KKR Real Estate Finance Trust

Q1 Financial Results Conference Call

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CORPORATE PARTICIPANTS

Sasha Hamilton – *Investor Relations*

Michael Shapiro – *Investor Relations*

Chris Lee – *Co-Chief Executive Officer*

Matt Salem – *Co-Chief Executive Officer*

Patrick Mattson – *Chief Operating Officer*

Mostafa Nagaty – *Chief Financial Officer*

CONFERENCE CALL PARTICIPANTS

Ryan Tomasello – *KBW*

Arren Cyganovich – *Citi*

Rick Shane – *JPMorgan*

PRESENTATION

Operator
Good morning, and welcome to the KKR Real Estate Finance Trust Inc. First Quarter 2019 Financial Results Conference Call. All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing the star key followed by zero. After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star, then one on your telephone keypad. To withdraw your question, please press star, then two. Please note this event is being recorded.

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

Sasha Hamilton
Thank you. Welcome to the KKR Real Estate Finance Trust earnings call for the first quarter of 2019. I'm joined today by Chris Lee and Matt Salem, our Co-CEOs; Patrick Mattson, our COO; and Mostafa Nagaty, our CFO. In addition, we are joined by our new Head of Investor Relations, Michael Shapiro. Michael will be reaching out shortly to further introduce himself.

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.

Before I turn it over to Chris, I'll provide a quick recap of our results. For the first quarter of 2019, our GAAP net income was $24.7 million, or $0.43 per share. Net core earnings were $25.3 million or $0.44 per share. Book value as of March 31, 2019 was $19.67. In April, we paid a dividend of $0.43 per share with respect to the first quarter. Based on yesterday's closing stock price of $20.14, the dividend reflects an annualized yield of 8.5%. Our Board is scheduled to meet in mid-June to discuss the second quarter 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. Thank you for joining us for our first quarter earnings call. This month marks the second anniversary of our IPO. Since then, we have established ourselves as one of the preeminent commercial real estate finance companies in our competitive set. Our brand awareness and market presence has led to improved market penetration and increased market share. Since the end of the second quarter 2017, the quarter in which we went public, we have grown our portfolio by nearly 200%, from $1.3 billion to $3.7 billion, and we've increased our funding capacity by $2.4 billion to $4.2 billion as of March 31, 2019.

This quarter reflected our fully invested earnings potential. Of course, as typical for the industry, we will continue to see fluctuations in deployment due to the timing of closings, repayments, and capital markets activity. As Sasha mentioned, we paid a $0.43 dividend per share with respect to the first quarter. Covered by our net core earnings of $0.44 per share, which as Matt and Patrick will discuss, was positively impacted by increased repayment income.

The economic backdrop continues to be favorable for our business. We continue to see robust capital flows into real estate and strong demand for space driven by a healthy economy and job market. Additionally, the recent flattening of the yield curve, interest rate expectations, and the low global interest rate backdrop support our strategy of lending on transitional assets in larger liquid markets to experienced sponsors.

Before I turn the call over to Matt, I will summarize some of the progress we've made on a few key initiatives for 2019, which we discussed on our last earnings call. First was to continue our conservative capital preservation-oriented investment strategy by lending on institutional quality real estate owned by high-quality sponsors in the most liquid markets. Despite a competitive lending environment, we have secured attractive opportunities to invest capital, consistent with the same risk-return parameters we have had since we first went public.

While timing of closings in the first quarter was impacted by the volatility in the market at the end of 2018, we are still well on track to meet the deployment pace that we saw in 2018. For the first four months of the year, we originated approximately $400 million of floating rate loans, including $214 million in the first quarter and $183 million post quarter end. Through April, we have originated $2.7 billion over the last 12 months. In addition, we have built a robust pipeline of another $1.1 billion of loans currently under exclusivity that we expect to close within the quarter, subject to customary closing conditions. Matt will elaborate on recent investment activity in his remarks.

With respect to the right-hand side of the balance sheet, in collaboration with our partners in KKR Capital Markets, we increased our corporate revolving credit facility by $40 million to $140 million. Subsequent to quarter end, we have further increased the borrowing capacity to $235 million. As of quarter end, 63% of our outstanding borrowings were non-mark-to-market compared to 13% at yearend 2017.

