR's finance group.

We often talk about the benefits of KREF's integration within KKR which range from sharing views with our macro and real estate equity teams to differentiated financing by partnering with KKR Capital Markets. We also benefit greatly from a deep bench of talent, and having Kendra join our leadership team is a great example of that.

Now turning to the first quarter, KREF delivered strong financial results with distributable earnings of $0.47 per share covering our $0.43 per share dividend, and we grew our book value for the eighth consecutive quarter. We also had a strong investing quarter originating nine senior loans totaling $844 million bringing our total funded portfolio to a record $7.25 billion up 36% on a year-over-year basis.

Multifamily loans represented 55% of our Q1 origination commitments and continues to be the largest property type in our portfolio. In addition to multifamily, we are placing emphasis on other strong performing property types demonstrating the highest rent growth which includes industrial and life sciences. These property types represented 18% and 15% of our first quarter originations, respectively.

In the first quarter, increased volatility and heightened geopolitical risks created a more conservative lending environment. Spreads in the senior secured CRE lending market widened slightly by approximately 25 basis points relative to the fourth quarter, and we are lending with more conservative terms and structure.

We believe our lending strategy offers strong risk-adjusted returns in this environment. Our focus on first mortgage loans secured by high-quality real estate owned by institutional sponsors provides a defensive investment with significant equity cushion, and our returns also benefit from the steepening of the front end of the yield curve.

Pipelines remain strong with an increase in activity from larger sponsors seeking a balance sheet solution to avoid the volatility in the single-asset, single-borrower CMBS market. Increases in market rents have also created more transitional lending opportunities for KREF as sponsors need more time to convert in-place rents to market. This has been particularly pronounced in the multifamily and industrial sectors.

In short, now is a good time to be making loans, and we are well capitalized to do so with over $750 million of liquidity as of quarter end. As we look at our pipeline, we continue to see strong activity and have approximately $1.3 billion of loans either closed or under exclusivity subsequent to quarter end.

Throughout 2021, we generated mid-teens ROEs as rates declined due to our in-place rate floors on our loan portfolio while our liabilities in large part were not subject to rate floors. As those loans with higher floors have repaid, we now feel our earnings are neutral to minor increases in rates, and based on the forward curve, we would expect earnings to become positively correlated with rate increases in the second half of this year.

Finally, in Q1, we received $282 million driven by four repayments. Given our strong origination volumes and modest repayments, our growth trend continued with net funding of $462 million. We expect to continue to match our repayments with attractive origination opportunities and feel we are well positioned in the current lending environment.

With that, I will turn the call over to Patrick.

Patrick Mattson
Thank you, Matt. Good morning, everyone. I'll focus today on our efforts on the capital and liquidity front, some updates on our watch list, and the progress we're making around the LIBOR to SOFR transition.

We had a very active first quarter across the entire capital base. On the liability front, there are three notable transactions all of which enhanced our market-leading liability structure. First, we successfully priced a new $1 billion CRE CLO in February. The CLO issuance, which allowed us to continue to grow our brand in the market, is supported by 100% multifamily properties and achieved an investment grade advance rate of 84.75%. This CLO priced at a running cost of capital of SOFR plus 171 basis points and features a two-year reinvestment period.

Second, in March, we upsized the bespoke fully non-mark-to-market facility from $500 million to $750 million which features three years of availability and match term financing.

Finally, also in March, we upsized our existing revolving credit facility from $335 million to $520 million and extended the maturity date with a new five-year term. Subsequent to quarter end, we further increased the size of the revolver to our target $610 million. These achievements increased our fully non-mark-to-market financing to 79% as of quarter end with the remaining 21% balance only subject to credit marks.

We also made significant progress on the equity front. First, we raised $151 million in net proceeds through a follow-on issuance of our Series A preferred shares at a fixed-for-life cost of 6.5%. Additionally, we raised $134 million of net proceeds through a common equity offering which is accretive to book value by $0.11 per share. This increase of $285 million in permanent equity in 1Q decreased our total leverage ratio from 3.7 times as of year end to 3.2 times at quarter end. We are continuing to deploy proceeds from this recent equity offering and would expect leverage to increase back to the target in the mid to high 3 times range over Q2 and into Q3.

Our liquidity position remains very strong and exceeded $750 million as of quarter end. This total included over $170 million in cash and $520 million in undrawn corporate revolver capacity available to us as of quarter end.

