KKR Real Estate Finance Trust, Inc.

Q4 2018 Financial Results

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CORPORATE PARTICIPANTS

Chris Lee – *Co-Chief Executive Officer*

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CONFERENCE CALL PARTICIPANTS

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

Don Fandetti – *Wells Fargo*

Steven DeLaney – *JMP*

Kaili Wang – *Citi*

PRESENTATION

Operator
Good morning and welcome to the KKR Real Estate Finance Trust Inc. Fourth Quarter and Full-Year 2018 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 also note today's 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 fourth 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. 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 we start, we found a computational error in the Company's 2018 annualized non-GAAP financial measures net core earnings and core earnings and related per-share amounts. We filed an amended 8-K this morning with the corrected annualized earnings numbers in the earnings release and the supplementary presentation. No other information has been modified. We also intend to file an amended 10-K shortly. We apologize for any inconvenience that this may have caused.

Before I turn things over to Chris, I'll provide a quick recap of our results. For the full year of 2018, our GAAP net income was $87.3 million or $1.58 per share. Net core earnings was $100 million or $1.81 per share. For the fourth quarter of 2018, our GAAP net income was $19.7 million or $0.34 per share. Net core earnings were $22.2 million or $0.38 per share. Book value as of December 31st was $19.66. In January, we paid a dividend of $0.43 per share with respect to the fourth quarter. Based on yesterday's closing stock price of $20.21, the dividend reflects an annualized yield of 8.5%. Our Board is scheduled to meet in mid-March to discuss the first 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 and thank you for joining us for our fourth quarter earnings call. 2018 was a milestone year for our Company. It marked our first full calendar year as a public company and our fourth full year of operations since we began our investment activities in October of 2014. We originated a record $2.7 billion of senior floating rate loans during the year, an 84% increase over 2017 loan originations. We grew our portfolio to $4.1 billion as of December 31st, a two times increase from the end of 2017 and more than a three times increase from the second quarter of 2017 when we completed our IPO. And, on the right side of the balance sheet, we've significantly improved the cost and structure of our liabilities, and we increased our total funding capacity during the year by $2.3 billion to $4.1 billion. 2019 is off to

a busy start. We closed a $76 million loan in January and have also built up a robust pipeline of opportunities. Matt will provide more details on our investment activities shortly.

The macroeconomic backdrop for our business remains favorable. In 2018, commercial real estate transaction volume reached the second-highest annual level since the global financial crisis. We also continue to see strong demand for real estate by global institutional investors as evidenced by dry powder in the value-add and opportunistic real estate funds increasing to over $180 billion compared to $150 billion at the end of last year and a low of $100 billion coming out of the financial crisis. Overall, the underpinnings of real estate capital flows have remained strong and support our strategy of lending on transitional assets in larger, liquid markets to experienced sponsors.

Before I touch on our goals for 2019, let me review our 2018 strategic initiatives and the progress we made on each. Our first initiative was to continue to deploy capital in a prudent manner. 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 since we first went public. Our record originations pace demonstrates the strength of our extensive relationships with sponsors and intermediaries in the marketplace, and the benefit of our integration with the KKR Real Estate platform and with KKR more broadly. We believe we have built a defensive portfolio with a focus on institutional-quality real estate owned by high-quality sponsors in the most liquid markets. Matt will discuss our portfolio in more detail shortly. Our second initiative was to improve the liquidity of our shares and grow the Company prudently and accretively. KKR is the largest investor in the Company, owning approximately 35% of outstanding shares. We are extremely aligned with our shareholders and are focused on being good long-term stewards of capital. Given our performance and investment pace, we raised accretive equity twice in 2018. These transactions helped fund our growing pipeline and increased the three-month average daily trading volume of our shares by approximately six times, from 55,000 shares per day at the end of 2017 to 320,000 shares per day currently.

