KKR Real Estate Finance Trust, Inc.

Third Quarter Financial Results

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CORPORATE PARTICIPANTS

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Matt Salem – *CEO*

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PRESENTATION

Operator
Good morning and welcome to the KKR Real Estate Finance Trust Inc. third quarter 2020 financial results conference call. All participants will be in a listen mode. Should you need assistance, please signal 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 Michael Shapiro. Please go ahead.

Michael Shapiro
Thank you. Welcome to the KKR Real Estate Finance Trust earnings call for the third quarter 2020. We hope that all of you and your families are continuing to stay safe and healthy. Today, I am joined on the phone by our CEO, Matt Salem, our President and COO, Patrick Mattson, and our CFO, Mostaga Nagaty. 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-K for cautionary factors related to these statements.

Before I turn the call over to Matt, I'll provided brief recap of our results. For the third quarter, we had a record GAAP net income of 31.4 million, or $0.56 per share, which included a .1 million benefit from a lower CECL provision. Core earnings this quarter were 32.5 million, or $0.58 per share, driven by the continued strong performance of our portfolio and significantly in the money LIBOR floors. One change to note, as per SEC guidance, beginning with our fourth quarter results in early 2021, we will begin reporting core earnings inclusive of the change in CECL provision. Consequently, we will recast prior quarter's results to reflect the change in presentation. Please note that, had we adopted the aforementioned change in presentation, core earnings per share this quarter would have benefited by 1 penny and been $0.59 per share.

Book value for share as of September 30, 2020, increased to $18.73, which included the impact of $1.16 per share from CECL as compared to $18.57 as of June 30th. Finally, I would note that in mid-October we paid a cash dividend of $0.43 per share with respect to the third quarter. With that, I would now like to turn the call over to Matt.

Matt Salem
Thank you, Michael. Good morning and thank you for joining us today. We hope you are all healthy and safe. We had a strong quarter on many fronts. We continue to see the benefit of our company's conservative positioning on both our lending strategy and liability management, which has allowed us to differentiate ourselves during this volatile market. Since the onset of COVID, we have maintained a best in class portfolio, comprised of $5 billion of lighter transitional floating rate senior loans with a significant overweight to multifamily and office properties and only 8% exposed to hospitality and retail, increased our market leading fully non mark to market financing to 78% in order to further de-risk our liability set, increased our liquidity position through the inaugural issuance of a $300 million term loan B, which enables us to take advantage of the current lender friendly market, all while delivering record quarterly earnings, which has benefited from that interest margin expansion resulting from our strategically negotiated in the money LIBOR floors.

As of September 30th, our portfolio balance was approximately $5 billion, with only $452 million, or 9% of total commitments, for future funding obligations. Our almost exclusive senior loan portfolio focuses on institutional real estate and sponsorship and is secured predominately by Class A, lighter transitional, multifamily and office properties in the most liquid real estate markets. Our average loan size is $135 million, and approximately 80% of our loans are secured by properties located in the top ten markets in the United States. Our investment portfolio is 99% senior loans with no direct holdings of securities.

As I mentioned, our two largest property type exposures are multifamily and office, which represent 83% of the portfolio collectively and have a weighted average occupancy in the mid-70s. In addition, 86% of our multifamily loans and 75% of our office loans are secured by Class A properties. Underlying tenant collections have been consistently high. As a reminder, none of our office properties are located in New York, San Francisco, or Los Angeles, markets which have seen significant increases to coworking tenants in recent years.

Over 99% of our collections are current through October. Through our robust quarterly asset review process, we re-evaluate every loan in the portfolio to assign an updated risk rating. Our portfolio has a weighted average risk rating of 3.1 on a 5 point scale, consistent with the weighted average risk rating at June 30th. 84% of the portfolio was risk rated three or better, and we feel confident about the performance of those—on those properties. We don't anticipate much transition in our ratings in the near term. As we did in the second quarter, we provided a detailed breakout of our watch list loans and our supplemental presentation. We feel good about our position in many of these properties that are seeing improving trends in a number of business plans. However, we haven't been completely unimpacted.