Finally, we will continue to focus on improving the liquidity of our shares. We are extremely aligned with our shareholders and are focused on being good long-term stewards of capital. In February, we instituted a $100 million At the Market program. Like trading at a premium to book value, we were disciplined in our use of the program issuing no shares to date. We will continue to evaluate the usage of this program while focusing on balancing the timing of issuance and use of proceeds, balance sheet growth, and book value accretion.

In summary, we are happy with the start of 2019. We believe that our risk-adjusted return on equity in this rate environment is attractive. We are encouraged by our pipeline and ability to continue to deliver attractive risk-adjusted returns to our shareholders.

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

Matt Salem
Thanks, Chris, and good morning, everyone. I'll start by discussing our recent investment activity. In the first quarter we originated two floating rate senior loans totaling $214 million. These loans are collateralized by a 390-unit, Class A, multifamily project located in Boston, and by 196 key full-service hotel in Brooklyn, New York. The weighted average LTV and coupon for these loans are 65% and LIBOR plus 2.8% respectively. And on a levered basis, the loans have a weighted average underwritten IRR of 12.4% 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.

As Chris mentioned, the volatility, at the end of 2018, more heavily weighted our originations into the second quarter. Through April we closed an additional $183 million loan secured by a 711,000 square

foot mixed-use portfolio in Philadelphia, Pennsylvania. In the last 12 months, ended April 30, 2019, we originated $2.7 billion of senior loans, an 89% increase over the same period ended April 30, 2018, and in line with our record full-year 2018 originations.

Our forward pipeline is particularly strong with four loans totaling approximately $1.1 billion under exclusivity to close within the quarter. As always, these are subject to customary closing conditions.

In this competitive market, we have continued to differentiate ourselves through non-economic variables, like speed, certainty, and creativity as it relates to structuring around complexity. We also have developed a strong reputation as being a responsive partner to our borrowers, during the post-close phase of the loan, which is driving significant repeat business across our portfolio.

That said, we continue to add to our client base and specifically target the highest quality institutional sponsorship. I'd like to highlight a few of the relationships we have created this year. We have closed on new relationships with a publicly-traded global asset manager, with approximately $131 billion in assets under management, a global investment bank, with an approximately $79 billion market cap, and a nationally-recognized developer and operator of multifamily with over 19,000 units. These new relationships contributed to our average loan size of $132 million year-to-date and should help drive institutional deal flow going forward.

As we had discussed on previous calls, we expected to see a pickup in pre-payment activity in the first half of this year as our portfolio seasoned. Most of the first half 2019 repayments were weighted to the first quarter and we would expect these to normalize beginning with the second quarter. In terms of repayments this quarter, we received $623 million from our senior loan portfolio, $20.7 million of proceeds from the sale of five mezzanine loans, and had a $4.7 million pay down of our condo inventory loan. Post quarter end, we received a $67 million repayment on a two-property, multifamily portfolio located in Atlanta and Tampa.

Turning to our portfolio, as of March 31st, the balance totaled $3.7 billion, with another $366 million of future funding obligations. One hundred percent of our loans are performing, and our securities portfolio is performing as expected. The portfolio is 99% invested in senior loans and is diversified both geographically and across property types. Notably, office and multifamily loans comprise 83% of the portfolio.

We continue to concentrate on the multifamily and office property types due to their shorter term, light transitional business plans. As of quarter end, the average occupancy of the office properties in our portfolio was approximately 82%. We are focused on maintaining a defensively-positioned portfolio and we will continue to target the highest quality opportunities, trading incremental yield for credit quality.

In summary, we made good progress since the start of the year. We are in line with our target pace of originations, with approximately $1.5 billion of loans closed or pending closing as of today, and we are pleased with the quality and performance of our portfolio.

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

Patrick Mattson

Thank you, Matt, and good morning, everyone. As we closed in on full deployment, our taxable and net core earnings for the quarter were both $0.44 a share. This was positively impacted by the pace of repayments and acceleration of OID income. Given the quantum of repayments in the first quarter, and the expected timing of closings for new originations, we expect some impact on earnings quarter-over-quarter that should subside in the second half of the year as repayments and originations are expected

to normalize.