Third, we discussed our strategic initiative to diversify our funding sources and improve the cost and structure of our liabilities. We engaged KKR Capital Markets to help us source this differentiated capital. By leveraging the broad capital markets relationships of KKR, we exceeded expectations. We created an attractively priced $1 billion nonrecourse non-mark-to-market term loan facility, another $200 million non-mark-to-market asset-specific financing facility, and issued one of the largest commercial real estate-managed CLOs in over a decade. In 2018, the Company significantly diversified its financing sources, especially those sources that provide non-mark-to-market financing, reducing our exposure to market volatility. As of year-end, 60% of our outstanding borrowings were non-mark-to-market compared to 13% at year-end 2017. By diversifying our funding sources and reducing our cost of liabilities we were able to offset some of the spread compression that we've seen, and we can continue to deliver an attractive risk-adjusted return to our shareholders.

In 2019, we will focus on executing the same strategy that has made us successful thus far. We will continue our conservative investment strategy to preserve capital. We'll continue to be creative and seek out ways to further enhance our balance sheet and drive down our cost of capital and increase our non-mark-to-market financing sources. Finally, we will continue to focus on improving the liquidity of our shares and we'll look at various alternatives to grow our Company when it is prudent and accretive. 2018 was a record year for our Company. Overall, we are pleased with our origination activity, our market positioning, our portfolio, and pipeline. We are excited about the growth opportunities for KREF in 2019, and we look forward to continue to create value for 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 investment activity. The fourth quarter was a record origination quarter for us, capping our record year. We originated seven floating rate senior loans totaling $908 million. These loans are collateralized by six multifamily properties located in New York, Queens, Philadelphia, West Palm Beach, and San Diego, and by an upscale hotel in Fort Lauderdale. The weighted average LTV and coupon for these loans are 69% and LIBOR plus 3% respectively. And, on levered basis, the loans had a weighted average underwritten IRR of 12.1% 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, in 2018 we originated $2.7 billion of senior loans compared to $1.5 billion last year. The 19 loans have a weighted average LTV and coupon of 70% and LIBOR plus 3% respectively and were originated to generate a weighted average IRR of 11.9% on a levered basis. The loans are secured by mix of property types, including multifamily, office, industrial, and hospitality located across major markets. Multifamily and office property types represent 92% of total 2018 origination volume.

Importantly, our average loan size is also increasing, with an average of $144 million in 2018, up 16% compared to last year. Our brand awareness and market presence have improved in 2018, which has led to increased market penetration. In this competitive market, we differentiate ourselves through non-economic variables like speed, certainty, and creativity as it relates to structuring around complexity. We have also 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. Four of the seven loans this quarter and half of the loans originated in 2018 were to repeat borrowers. Borrower experience is important in transitional lending, and we pride ourselves on being responsive and providing high-quality service. Our ability to convert existing borrowers to repeat borrowers speaks volumes about our team, process, and reputation.

As our origination volume and portfolio has expanded, we continue to add resources to our team. In the fourth quarter, we hired Christine Patterson to lead our asset management platform across the real estate credit business. Our strong origination pace has continued into the first quarter. We have already closed one senior loan totaling $76 million. The loan is secured by a 196-key, full-service hotel located in Brooklyn, New York, and has a weighted average LTV and coupon of 69% and LIBOR plus 2.9% respectively. In terms of repayments this quarter, we received $100 million repayment of a senior loan secured by a multifamily property in Hawaii, and we had an $11 million pay down of our condo inventory loan. Post quarter end, we received $300 million of loan repayments, including a multifamily property in Denver, an office in Atlanta, and an office in Brooklyn. As discussed on previous calls, we expect to see a pickup in repayment volume as we enter our more run rate payoff schedule in the first half of 2019.

Turning to our portfolio, as of December 31st our portfolio totaled $4.1 billion with another $430 million of future funding obligations. 100% of our loans are performing, and our securities portfolio is performing as expected. The portfolio is 98% invested in senior loans and is diversified both geographically and across property types. Notably, office and multifamily comprise 86% of the portfolio. As we've discussed on the last few calls, 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 80%. 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. In summary, we have a defensively positioned portfolio and our origination activity continues to meet our expectation in terms of credit, volume, and return.