As we have previewed prior, our Portland retail property is most negatively exposed and was downgraded from a 4 rating to a 5 rating this quarter. While this loan is current as of October. We expect to be entering workout discussions giving the pending maturity. We believe we have adequately reserved against any potential impacts from this loan through the CECL evaluation process.

For the second straight quarter, we are beginning to see some signs of normalcy in the broader market, both from an origination and repayment perspective. Starting with repayments, during the quarter, we received approximately $274 million of repayments, including an approximately $30 million paydown on one of our New York condo inventory loans. Subsequent to quarter-end, we received an additional $65 million of repayments. It is always difficult to actually accurately predict repayments and even more so in this market environment. But as a reminder, we have several loans in our portfolio near or at stabilization.

On the origination side, while we didn't close any new loans prior to quarter-end, we did close three transactions in October. With many lenders on the sidelines, we were seeing a favorable market dynamic resulting in better credits and opportunities to create net interest margins in the mid to high 100s as compared to the low one hundreds earlier this year, pre-COVID. Let me spend a couple of minutes providing incremental details on our recently closed deals.

All three are good examples of our return to market and continued focus on the same high quality real estate we have been underwriting since our IPO. Additionally, they highlight the benefits KREF receives from being part of a leading global alternative asset manager and a growing real estate platform. As you may have noted, KREF co-originated these transactions with other KKR private strategies. KREF is our flagship transitional senior loan strategy and has

priority over these investments. But at times, where it makes sense, we will share risks depending on factors such as the timing of commitment, the loan size, and KREF's liquidity position.

The first two examples are similar to loans we were making pre-COVID. Refinancing newly delivered luxury Class A multifamily buildings and markets with strong underlying demographics. Our loan provides our sponsors a better cost of capital and time to lease the property and burn off the initial lease up concessions. Both properties have commenced leasing, and there were no moving pieces as it relates to construction. We were able to underwrite recently signed leases and extrapolate into a stabilized cash flow, leading to a straightforward underwriting on a simple business plan.

In a notable transaction, KREF co-originated $509 million whole loan, with KKR committing 160 million to leading real estate development company in the San Francisco Bay area to acquire and renovate a 1 million square foot Class A office in Oakland, California. We are executing a senior loan sale of approximately 135 million to finance our retained $25 million piece. This financing is a great example of the benefits of having access to a broader asset management platform, utilizing the full KKR brain to lend on high quality, well located real estates.

The best examples of this are, from a sourcing perspective, it was an institutional sponsor that was an existing JV operator for our real estate equity team. From an underwriting perspective, effectively single tenant asset that our corporate credit team was already familiar with and had underwritten. And we had local market knowledge where KKR Real Estate owns office properties.

Finally, from an execution perspective, we work closely with our capital markets team to speak for the whole 509 million while having line of sight on the sale of the senior portion to generate an attractive return. Our forward pipeline remains strong, with several loans under exclusivity, which are expected to close within the next few months. You will continue to see us focus on investing in defensive property types, in liquid markets, and with top tier sponsors, while maintaining our focus on capital preservation.

Sitting within the broader KKR platform gives us a unique perspective and a look into risk adjusted returns across asset classes. The combination of KREF's in place portfolio, our cost of liabilities, and the addition—and the additional new loans underwritten in today's environment, we believe are delivering attractive risk adjusted returns relative to other yield proxies. We're excited about our franchise and our competitive positioning in the market and the continued growth opportunities for KREF for the remainder of 2020 and going into 2021. Now, let me turn the call over to Patrick.