Our portfolio, which totaled $3.7 billion at the end of the quarter, has a weighted average risk rating of 2.8 on a 5-point scale, a slight improvement from 2.9% at year-end. And, we have no loans with a rating above 3. As of quarter end, 99% of the portfolio was invested in LIBOR-based floating rate loans, which positions us well to benefit from increases in short-term interest rates. Additionally, 95% of the portfolio features LIBOR floors, minimizing the impact of any interest rate decreases.

Looking at the right-hand side of the balance sheet, we continue to optimize our financing. As Chris mentioned, in the first quarter, we increased the size of our corporate revolving credit facility by $40 million to $140 million and subsequent to quarter end, we further increased the borrowing capacity to $235 million. In addition, we are focused on continuing to work with KKR Capital Markets to create additional non-mark to market term financing capacity. As always, we'll keep you updated as we make progress.

Turning to the debt-to-equity ratio, we closed the quarter at 1 times and 2.3 times from a total leverage perspective. As a reminder, we generally target a 3 to 4 times leverage ratio on new senior loans, depending on the source of financing.

One other note on the balance sheet, we repurchased approximately 213,000 shares at a weighted average price of $19.25 per share for a total of $4.1 million. As of today, $22.5 million is remaining for future stock repurchases below book value, and an additional $50 million is generally available during the authorization period.

We also implemented a $100 million ATM program this quarter. We view this capital raising tool as an efficient way to raise costs, advantageous just-in-time capital to fund our pipeline. We did not issue any shares under the ATM program and the full $100 million remains outstanding.

In summary, it was a great start to 2019, another strong quarter and a solid start to the second quarter. Our origination pipeline remains robust. Our portfolio is performing, and we continue to make significant progress creating differentiated financing. Thank you again for joining us today.

And 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 telephone keypad. 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.

Our first question comes from Jade Rahmani with KBW. Please go ahead.

Ryan Tomasello
Good morning, everyone. This is actually Ryan on for Jade. Just starting with the $1.1 billion of loans under exclusivity for 2Q, I'm assuming that's in addition to the $183 million you disclosed in the release. Can you just give us some color on the types of loans, including the spread, the types of property types, how much of that is funded, and despite the repayments you received in the first quarter, if you expect to need any additional equity to close those loans?

Matt Salem
Good morning, Ryan, thanks for your question and joining us on the call. It's Matt Salem and I'll take a few of those questions. First off, the $1.1 billion is incremental to what we announced in terms of what's been closed subsequent to quarter end. And I would say, the pipeline looks a lot like what we've closed and what's in the portfolio currently. This particular quarter will be pretty heavily weighted towards our multifamily program with spreads coming in line with where we're originating loans currently in that, call it, mid to high 200s to low 300s over, where it's really where we see the context of the market today for the light transitional lending segment.

In terms of equity, we have enough capital today to fund the existing pipeline.

Ryan Tomasello
And, it seems like you've done a good job rebuilding the pipeline post the strong 1Q repayments. But, just going forward, can you provide some commentary on your level of confidence in the ability to balance the trade-off that comes with the higher credit quality of the existing portfolio, which inevitably comes with fast repayments and the need to quickly redeploy that capital to stay fully invested?

Matt Salem
Yes, I think the portfolio, really it comes down to the pipeline and how robust the pipeline is. And I think you can see in the second quarter, after some slowness in the first quarter due to volatility coming out of yearend, has really picked up. And, as we look forward, I think we still see the ability to reach our target originations for the year of $2.5 billion and we talked a little bit about the repayments but I think our ability to keep the portfolio invested, albeit there could be time differences in repayments versus originations. I think we feel pretty confident that we can keep the quality of the portfolio very similar to what we have today given what we see in the pipeline.

Ryan Tomasello
And, considering the lumpiness with the loan closings and repayments, would you ever consider diversifying the business model to add, say CMBS securities outside of the B pieces or potentially net leased to help mitigate the impact of those repayments and stay fully invested as you grow the capital base over time?

