

KKR Real Estate Finance Trust, Inc.
Second Quarter 2018 Financial Results
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CORPORATE PARTICIPANTS

Chris Lee – *Co-Chief Executive Officer*

Matt Salem – *Co-Chief Executive Officer*

Patrick Mattson – *Chief Operating Officer*

Mostafa Nagaty – *Chief Financial Officer*

Sasha Hamilton – *Investor Relations*

CONFERENCE CALL PARTICIPANTS

Stephen Laws – *Raymond James*

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

Rick Shane – *JPMorgan*

PRESENTATION

Operator

Good day and welcome to the KKR Real Estate Finance Trust Second Quarter 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 (0). After today's presentation there will be an opportunity to ask questions. To ask a question, you may press star (*) then one (1) on your telephone keypad. To withdraw your question, please press star (*) then two (2). Please note this event is being recorded.

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

Sasha Hamilton

Thank you. Welcome to the KKR Real Estate Finance Trust earnings call for the second quarter of 2018. I'm joined today by Chris Lee and Matt Salem, our co-CEOs; Patrick Mattson, our COO; and Mostafa Nagaty, 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 recently 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 second quarter of 2018, our GAAP net income was \$23.5 million or \$0.44 per share. Net core earnings were \$37.5 million or \$0.71 per share, up significantly from the prior quarter due to the realized gain on our sale of CMBS B-piece investments in the quarter. Book value per share as of June 30, 2018 was \$19.82, up \$0.03. In July we paid a dividend of \$0.43 per share with respect to the second quarter. Based on yesterday's closing stock price of \$20.68, the dividend reflects an annualized yield of 8.3%. Our Board is scheduled to meet in mid-September to discuss the Q3 dividend, and we will make an announcement shortly thereafter.

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. We continue to demonstrate the strength of our franchise this quarter. We originated \$729 million of loans, a record quarterly originations volume for us. Post quarter end, we originated an additional \$416 million of loans, bringing us to total year-to-date originations of \$1.6 billion compared to \$1.5 billion for the entire year of 2017. In the last 12 months ended August 7, 2018, we originated \$2.1 billion of senior loans, a 50% increase over the same period ended August 7, 2017, and a 42% increase over full-year 2017 originations. We have built up a robust pipeline of another \$405 million of loans currently under exclusivity that we expect to close in the coming months subject to customary closing conditions. As of June 30th, the total portfolio stood at \$3 billion, a 42% increase since the beginning of the year. Matt will provide more details on our investment activity shortly. Despite a competitive lending environment, we have been able to secure attractive opportunities to invest capital, consistent with the same risk-return parameters we have had over the last several quarters. Our record originations pace demonstrates our extensive relationships with sponsors and intermediaries in the marketplace and the benefit of our integration with the KKR Real Estate platform from a sourcing and underwriting perspective. These competitive advantages played a key role in the loans that we have originated in the first

seven months of 2018.

Our brand awareness and market presence have improved, which has led to improved market penetration. In this very competitive market, we have continued to differentiate ourselves through noneconomic variables like speed, certainty, and creativity as it relates to structuring around complexity. We have also developed a strong reputation as being a borrower-friendly lender during the post-close phase of the loan, which is driving significant repeat business across our portfolio. We have also continued to focus on achieving a best-in-class cost of capital, which enhances our competitive positioning when trying to originate loans in the lighter transitional segment of our opportunity set. We are encouraged by the conversations we are having with borrowers and intermediaries. We have a robust pipeline and are confident in our ability to secure our share of the highest quality transitional lending opportunities. We've had an exciting first half of the year and are pleased with our origination activity, our competitive positioning, and the progress we're making on the right side of the balance sheet. We look forward to continuing this momentum for the remainder of 2018.

With that, I will turn it over to Matt.

Matt Salem

Thanks Chris, and good morning, everyone. I'll start by discussing our recent investments. In the second quarter, we originated three floating-rate senior loans totaling \$729 million. These loans are collateralized by three class B and B+ office properties located in Queens, Boston, and Philadelphia. The weighted average LTV and coupon for these loans are 70% and LIBOR plus 2.8% respectively. And on a levered basis, the three loans have a weighted average underwritten IRR of 11.3% at spot LIBOR, which is consistent with our existing portfolio. These loans fit our program of light transitional lending to institutional sponsors in major markets. Notably, the average occupancy of these three office properties is 75%, which creates in-place cash flow and the possibility for near-term stabilization.