Patrick Mattson
Thank you, Matt. Good morning, everyone. I hope that you continue to stay safe and healthy. As of quarter-end, a market leading 78% of our in-place asset financing was completely non-mark to market, and the 22% remaining balance was only subject to credit marks. We continue to invest a considerable amount of time and resources across KKR, differentiate and diversify our financing sources, and, in September, we were excited to close or inaugural term loan B issuance. The proceeds from the $300 million 7 year loan allow us to take advantage of the current lending opportunity, as well as continue to reduce some of our mark to credit facilities.

Additionally, the pricing flexibility of the term loan B affords us the ability to adjust the cost of capital in the future to match the conservatively positioned profile of our assets in other

liabilities. Our intense focus on non-mark to market financing has allowed us to lower the risk of our liabilities while at the same time maintain target leverage levels despite the volatility this year. As of quarter-end, our debt to equity ratio and total leverage ratio were 1.9 times and 3.8 times respectively, down from the second quarter. As a reminder, we have generally targeted a three to four times leverage ratio, on new senior loans, depending on the source of financing.

While we've been willing to finance loans at a low 80s advance rate on our non-mark to market financings, we would expect our total leverage ratio to gravitate more toward the mid threes in the coming quarters. Our repo financing, which currently represents only 22% of our outstanding secured financings, is the diversified across three banks and currently has a weighted average advance rate of approximately 65%. The repo facilities financed 10 loans, predominantly secured by Class A multifamily and office assets. Notably, we have not received any margin calls on these mark to credit facilities.

KREF's liquidity position remains very strong, with over 700 million of availability, including cash of approximately 300 million as of 3Q and access to an additional 335 million on our corporate revolver. While we have currently ear marked some over liquidity for our increasing pipeline of blown opportunities, given the level of uncertainty in the markets, we do expect to hold incremental cash on the balance sheet versus prior years to maintain flexibility for the foreseeable future, which could create some incremental drag on earnings. Additionally, as we started to see in the third quarter, a higher rate of repayments and timing mismatch between repayments and new originations may add to our liquidity position in the near term.

Finally, almost the entirety of the portfolio remains invested in LIBOR based floating rate loans. 98% of the loan portfolio has a LIBOR floor of at least 95 basis points, while only 2% of our liabilities, excluding the new term loan B, have LIBOR floor above 0. So, with spot LIBOR averaging 16 basis points for the third quarter, our rate floors were almost entirely optimized for the full quarter, providing a significant earnings benefit.

For further context on the benefit, since the beginning of 2020, one month LIBOR has decreased 160 basis points. During this same period, bolstered by our rate floors, our loan coupons have only decreased 20 basis points from 5% to 4.8%. At the same time, the decrease in LIBOR has dramatically reduced our liability costs, resulting in an expansion of our effective net interest margin by 130 basis points to a level above 100—to a level above 280 basis points on our direct secured borrowings. As we experience a rotation in our portfolio through loan repayments and new originations, we expect them to compress overtime.

In summary, our best in class investment portfolio is providing strong earnings power through loan performance and significant in the money rate floors. We generated record net income during the quarter. We continue to diversify our financing sources, including growing our market leading 78% non-mark to market secured liabilities with the issuance of the new 7 year term loan B. We have a very strong liquidity position, allowing us to return to the new originations market lending at attractive levels on credits consistent with our restored underwriting. Thank you, again, for joining us this morning. And now, we are happy to take your questions.

Operator
We will now begin the question-and-answer session. To ask a question, you may press star then one on your touchtone phone. If you are using a speaker phone, 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 today comes from Jade Rahmani of KBW. Please go ahead.

Jade Rahmani
Thanks very much. Can you give some color as to the types of deals you're seeing and what the sponsors are looking to achieve? If there's been any changes in the way they're underwriting deals? I notice one of the deals had below a 50% LTV. Just some color on the transaction market.