In addition to this, we had $377 million of unencumbered and unpledged senior loans. As Matt mentioned previously, we have the opportunity to generate attractive risk-adjusted returns in the current market environment given our strong liquidity position.

I also want to update on our watch list. The current portfolio has a risk rating of 2.9 on a 5 point scale in line with last quarter, and 95% of our loans are risk rated 3 or better relative to 94% last quarter. Quarter-over-quarter, our watch list has decreased by a net $40 million on a committed basis.

Three assets came off the watch list this quarter. First, in January, our 4-rated Brooklyn-based hospitality loan, which was originated in January 2019, was repaid in full through a property refinance with a large money center bank. Second, in February, we originated a new loan to finance the acquisition of the Queen's industrial property with a new sponsor coming in with fresh equity. Third, good progress has been made at our 107-unit New York condo conversion loan, and we reduced the loan's risk rating from a 4 to a 3 and removed the loan from the watch list.

In terms of the asset that remains and assets that have been added to the watch list, our New York luxury condo loan remains on the list. As a reminder, this loan had an initial balance of $240 million and is paid down to $32 million. We were in well margined to where recent sales have been. Just four units remain to be sold with one unit under contract.

Lastly, we've added two office loans based in Philadelphia to our watch list. Both loans are performing with in-place occupancy to very strong sponsors, but we placed these loans on the watch list to reflect softer office leasing velocity within the broader Philadelphia MSA.

Finally, we made strides on the LIBOR to SOFR transition with the goal of mitigating basis risk throughout this transition period. As of quarter end, 25% of our floating rate liabilities were SOFR-based, and 13% of our assets were SOFR-based. We expect the transition to SOFR to be non-material to us from an earnings perspective.

In summary, KREF finished the quarter with a record $7.25 billion total funded portfolio which has grown by 36% on a year-over-year basis. We originated nine senior floating rate loans in Q1 for over $840 million and grew the funded portfolio by $462 million. We expanded our permanent equity base by 21% to $1.65 billion and executed on a CLO, upsized a bespoke non-mark-to-market financing facility, and upsized our revolving credit facility by $275 million to a total of $610 million post quarter end. We grew book value per share by $0.09 per share.

Finally, we have ample liquidity to capitalize on the current market backdrop, and we feel we are well positioned to generate attractive, risk-adjusted returns in today's lending market.

Thank you for joining us today, now we're 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 one on your touchtone phone. If you're 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.

The first question will be from Jade Rahmani with KBW. Please go ahead.

Jade Rahmani
Thank you very much. Can you talk to the tone in the current market and what you're seeing from borrowers as well as competitor lenders? Also did your pace of originations underperform perhaps your estimates relative to where you said loans and closing were at the last quarter's comments?

Matt Salem
Hi, Jade. It's Matt. Thank you for the question. It's good to hear from you. Just in terms of the tone in the market, I think clearly we're seeing at the macro level a lot of uncertainty as it relates to inflation, as it relates to short-term interest rate increases, certainly geopolitical environment. Then, when you look down at the real estate level, things feel pretty healthy especially in the growth sectors with some pretty substantial rent increases across a lot of the property types that we invest in.

I'd say what we're seeing in the market from our borrowers is trying to navigate that dichotomy and trying to understand what is going to be the long-term impact or short-term impact on real estate fundamentals and values, but I think we're still seeing an increase in allocation to real estate if you think about some of the inflation prints that we've seen in the market. People view real estate as an inflation hedge, as a good investment within an inflationary environment. There's still a lot of demand for real estate, and it's a very active acquisition market today as well.

On the lending side, it's more cautious today for sure. You've seen the CMBS market reprice pretty substantially in line with other capital markets. That has a little bit of a knock-on effect on the balance sheet. Lenders, as you just start to see more supply come out of the securitized markets into our market, and we're certainly looking at a number of opportunities that wouldn't historically be in the capital market space.

From a lender's perspective, it's certainly as we mentioned in our comments, there's more structure, there's a reduction in leverage, and an overall more cautious tone. Whether it's in the security space or in the lending space, everything is functioning, you can execute in either market, but it's just obviously a little bit more costly, and it has more structure attached to it.