Our strong origination pace has continued into the third quarter. We have already closed two senior loans, a \$341 million senior loan secured by an 88% occupied multifamily portfolio located in Atlanta and Tampa. We also refinanced an existing loan in our portfolio, creating a new \$75 million senior loan secured by an 83% occupied class B+ industrial property in Atlanta, Georgia, with an additional 18 months of call protection. The weighted average LTV and coupon for these loans are 75% and LIBOR plus 3.1% respectively. And on a levered basis, the two loans have a weighted average underwritten IRR of 10.9% at spot LIBOR. Both of these loans are to repeat borrowers. Our team's extensive relationships with owners and operators of real estate and the first-class experience that we provide borrowers have been key drivers of our origination activity. We've been able to differentiate our platform with our borrowers through the closing process and subsequent asset management, and our ability to convert existing borrowers to repeat borrowers speaks volumes about our team and process. Repeat borrowers represent one-third of our last 12 month originations and nearly 50% of year-to-date originations.

Looking at our forward pipeline, our strong origination pace has continued, with five loans under exclusivity to close over the next few months totaling approximately \$405 million. As always, these are subject to customary closing conditions. Again, this pipeline is driven by existing relationships, as four of the five loans are to repeat borrowers. In terms of repayments, we had a \$15 million paydown of our condo inventory loan this quarter associated with the sale of units. Subsequent to the quarter end in addition to the refinance I mentioned earlier, we received a \$63 million repayment of a senior loan secured by a multifamily property in Austin, resulting in

prepayment income of approximately \$680,000 in the third quarter. As our portfolio seasons, we are starting to see a pickup in repayment volume. We expect additional repayments over the next few quarters and to enter a run rate pay-off schedule in the first half of 2019.

Turning to our portfolio, as of June 30th the portfolio was \$3 billion, with another \$441 million of future funding obligations. 100% of our loans are performing, and our securities portfolio is performing as expected. The portfolio is 97% invested in senior loans and is diversified both geographically and across property types. Office and multifamily loans comprise 80% of the portfolio. Also of note, our hotel exposure is less than 1%, and we have no construction loans in the portfolio. As we discussed on the last few calls, we continue to concentrate on the multifamily and office property types due to their short-term, light transitional business plans. As of quarter end, the average occupancy of the office properties in our portfolio was 73%. We are focused on creating a defensively positioned portfolio, and we will continue to target the highest quality opportunities, trading incremental yield for credit quality.

On another note, during the quarter we sold the majority of our CMBS B-Piece investments for net proceeds of approximately \$113 million. For GAAP net income, we realized a gain of \$13 million for the six months ended June 30th, of which \$5.5 million was recorded as unrealized in the first quarter. For core earnings, we realized a gain of \$19.4 million or \$0.37 per share over the initial cost basis of the CMBS investments sold. All of this income has been recognized in GAAP, but has been excluded from core earnings until this quarter, when the sale was completed and the gain was realized. This will result in a \$3.3 million incentive fee in the third quarter. Patrick will discuss this in more detail shortly. We are pleased with the outcome of this sale and the positive economic impact for the Company and our shareholders. Post the sale, we continue to hold direct CMBS investments with a fair value of \$13.2 million, and we have a \$40 million commitment to RECOP, which is 55% funded.

In summary, we made good progress the first half of the year. We are in line with our target pace of originations, with approximately \$2 billion of loans closed or pending closing as of today, and we are pleased with the quality and the performance of our portfolio.

Now I'll turn the call over to Patrick.

Patrick Mattson

Thank you Matt, and good morning everyone. Our portfolio, which totaled \$3 billion at the end of the quarter, has a weighted average risk rating of 2.9 on a five-point scale, consistent with the prior quarter. Additionally, as of quarter end, 98% 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 optimize our financing. As highlighted last call, we've been working closely with KKR Capital Markets to explore funding options and improve the cost and structure of our liabilities. In April, we entered into a term loan financing agreement that provides us matched-term financing on a non-mark-to-market basis and nonrecourse. During the quarter we subsequently increased the size of this facility from \$200 million to \$600 million of total capacity. As of June 30th, the weighted average rate on the term loan facility was LIBOR plus 1.4%.