Matt Salem
Hey, Jade. It's Matt. Thanks for joining and good to hear you. Yeah, as a little bit of color, we're seeing the market slowly reboot here, and obviously we're starting to take advantage of that. All in coupons are in the 4 to 4.5% range for the higher quality assets, and there's a real bifurcation, I would say, in the market today between the haves and the have nots. So, clearly you can understand hotels and other sectors that have been the most impacted. Financing there is much more difficult and coupons much wider there where we're focused is—where we've been focused historically. So, I don't think we really changed our credit DNA at all. So, really trying to focus on the multifamily sector of the market and then well leased office.

What's a little bit different now is two things. One, it's more than lenders market, as you would expect. So, you get better structure, better credit, in some cases lower leverage. Obviously, the all in coupons similar to what we were lending at pre-COVID but the compositions changed quite dramatically given where LIBOR. So, the spread is very high. And the overall NIM, as we mentioned on the call, is increased from low one hundreds to very high 100. And the other thing I would say is that the fact pattern or the business plan that you're lending on is a little bit more advanced.

And so, for instance, if we were making a multifamily loan pre-COVID on a construction take out lease up, that property may have been somewhere between 10% and 30% occupied. So, some opportunities we're seeing today are more 50% occupied or higher. And clear there's going to be range, but it—what the sponsors need is just more time, right? Everyone's trying to buy time. And so, I think that the transitional segment of the market will continue to have a lot of opportunities to lend as sponsors just need to—they need to—their business plans are all elongating, whether that's any type of lease up. And so, they're just going to need to buy that time and get a new financing that allows them to (inaudible) that business plan.

Jade Rahmani
Coming through the office sector, are you seeing any broader changes in the way either sponsors, lenders, or the market overall is looking at office space? I think that, pre-COVID, the average office lease was somewhere in the 8.5 to 10 year range, and there is some chatter about typical lease durations being curtailed. JLL CEO said that in the second quarter that average lease deal had 16% shorter term. How are you thinking about that, or what are you saying with respect to the office market?

Matt Salem
Yeah, well, I think everyone puts office in this category of—it has a big question mark around it. And, in my mind, there's a real cyclical issue with office. You never want to lease that office in an economic downturn. And then there's the secular question that we're all debating around usage going forward, changes in behavior. So, I would say we're given those—are both at play. Both secular and cyclical, I think—we're very cautious right now in the sector overall. We don't have enough data points to answer your question directly. Are leases getting shorter? I would say, as we're underwriting new office loans, we want a higher occupancy, longer leases, more stability, but we're still taking a lenders view and protecting our downside. So, I don't think the

market's involved enough to really tell you what—this is exactly what we're seeing in terms of shorter lease terms. It certainly wouldn't surprise me, but, again, I'm not sure that's a secular issue or cyclical issue.

Jade Rahmani
Okay. I'm turning to the Portland asset. You said that you feel adequately reserved with respect to your basis and the CECL reserved. What are you looking at the outcome in a workout? Is this going to be essentially a foreclosure whereby KREF takes control of this asset and figures out a repositioning strategy? Would you bring in third party capital for this? And just directly, what impact will this have on the company's liquidity? Is—I believe this after does not financed any repo lines. So, it probably will have a minimal impact on liquidity, but if you could just touch on that.

Matt Salem
Sure. I think it's too early to tell on how exactly the workout proceeds. We have a sponsor in place still. That's kept our loan current. And so, we'll be working with them on what the business plan is going forward, and I think it's too early to speculate how this may play out. Patrick, I'll turn it over to you for the liquidity perspective. But overall, it's not a big position, obviously, for us, and we have as much liquid as we've had in the company. But, Patrick, you want to give any specifics?

Patrick Mattson
Sure, Jade. Just to follow up on that—so, we've got a small amount of leverage against this something on the order of less than 20% of the face amount of the loan. So, not a not a big mover in terms of our liquid usage if we decide to pay off that financing.

Jade Rahmani
Thanks very much.

Operator
The next question comes from Don Fandetti of Wells Fargo. Please go ahead.