Then, on the—I think you'd ask around the originations as well. I think we had said we did around a billion dollars a quarter. We were slightly under that in the first quarter, and it's always hard to predict, obviously, and land that exactly. Then you can see where what we signed up with in the second quarter, and if you add them together, it's pretty close to that billion dollars a quarter. Maybe slightly behind the first quarter, but there's a number of factors in play. Obviously, the macro environment was changing, and we were mindful of that and just watching pacing a little bit. The equity raise that we did was towards the back half of the deployment schedule for the first quarter.

Some of that capital probably wasn't available to us, just a number of factors, but I think if you look across the year, we still feel pretty good about that estimate. Obviously, when you add the two together, it gets close to those numbers

Jade Rahmani
Thank you. The growth in the non-traded REIT sector has been astonishing, I think, BREITs raising $3 billion a month with non-traded REITs raising, I don't know, a billion a month maybe, and Blackstone seems to announce a new REIT acquisition every week which probably has to continue for them to deploy that capital. What impact on the market, if any, do you believe that influence is having, and do you view it as a negative, a positive, or not really relevant to overall real estate? I mean, the concern would be that they're, in fact, setting pricing in some areas of the market, and that could be feeding into, for example, multifamily.

Matt Salem
Yes, I wouldn't want to comment on how it's impacting the broader real estate markets. I can tell you how it's impacting Real Estate Finance and the things that we do on a day-to-day basis. It's creating just a lot more lending opportunity. If you think about the publicly traded REITs, historically they would finance themselves not through the CMBS market, not necessarily through the mortgage market. They would pretty heavily use corporate unsecured. You see the transfer of debt from that unsecured market into the mortgage market, and I think that drove a lot of the issuance in SASB in the single-asset, single-borrower CMBS market last year.

Locally sitting here, I think it's a net positive, because it gives us more opportunities to lend to high-quality sponsors, and they're typically not high-leverage borrowers either, it's a relatively safe lending profile. If you take one step back out of KREF and think about what we're doing across our—picking our real estate credit platform, with the insurance capital we have, with securities capital that we have, it certainly created a good investing environment for the debt side of our business.

Jade Rahman

Okay, so you're saying that you are lending to them? I don't think that the negative. It's positive probably because they are very low leverage, but is that what you're saying?

Matt Salem
Yes, it's a great lending opportunities for—I'd say investing opportunities for us both on the direct lending side, as well as on the on the securities investing side away from KREF and some of the private funds that we manage.

Jade Rahmani
Thank you very much.

Matt Salem
Sure.

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

Stephen Laws
Hi, good morning. Matt, I wanted to start a kind of bigger picture. A lot moving around with asset yields, interest rates, financing costs, etc. Can you can you maybe walk through ROE on a say a new dollar put into a senior loan multifamily today versus kind of how that ROE build looked in the fall maybe looking at coupon financing costs and the leverage you can get either to CLOs or your counterparties?

Matt Salem
Yes, Stephen, thank you for the question, I can take a shot at that. I think that the math is relatively straightforward. I would say asset and liability spreads have widened call it 25 or so basis points on the year. Those are largely offsetting. Leverage available to us as a borrower is largely unchanged, and you do have to seek financing in other places. There's more dispersion in the cost of financing today. The CLO market obviously is the wider end of pricing, but there's certainly other alternatives to that that you can use that haven't widened out as materially.

You have to be a little bit more discerning in where you're borrowing, but overall, I would say from an ROE basis, most of the impact we're seeing is really from the forward curve and a little bit more obviously, conservative lending environment for what we're doing. We're thinking about ROEs now call it probably up 100 or so basis points, maybe slightly more from the fall of last year.

The posture of the market just away from ROE, as we mentioned in our call, I mean, the posture of the lending market is certainly very different than the fall of last year. There's much more conservatism in the market today, and it's a little bit more of a lenders' market, if you will.

Stephen Laws
Great, thanks for those comments, Matt. Patrick, shifting the interest rate sensitivity, appreciate the disclosure you guys provide. Certainly, it'll become a tailwind here soon. You know, with our information, we tend to do more things on average, but trying to think about any lumpiness in that are there any large loans that could repay that have significance in the money floors or anything we need to look at from a lumpiness and a LIBOR sensitivity standpoint?

Patrick Mattson
Sure. Good morning, Stephen. Thanks for the question. I think that's right. Where we'd have some sensitivity as to the positive, meaning that we still have a few larger loans that have higher

LIBOR floors, and as we forecast over the course of this year and beyond those are, as you can imagine, some of the loans that are expected to be repaid. We think that there's modest improvement as those loans get repaid.