Separately, earlier this month we closed on a similar new \$200 million facility, which is matched-term, non-mark-to-market, and partial recourse for the Company, with pricing rates of LIBOR plus the mid-100s. The attractive cost of these facilities allows us to compete for the highest-quality lending opportunities and secure better credit for KREF, while still delivering an attractive

return to the Company. In addition, the liability structure is more durable from a mark-to-market perspective and improves our ability to manage risk and liquidity on the balance sheet. We are focused on increasing the size of both of these facilities, and we'll continue to work with KKR Capital Markets to create additional matched-term, non-mark-to-market financing capacity. In addition to these new facilities, we also issued \$144 million of five-year convertible notes this quarter, raising \$139 million of net proceeds for the Company. These notes diversify our balance sheet, provide us new capital to further grow the portfolio and earnings power of the Company, and increase our positive correlation to rising interest rates.

Turning to the debt-to-equity ratio, we closed the quarter at 1.2x, and 1.8x from a total leverage perspective. We continue to releverage the portfolio as we fund new originations, and as a reminder, we generally target a 3x leverage ratio on new senior loans and slightly higher when financing on a non-mark-to-market basis.

One other note on the balance sheet. In the second quarter, we repurchased 78,000 shares at a weighted average price of \$19.72 per share. Post quarter end, we repurchased an additional 9,000 shares, bringing year-to-date repurchases to 697,000 shares at a weighted average price of \$19.54 per share. Our Board authorized a new \$100 million repurchase program for one year starting in June. As of today, \$49.3 million is remaining for future stock repurchases below book value, and an additional \$50 million is generally available during this authorization period.

Finally, one clarifying item related to the incentive fee before we open it up to questions. As a reminder, the Company pays a quarterly incentive fee of 20% of trailing 12-month earnings over a 7% hurdle rate. The incentive fee is calculated and paid with a lag, so in connection with the gain on sale of our CMBS investments in the second quarter, the third quarter will include a total estimated incentive fee of approximately \$3.3 million, of which \$2.4 million is directly related to the CMBS sale. Based on current operations, we expect run rate incentive fees of approximately \$1.1 million to \$1.4 million per quarter, which will be included as an expense for calculating net core earnings.

Wrapping things up, another strong quarter and a solid start to the third quarter. Our origination pace remains robust, our portfolio is performing, and we made significant progress creating differentiated financing. Thank you for your support, and thank you again for joining us today.

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 (1) 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 (2). At this time we will pause for a moment to assemble our roster. Our first question will come from Stephen Laws of Raymond James. Please go ahead.

Stephen Laws

Hi, good morning. Thanks for taking my question. I guess, first, maybe can we touch on core earnings if we try and isolate the loan portfolio. Can you give us an idea of how much the CMBS B-Piece assets contributed in the first quarter? And then maybe any second quarter impact from those assets that we need to consider as we think about kind of a run rate core EPS in the back half of the year?

Mostafa Nagaty

Good morning. This is Mostafa Nagaty. So just picking on the CMBS, during the quarter, we sold obviously, the majority of our CMBS for net proceeds of about \$115 million. Our initial cost basis for the CMBS Pieces sold was \$94 million, and the fair value as of December 31st was about \$100 million. So as Matt and Patrick mentioned in the remarks, for GAAP net income we realized \$13 million for the six months ended June 30th. And remember, of that \$13 million, \$5.5 million was unrealized in the first quarter. As of June 30th, the remaining fees have amounted, I guess, around a principal balance of \$35 million and fair value of \$13 million. So if you look at core earnings for the six months, the \$11.9 million, that includes \$5.4 million reversal of the Q1 unrealized piece and includes \$7.5 million -- approximately \$7.5 million related to the difference between our initial cost basis in the CMBS and our December 31st mark.

Stephen Laws

Okay. And of the \$0.71 in core earnings, the gains contributed \$0.37, is that correct?

Mostafa Nagaty

\$0.37. So you define \$7.8 million included in net income, this is basically the pieces realized during Q2; and \$11.9 million, which is the \$5.4 million, the reversal of the Q1 unrealized as well as the \$7.5 million, the difference between the initial cost basis and the December mark.

Stephen Laws

Okay, great. I appreciate those numbers. Can you talk a little bit about asset yields and what you're seeing on new investments? It seems like things got a little tight in the second quarter, have widened out a little bit. Is it just a small sample size? Do you feel like competition has flattened out a little bit as far as where other borrowers and competitors are willing to lend? Can you talk about what you're seeing on the new investment spread to LIBOR?