Matt Salem
I think, first and foremost, it's about relative value, and can you commit capital in a different area where you feel like it's accretive to the credit story that we have today and to the return story we have today. So, I think that would be first and foremost. And then, second considerations would be things like duration and deployment and things like that. I think from where we sit today, we're focused on just the origination of senior home loans and light transitional space, again, that's largely driven by where we see relative value, where we see our pipeline today. And so, in the near term, I think our focus will continue to be where it has been over the last few years.

Ryan Tomasello
And then, just one more last housekeeping item, I'm not sure if I missed it earlier. What are the expected initial fundings on the $1.1 billion of loans under exclusivity?

Matt Salem
The vast majority of that will be funded at closing.

Ryan Tomasello
Got it. Thanks for taking the questions.

Operator
Our next question comes from Arren Cyganovich with Citi. Please go ahead.

Arren Cyganovich
Thanks. Just thinking about the size of the four that you have in the pipeline right now, looking at the current portfolio that on average would put them all in the top five of the size, are you seeing more opportunities in the upper end of the loan sizes out there, or it just happened to be what happened to come to you for this quarter?

Matt Salem
It's Matt again. Thanks for your question. I would say we have continued to gravitate up in size and you've seen our average loan size increase pretty consistently year-over-year. And, we think that there's somewhat less competition up there in terms of number of lenders, but I think it's more about the quality of the real estate. It's about the quality of the sponsorship and the market. And, we just feel like through cycle we want to be lending on institutional quality, sponsorship and assets, and they're going to perform better through the downturn. So, we've been gravitating up into that area because of credit and a little bit because of competition.

You're always going to have a range, because we're being responsive to our client base. And so you can see in this quarter where our average loan size was versus whatyou can predict versus the second quarter. So, it'll move around a little bit but I would say we are targeting larger opportunities given those reasons.

Arren Cyganovich
Thanks. And then, you added in a new hotel loan and it's pretty small relative to your total portfolio, but yet you hadn't really had much exposure there. Is there anything particular about this asset that drew you to make the investment?

Matt Salem
Yes, I'll talk about hotels at a higher level first. So, we made our first hotel loan in two years in the fourth quarter of last year, and then obviously we've done another deal here in New York, that's located in Brooklyn. And, I think that we've seen interesting opportunities in the hotel sector for a number of years now. I think what's changed our posture in terms of putting them into the portfolio is really being driven by our liabilities, and we've put in a number of facilities that Patrick has described over time and you can see is over a majority of our financing today is non-mark-to-market facilities. That is really where we have comfort in putting these in a portfolio because we have the appropriate terms of the financing that allow us to add those higher quality hotels and higher quality markets to the portfolio.

The other thing I would mention on the two hotels that we have, including obviously the one we did this quarter, these are largely stabilized hotels, with very competent sponsors. So, I think if we continue to see those kind of opportunities and we have that non-mark-to-market financing available, we'll continue to look at those and add those to the portfolio. That said, if you look at our hotel percentages versus any other competitors, we are very light in that sector and I think it will always be a smaller component of what we're doing here.

Arren Cyganovich
Okay, thanks. That's helpful. And then just lastly, on the timing of these four loans there that are relatively large, do you expect that any could slip into the third quarter? And if not, would they be more weighted towards the end of the quarter?

Matt Salem

You know I think our prediction right now as we said on the statements, we expect those to close in the second quarter. Things can slip and timelines can change a little bit but from where we sit today, we think it's going to be in this quarter and that's what we're predicting.

Arren Cyganovich
Okay, thank you.

Operator
And as a reminder, if you have a question, please press star, then one.

And, we have a follow-up question from Jade Rahmani with KBW. Please go ahead.

Ryan Tomasello
Hi, guys. Ryan again. Just wondering if there was any possibility of utilizing some type of warehouse facility off balance sheet to incubate closings prior to moving them over to you guys from the managers, similar to what one of your peers recently did in order to help mitigate this concept of being under-deployed with repayments.