Obviously, keep in mind that as we make any new loans, those new loans are set at floors that are at spot or below sort of spot rate. They're 100% sensitive to the rate movement, this is a snapshot, obviously, as of the first quarter, but as we think into the second quarter, two factors are happening. One, rates are going higher, and as you think about the chart we're kind of shifting our starting point to the right a little bit.

Second, we're increasingly turning over those LIBOR loans into new SOFR loans which also should have a positive bend to the outlook on this chart in subsequent quarters.

Stephen Laws
Great, appreciate the comments, Patrick. Thanks for taking my questions this morning.

Patrick Mattson
Thank you.

Operator
The next question is from Don Fandetti with Wells Fargo. Please go ahead.

Don Fandetti
Yes. Can you talk a little bit about the two Philadelphia office buildings that were added to the watch list? Is that just a situation where the business plans are a little behind schedule? Is it pandemic-related? Then, maybe just broader comments on office. Do you think there's still risk of like these laggard office credits popping up to the watch list?

Matt Salem
Don, it's Matt. Thank you for joining us, and thanks for the question. A couple comments on the two we added. They were both called light value-add, lease-up plays, pretty typical for the office profile lending we would do. Was it COVID-related? I certainly think COVID had an impact on office leasing overall and certainly within the Philadelphia market. I think that it's hard to say that wasn't impacted by that.

Why we put them in our watch list is because we haven't seen progress on the leasing front there. Certainly, the business plans are a little bit behind, not materially, but a little bit behind what we would have projected or budgeted from a leasing perspective.

The occupancies are similar to where we originally went on them. Both, I would say, have significant cash equity behind us in terms of at closing capital contributions from sponsors. We'll continue to monitor those and keep everyone updated.

Overall, I'd say on the office sector, it still feels pretty bifurcated. The growth markets and high-quality assets we're seeing a pretty strong leasing demand in in those areas whereas as you get into the more stagnant markets or Class B type of office, that's really where you're seeing the least amount of need for space. I do think that will continue to play through the market, and that's our expectation going forward.

Don Fandetti
Got it. Thank you.

Operator
The next question will come from Rick Shane from JP Morgan. Please go ahead.

Rick Shane
Thanks for taking my call this morning. Look, you've talked a great deal about your emphasis on multifamily and life science. Obviously, you continue to participate in all segments of the market. I'm curious, given the competition and sort of think of it on a continuum basis for multifamily down to probably office or at the other end, can you talk a little bit about how the competitive landscape and how that impacts deal term and pricing? So, what would you expect the differential to be at different parts of the continuum?

Matt Salem
Rick, it's Matt. I can try to take that. It's interesting, and I'll kind of give you the update locally here in what we're seeing, and clearly we're operating in an environment that has more uncertainty than the past.

Overall, it feels like leverage has dialed back call it 5% or so across all property types, but I think you were asking more about the relative continuum between multifamily at one end and office on the other. I would say that, generally speaking, that continuum is probably not as wide as you think from a leverage perspective. Multifamily is currently in that maybe high 60% to 70% LTV on a transitional asset, again dialed back about 5% from the end of the end of last year, and office leverage depends on the amount of transition, but you're probably thinking more around 60% to 65% leverage.

Again, every office is going to be pretty unique, but if you have a lot of in-place tenancy, and you have some duration to those leases, then you could certainly see a 65% leverage profile.

Then from a cost of capital perspective, multifamily is at the tight end of the range. We're seeing that pricing and today's market in the called very high 2s over SOFR. Office clearly has a three-handle on it. A little bit depending on leverage, but call it low to mid-3s would probably be the office quote, depending on the dynamic there.

Hopefully, that gives you a little bit of the range in terms of multifamily and office, and I would say industrial is pricing somewhere in the middle but probably closer to the multifamily end of things than the office.

Rick Shane
No, it's a great answer. I really appreciate the effort to be that specific. Thank you very much.

Matt Salem
Sure.

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

Steve Delaney
Thanks. Congratulations on a strong quarter, dividend coverage, and also the Capital Markets activity. Let me start with Capital Markets. The preferred deal, the common deal, I guess $280 some-million combined. Is there a direct linkage in terms of that equity formation to your ability to increase your revolver and your term loan facility the way you did in the quarter?