Matt Salem

Yeah, so I mean, -- and Stephen, thanks for joining us. It's Matt. I'll answer that. I think if you look quarter-over-quarter and what we've done subsequent to quarter end, the market feels largely similar. It's clearly competitive. I would say we compete mostly in price base on spread. And so when you see, I would say, the differences in quarterly originations in terms of spread quarter-over-quarter, I think that's mostly due to just the transitional nature of the underlying property and business plan. And so I think if you look at what we did specifically within the second quarter, you'll note that those were very light transitional lending for us or for the segment of the market. And so you see a slightly tighter spread for those types of opportunities. I think on the last call we mentioned that we really see the market anywhere between the LIBOR plus mid-200s to low 300s. I think that's still largely consistent with what we're doing today. And that, again, that range is largely based on how transitional the underlying nature of the property and the business plan is.

Stephen Laws

Great. Appreciate that color, Matt. And, switching sides to the financing, you guys have done a great job of driving down your cost of financing. Where do you stand in that? Is there more room to go? Where do see your -- is there a target in mind as far as your blended financing costs?

Patrick Mattson

Good morning Stephen, it's Patrick. Thanks for the question. Yeah, I think there's definitely more room to go here. I think what we're trying to do is to increase this kind of matched-term, non-mark-to-market financing. So, if you look at kind of where we've been achieving financing

rates on those facilities in the mid-100s, obviously, the more that we can grow that, the more we can bring our overall costs down. That said, we have seen some compression in our regular weight repos, which don't show up on a blended basis. But on newer deals, we're continuing to see compression in that side of the market. And then of course, we continue to have an eye on other alternative non-mark-to-market financing, such as the CLO market. So, I think there are ways for us to continue to drive the increase in the non-mark-to-market facilities and at the same time, drive the overall costs down.

Stephen Laws

Great. Thanks for that color, Patrick. Appreciate you taking my questions. Thank you.

Patrick Mattson

Thank you.

Operator

Our next question will come from Jade Rahmani of KBW. Please go ahead.

Jade Rahmani

Thanks very much. Concerning the recent uptick in your average loan size, I wanted to find out how you're approaching concentration risk from a risk-management perspective? And also, if you can give some color on these recent loans, the three in the quarter and the one large multifamily loan post quarter end?

Chris Lee

Hey Jade, good morning. It's Chris. I'll start with the first part of that question. You know, on concentration, we think about it with respect to how transitional the loan is first of all. I think the loan that we have -- that we made in the second quarter, which was an office loan in Queens, that was a larger loan, but we thought it was quite stable from an underlying risk profile. It was 70% leased on a 20-plus year basis to a major investment-grade tenant. So we're willing to lean in and take a little bit more concentration to the extent we really liked the underlying credit is also to a top-tier private equity sponsor. I think on the more recent loan that was in -- above \$300 million, it was also a repeat borrower, but it was also cross-collateralized collateral. So we have a multifamily, which we think is one of the more stable asset classes, and we had multiple properties comprising that collateral base. So again, we thought this was a very attractive risk profile that we were targeting. And we liked it enough to where we were also willing to lean in on size. I think as you see our business continue to mature, the average loan size will continue to gravitate up. Number one, we think we find better sponsors; we're in larger, more liquid markets. But you should expect us to gravitate to slightly larger loans, you know, in that kind of \$100 million to \$200 million-plus range, and occasionally we will have some of these larger opportunities that we target. So maybe with that, I'll turn it over to Matt, and he can talk about some of the last few deals that we did.

Jade Rahmani

And if you could give any color on just the office lease-up strategy, you know, the timeline that it takes to execute these business plans?

Chris Lee

Yeah, it's typically -- we look to business plans where it's kind of a 12- to 24-month business plan. Some can be quite short. Some of the refinancings we've done, the business plan is already in process. I think that's consistent with the loan that we made in Philadelphia. The renovation had already been done. It was already substantially leased or already a lot of the

letters of intent in process. Similar to the loan we made in Boston, it was effectively 80% leased. The business plan was quite short, and there was already a fair amount of leasing in place. And I think that's also consistent with the loan that I talked about in Queens. The majority of the value creation had occurred due to this large recut of this major tenant lease. And so the remaining 30% of the business plan we expect to happen over the next 12 months to 18 months. It's really a focus of ours to have these shorter business plans that we think we can underwrite in real time today, and we're not taking a lot of longer-dated leasing risks around kind of a more uncertain economic environment two to three years out.