Don Fandetti
Good morning. So, look, I mean, it's good to see you guys holding your own in the difficult market. I was wondering, Matt, if you could just provide an update on some of the other watchlist assets, in particular, the New York condos and then the Fort Lauderdale hotel?

Patrick Mattson
Hey, Don. It's Patrick. Let me start with that one. So, just first on the on the New York condo hotel, this is an asset that, over the last couple—in the last couple of quarters, we've actually seen an increase in sales. So, both in the second in the third quarter, we saw three units sell in each of those quarters, and there's an additional unit that sold and closed here in the fourth quarter, which will get reflected when we report next quarter. I think we've been pleased with the progress of the pay down. Those sales, for context, have been in the $2,200 a foot range, and, for context, our loan is around 1,720 square foot. And so, from a business standpoint, we feel good. We like the velocity against those—on those sales, and the amount of leverage that we have, similar to our Lloyd asset is really a fraction of our outstanding loan balance. So, in total we've had about 41 million of pay downs these last two quarters.

On the asset in Florida, we continue to work closely with the sponsor. As you recall, this is an asset where we've entered into a partial forbearance on the payment in exchange for some

cash that came in from the sponsor. That partial forbearance period extends for several more months, and we've seen some improvement in terms of the occupancy of that asset. But it remains challenged in terms of the pre-COVID level. So, one that we continue to sort of monitor but one where we've got a path that continue to work with the sponsor and help them really sort of manage through this situation.

Don Fandetti
Got it. And how would you describe the overall commercial real estate lending markets from a stress perspective? I know there's a lot of concern. Could you just talk about it from a high level?

Matt Salem
Sure, Don. It's Matt. I can jump in there. I guess a couple things. One, I think it's lagging the more liquid markets. And so, it's certainly—we haven't seen anywhere near the level of yield compression that you see in a corporate credit market or the securitized markets. There was clearly a lag in the private markets or specifically in CRE lending. There's a bifurcation, like I mentioned before, between the have and the have nots, right, and that's really by property type for the most part that to some extent business plan and the transitional limit spending segment, but predominantly property type. And so, there's definitely a whole slough of retail assets and hotel assets that just don't have access to financing today, or it's extremely expensive. And then, as it relates to the business plans, as you can imagine, the more transitional you get, the heavier the left is. It's going to be tougher to finance right now. And again, that's a—we're in an unprecedented market, and I think people are cautious right now. And so, you can understand the conservatism on the lending with those assets.

And then I would just say, in terms of the participants in the market, what we're seeing, at least in our space, is there's definitely less competition, which is making it attractive and perhaps why we're lagging here. But there's capital out there. I wouldn't call the market distressed. I mean, we're lending at 4% to 4.5% coupons. I think that's attractive, but I don't think it's distressed. And you do see a number of participants in the market, as you would expect. The secure type lenders are back with CMBS product, both on large loans, as well as on conduit. Insurance companies are very active. I would say one of the sectors where we haven't seen as much activity on the big money center banks, and so that's one area that we're watching closely.

Don Fandetti
Thank you.

Matt Salem
Thanks, Don.

Operator
Next question comes from Stephen Laws of Raymond James. Please go ahead.

Stephen Laws
Good morning. I guess first want to ask about the LTV's on the new originations. I notice two were refinances. So, you would have done a new evaluation and analysis in October. Can you talk about how much the value declined on those two—appraised value declined on those two assets from the loan they were refinancing, which I assume that that that valuation was done pre-COVID. And please let me know if that's not the case.

Matt Salem
Yeah, thanks for the question. I don't think I have the exact answer in terms of like the appraisals lined up from their pre-COVID to what we're doing today. I will tell you, on the multifamily assets, generally—on lease up multifamily assets were generally underwriting down, call it, 10% to 15% area in value just because it's taking longer to lease up, and there's clearly a concession package involved in today's market. So, it's really the cash flows that are changing the valuation. As you would expect in this kind of interest rated market, we do—we are seeing and we expect to see more cap rate compression once the assets have stabilized. But it's taking longer to get there in our underwriting.