Patrick Mattson
Ryan, good morning, it's Patrick. I'll take that one. So, as we noted in the remarks and in the materials, we closed on the revolver at the end of the fourth quarter. We added to that revolver in the first quarter, and then again in the second quarter. So, we have now $235 million of capacity on that revolver, and the plan is to utilize it in the manner that you're describing. It really gives us the ability to manage cash efficiently on the balance sheet and to really manage the timing of originations and repayments so we can close on loans, and then as we are optimizing financing, move them to a more permanent financing solution.

Ryan Tomasello
I know you disclosed the one repayment post quarter end, but any sense of what the full quarter repayment level might look like for 2Q?

Patrick Mattson
No. It's Patrick again. No, I think that's difficult. We talked about entering the run rate in early 2019 which we feel like we have, but similar to our originations, any one quarter can be very lumpy. We expect about a third of our book to pay back in any one year. So, if you look at this first quarter that feels relatively outsized, and so as we look forward into the second quarter and beyond, we expect that to normalize a little bit over the course of the year.

Ryan Tomasello
Great. Thanks for the follow-up.

Operator
Our next question comes from Rick Shane with JP Morgan. Please go ahead.

Rick Shane
Hi, guys, sorry. I actually thought I'd buzzed in and I hadn't. A couple questions, given the strong prepayments during the first quarter, what was the contribution from make wholes and prepayment fees in the first quarter?

Patrick Mattson
Sure. Good morning, Rick. It's Patrick Mattson. So, we disclosed that in note three. So we had less

than $200,000 in spread maintenance fees. The additional $2.3 million came from the acceleration of OID, so you'll see that in the note. One other comment, I guess, just on the repayments that we had in the first quarter, almost half of that was driven by one loan. So just again, just to characterize a little bit of the lumpiness that we experienced in the first quarter.

Rick Shane
Sure, I mean, look, part of the business is actually getting paid back. It certainly beats the alternative. You guys talk about normalization of repayments going forward. Should we think of the portfolio paying down in the — and again, I realize it's going to fluctuate quarter to quarter— but on an annualized basis in the 25% range, given the maturity and the stratification of the portfolio at this point?

Patrick Mattson
I think, Rick, it's actually probably a little bit higher. I mentioned sort of a third. Again, that's a guide. In any one quarter, in any one year, we could be at a rate that's higher or lower than that. If you look at just the seasoning of the portfolio, two-thirds of the portfolio was originated in 2018 or 2019, but you look further back, we have assets that are originated in '15, '16, '17. Those are assets where we expect that the percentage of repayments are going to be higher as sponsors realize on their business plans and as we've talked about, we focus on a light transitional asset and so those types of plans generally get executed prior to the three-year initial term.

Rick Shane
Got it, okay. And then last question, if we look at the history of the company, fourth quarter '18 was the record in terms of originations, and if we look at your commentary on the third quarter conference call in terms of pipeline and originations, it was more muted than what you're providing today. Is everybody sort of prepping their models? Is it realistic, likely that Q2, and I just don't want to get ahead of ourselves in terms of our models that Q2 is actually going to be the new high watermark in terms of originations?

Matt Salem
It's Matt. It's difficult to predict quarter to quarter, as we said lumpy a couple times. We're dealing with loan sizes of $200 million, $300 million plus in some cases, which can skew quarterly originations. The second quarter is going to be a big quarter. After this quarter, do I predict that for the third? Most likely not. I mean, we think about things as more normalized, that $2.5 billion of annual originations spread out over four quarters. But, it's really, really hard to predict where those loans are going to hit and the size on a quarter-over-quarter basis.

Rick Shane
Got it. And again, look, we understand something in the pipeline might slip from Q2 to Q3 but like I said, I just don't want to overestimate what you're describing but it sounds like there's a high degree of confidence around that pipeline.

Matt Salem
Yes, from what we see today those are loans that are obviously signed up and are in the process of loan documentation and closing.

Rick Shane
Terrific. Thank you, guys.

Operator
Once again, if you have a question, please press star, then one. Showing no further questions, this concludes our question-and-answer session. I'd like to turn the conference back to Sasha Hamilton for

any closing remarks.

CONCLUSION

Sasha Hamilton
Thank you, everyone, for joining the call this morning. If you have any further questions, please feel free to follow up with us directly. Thank you.

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

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