Jade Rahmani

And in terms of the nature of the loans and the existing indebtedness that the property had prior to your loan, are you finding that you are refinancing or providing debt on properties that are paying off other bridge loans? Or are they paying off longer-term loans and there's a new owner with a value-added strategy?

Chris Lee

Yeah, I mean, it's really a mix. I mean, like Boston was an acquisition loan. Philadelphia, we're paying off another bridge loan. The cross-collateralized deal down in the Southeast, we're paying off another loan. So it's really a mix depending on what the business plan is for the sponsor. But it's probably, right now, it's a fair mix between new acquisition loans and refinancings of existing assets.

Jade Rahmani

And in terms of LTV's, the last few seem to be right in the 70% range. Are you seeing a trend of an uptick in LTVs? Or is that just a function of the light transitional nature of the asset?

Matt Salem

Hey Jade, it's Matt. I don't think we're seeing an uptick in LTV. I think it's a function of, like you said, occupancy, right, and the light transitional nature. And if we're lending -- if you think about us lending on the multifamily portfolio that Chris just described, I mean, that's 88% occupied multifamily today when we came in. So clearly, with that kind of -- it's mostly stabilized, we can lend at a little bit higher advance rate. And the same is true for what we did in this quarter on the office loan, as I mentioned in the prepared remarks. Our occupancy is really in the 80s across the board on those, or on a weighted-average basis. So like 12 months to 24 months of business plan execution, light lease-up strategy. And so we feel comfortable at those slightly higher leverage levels, as opposed to if you're making a construction loan or a full lease-up loan, you're going to want to be at a much lower loan-to-value or loan-to-cost.

Jade Rahmani

I'm just wondering if you could give an update on the condo inventory loan? It looks like the balance declined sequentially. How's that asset performing?

Chris Lee

Hey Jade, it's Chris. It's performing kind of as expected. We have a very strong sponsor there. We have very good collateral. As you're probably aware, the condo market in New York is a little bit slow for sales right now. But we have a lot of loan structure, and we have a significant amount of borrower equity behind it. So we expect to continue to see that loan paid down over the coming quarters.

Jade Rahmani

And just lastly, I wanted to confirm the incentive fee. Going forward, you will be -- core earnings

will be after the incentive fee, so it won't be added back for core earnings. Is that what your comments were saying?

Chris Lee

Yeah, net core earnings will be after the incentive fee.

Jade Rahmani

Okay. That's an improvement in the core earnings definition. Thanks very much.

Operator

Again, if you have a question please press star (*) then one (1). Our next question will come from Rick Shane of JP Morgan. Please go ahead.

Rick Shane

Hey guys. Thanks for taking my questions this morning. And again, look, we have a small sample size here in terms of originations to sort of figure out trends. I'm thinking Jade asked this question, but I'd like to sort of circle back on it, and then one other as well. The trend is a little bit of a pickup in LTV. I think your answer to Jade was that that's more noise than signal. The other trend that we see here is that there does seem to be more attractive pricing for the largest loans. Is there a place in the market, and I'm wondering if it's around \$300 million, where pricing improves due to less competition?

Matt Salem

Yeah. I mean, just on your first comment, I'm not sure it's just noise, the higher LTV. I think it's just, again, it's a function of how stabilized the assets are. So, if we continue to focus on these 80% occupied assets, you'll start -- I think you'll see those similar type of LTVs coming through. Where you get really low LTV is when you're doing construction loans and kind of the other real, full lease-up strategies. So I just want to make sure we're clear on that. I do think there is less competition as you gravitate higher in loan balance, and I think there's multiple kind of checkpoints along the way or thresholds, I suppose. And we think one is around \$100 million, as you get kind of above another, \$150 million, you can start to see less competition. Then clearly, when you get above \$200 million, there's only a handful of people that can play in that space. So, we'll continue to target and gravitate our average loan size up. It also allows us to focus on the markets that we like to participate in and the quality of the sponsorships. So, there's a bunch of reasons to do it outside of just competitive dynamics. We think it's a better credit overall. But I think you'll continue to see us try to do that.

Rick Shane

Great. Thank you very much, guys.

Operator

Ladies and gentlemen, showing no further questions this will conclude our question-and-answer session. At this time I'd like to turn the conference back over to Sasha Hamilton for any closing remarks.

CONCLUSION

Sasha Hamilton

Thanks everyone for joining us today. If you have any additional questions, please feel free to call me after the call. Thank you.

Operator

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

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