Stephen Laws
Okay. And then, shifting over to the change in core and then, coupled with that, an outlook on the dividend, kind of believe CECL's a non-cash item the CECL reserves. So, would love kind of a little more background and your thoughts to now include that noncash CECL change in the core metric, especially with some of the inputs that go into that being macro and not company specific. Additionally, I think historically we've used core earnings as a proxy for the dividend, but I don't believe that CECL is something that impacts retaxable income, which determines the dividend distribution. So, can you talk about, going forward, after this change, what we should look at as a proxy? Should we simply take your core earnings and back out CECL the way it's been done? And to that point, any spillover income from last year or any income you can spill forward that we need to think about with regards to satisfying the 90% distribution requirement for this year?

Mostafa Nagaty
Good morning, Steve, and thanks for the questions and this is Mostafa. So, I'll take that one. So, just to clarify that that change in the core earnings presentation prospectively is a result of the SEC directing us to no longer exclude the provision of credit losses or a portion of the provision for credit losses from our core earnings presentation going forward. And we noted that in our MD&A and also as noted by Michael in his prepared remarks. So, we'll expand that change starting with Q4 and all subsequent reporting periods. And obviously, for consistency, we will retain our full earnings presentation for the first three quarters to respond with the new presentation.

That said, we don't believe that the change—that this is just a change in the presentation of core earnings for reporting purposes. And obviously the CECL provision will continue to be reported as a single line item on our income statements. So, anybody can do the math there. With respect to the coverage from my dividend standpoint, I think the old presentation of core earnings would be a good proxy, and we believe that we will meet its distribution requirements from a dividend standpoint for this year.

Stephen Laws
Great. I appreciate the time today and the comments. Thank you.

Mostafa Nagaty
Thank you.

Operator
The next question comes from Charlie Arestia of JP Morgan. Please go ahead.

Charlie Arestia

Hey. Good morning, guys. Thanks for taking the questions. A bit of a follow up on the CECL there. Look, I think there's no better demonstration of kind of a more incrementally positive economic outlook than putting money back to work. In that context, should we see some tweaking of that seasonal reserve going forward? And just, how are you guys thinking about the overall reserve rate on the portfolio?

Mostafa Nagaty
Yes. This is Mostafa again. So, I think that is a good question. With respect to the reserve. I think, obviously, that reserve will fluctuate quarter-over-quarters, depending on a variety of factors, including, obviously, our originations, volume, our repayments, velocity, and also changes to the macro on top of that. But generally speaking, everything else equal, we would expect the biggest driver for that change and the CECL reserved would be resolution of any of the watchlist loans for the four or five rated loans and also the macro outlook over the next few quarters. Those will be the two key drivers.

Charlie Arestia
Okay. Got it. Thank you. And then just an unrelated follow up. I know there was some deferred interest discussions on, I think, the Portland loan, but I'm just wondering if there were any other additional loan modifications that were kind of executed during the quarter?

Patrick Mattson
Hi, Charlie. Good morning. It's Patrick. So, in terms of the quarter, we obviously had the two hotel loans where we had modifications in place. There was one other modification related to interest payments, which is on the New York condo loan, which I talked about earlier, and there we entered into a partial forbearance on a portion of the of the interest payments. There was a little bit of paydown associated with that, but that's it in terms of interest related modifications in the quarter.

Charlie Arestia
Great. Thanks so much for taking the questions, guys.

Patrick Mattson
Thank you.

Operator
This concludes our question-and-answer session. I would like to turn the conference back over to Michael Shapiro for any closing remarks.

Michael Shapiro
Thank you, everybody, for joining us today. We hope you stay safe, stay healthy, and if there's any follow-up questions, please feel free to reach out to any of us. Thank you, again.

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

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