Patrick Mattson
Hi, Steve, good morning. It's Patrick. Certainly, I think as you looked at what we've done over the last couple of years, as we've grown the equity base, we've gone back to a number of our facilities. There was two examples of that this quarter, both on the non-mark-to-market facility which we grew from $500 million to $750 million but also the revolver, which we grew from $335 million to $610 million subsequent to quarter end.

Certainly, we think about as we increase equity our ability to increase our liabilities. We did that in the fall with a term loan B. We had a $300 million term loan B that we repriced and then upsized an additional $50 million. I think as you see us continue to grow the company, we'll have opportunities to size up the debt pieces that we have in place.

We are still very focused on diversity, as you know, and we're not done evolving and continuing to innovate on the financing side. We'll continue to look to add other sources of financing, but clearly growing some of the existing facilities that we have through the relationships at KKR Capital Markets is one of our top goals.

Steve Delaney
Great. Yes, and as I looked over it I was thinking, okay, you really have your 79% non-mark-to-market, you have a lot of diversity in the funding, and if I see any kind of a gap, or let's call it an opportunity, you do have the one small convert, but I'm curious if you're watching the high yield notes market, another convert and with the objective of obtaining some fixed rate funding which would clearly make you more asset sensitive.

Patrick Mattson
Sure, I mean, those markets, the two that you mentioned, are ones that we track, we watch closely, and I think going forward we'll be opportunistic in thinking about how to access those.

Steve Delaney
Thanks, Patrick.

Patrick Mattson
Thank you.

Operator
The next question is from Eric Hagen with BTIG. Please go ahead.

Eric Hagen
Hi, thanks. Good morning. I think I have a couple. First, just want to ask about the coupon spread on the multifamily loans you originated in April and maybe understand a little bit more about what's driving that to come in a little tighter than the spread you have in the back book. Then, on the conditions in the CLO market, I imagine that having the multifamily loans makes it easier to potentially issue going forward, but can you share some detail around how other loan types are financing through CLO right now and your outlook there?

Matt Salem
Yes, I could take the first part, Eric. It's Matt. Thanks for the question.

You know, just on the multifamily deals that we did in in April, I think these are generally in line with where we see current market spreads. I can go back and compare him to what we did in the

first quarter on the multifamily side, but as I mentioned to Rick, I think we see that multifamily market from a spread perspective in that very high 2s area, and this is in line with that.

Then, I'm sorry, can you repeat your second question?

Eric Hagen
Yes, just checking in on conditions in the CLO market. I imagine that having the multifamily loans makes it a little more seamless to potentially issue another deal going forward, but any detail around how other loan types are financing through the CLO.

Patrick Mattson
Eric, it's Patrick. I'll take that question. Certainly, when I think about the range of assets that can be financed in the CLO market, it's relatively wide. I mean, it fits all of the major asset types that we think about from an asset selection standpoint, multifamily office, life science, industrial, all readily financeable in the CLO market.

We did the multifamily-only CLO and in the first quarter, and I think that was generally well received, and obviously we'll continue to have the benefit of that going forward from a reinvestment standpoint, but I think that the market is open to finance all of those property types. I think the range of capital structures in spreads differ a little bit, and probably there's been more differentiation this year than we've seen in the past. I think that's not uncommon when you see spreads widen out, but I think if you look at where the asset coupons are for those different property types away from multifamily, they can still be financed relatively efficiently.

Eric Hagen
Got it. That's helpful. Thank you.

Operator
Again, if you have a question, please press star, then one. The next question is a follow up from Jade Rahmani from KBW. Please go ahead.

Jade Rahmani
Thanks very much. Just to follow up on the watch list loans, the two Philly loans were they put on watch list merely because the Philadelphia office market index slowed and that was what triggered that, or are there asset-specific reasons for that?

Matt Salem
It really has to do with the business plan, just the leasing profile of each asset, and we just haven't seen a lot of net absorption or net positive leasing at each of the properties. It's obviously a comment on the broader Philadelphia market, but it's flowing through to these assets in particular.

Jade Rahmani
In your view, does the Philadelphia office market represent more of that sluggish trend that we're seeing in legacy office where there isn't that compelling a need to be back in the office, or is it a timing factor? What do you think the main explanation is?

Matt Salem
I think Philly is one of those markets that's lagged during COVID.

Jade Rahmani
Okay. Thanks very much for taking the follow-up.

CONCLUSION

Operator
Ladies and 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, everyone, for joining today's call. Please reach out to me or the team here with any follow-up questions. Take care.

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

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