Now, I'll turn the call over to Patrick.

Patrick Mattson
Thank you, Matt, and good morning, everyone. Our portfolio, which totaled $4.1 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, and we have no loans with a rating above a 3. 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. Additionally, our loans generally feature LIBOR floors, minimizing the impact of interest rate decreases.

Looking at the right-hand side of the balance sheet, we continue to optimize our financing. As Chris mentioned, in the fourth quarter we closed a $1 billion managed CLO. The closing of our inaugural CLO transaction represents another important step in diversifying our financing sources and increasing our total non-mark-to-market financing capacity. The CLO provides the Company with $810 million of match-term financing on a non-mark-to-market and non-recourse basis. It has a two-year reinvestment feature with an 81% advance rate at a weighted average running cost of capital of LIBOR plus 1.36% before amortized cost. The scale and quality of our loan portfolio positioned us to execute this market-leading financing at an attractive cost of capital.

KKR Capital Markets has been instrumental in helping us explore funding options and improve the cost and structure of our liabilities. In addition to the CLO, working with the capital markets team in 2018 we put in place a $1 billion matched term, non-mark-to-market, and non-recourse term loan financing facility. We also closed on a $200 million match term non-mark-to-market asset-specific financing facility. And, in the fourth quarter we added a new $100 million unsecured corporate revolving credit facility, replacing a $75 million secured revolver. The attractive cost of these various funding options allows us to compete for the highest quality lending opportunities and secure better credits 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. This financing activity brought our total non-mark-to-market financing to $1.8 billion as of year-end, representing 60% of our total outstanding asset-based financing. Our term credit facilities represent the remaining 40% of outstanding financing. As a reminder, these facilities do not have capital market’s mark-to-market provisions, further enhancing the durability of our balance sheet.

Turning to the debt to equity ratio, we closed the year at 1.1 times and 2.6 times from a total leverage perspective. As a reminder, we generally target a three to four times leverage ratio on new senior loans depending on the source of financing. One other note on the balance sheet. Given the equity market volatility in the fourth quarter, we repurchased approximately 900,000 shares at a weighted average price of $19.12 per share for a total of $18 million, bringing full-year repurchases to $31 million. As of today, $27 million is remaining for future stock repurchases below book value and an additional $50 million is generally available during this authorization period.

Finally, to discuss our dividend, as we have stated before, our dividend policy is to pay out essentially all of our taxable earnings on an annual basis. For the full year of 2018, we paid $1.69 per share in dividends to our shareholders compared to approximately $1.65 per share of taxable earnings. This compares to GAAP net income of $1.58 per share and net core earnings of $1.81 per share for 2018. As a reminder, net core earnings included the realized gain on the sale of our CMBS investments in the second quarter. Going forward, we would expect our taxable income, GAAP earnings, and net core earnings to be more closely aligned.

Wrapping things up, 2018 was a record year for our Company, and we are off to another strong start in 2019. Our pipeline remains robust, our portfolio is performing, and we made 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 (1) on your touchtone phone. If you are using a speakerphone, we ask that you 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 momentarily to assemble our roster. And, today's first question comes from Jade Rahmani of KBW. Please go ahead.

Jade Rahmani
Thanks very much. At the outset, can you give any color into how KKR is thinking about its interest in KREF, noting that the shares have been registered? Have gotten some questions from investors about this and I think this, some clarity could potentially be constructive to the stock price.

Chris Lee
Hey, Jade. Good morning, it's Chris. We can't really comment much about KKR's investment in KREF because it's clearly not within the control of this management team. I think what we would say is it continues to be a large strategic position for KKR, I think number one. Number two, KKR is a prudent seller of any shares in any of the portfolio companies that we have either seeded or have sponsored over time. So, I think you can look to some of the historical precedents over the last 42 years, we've transitioned companies to the public. But, I think you can think about anything that KKR does with shares, it will be in a responsible manner and it is a -- although it's a core position, it is not a position that is outsized from a KKR perspective. So, it's something that will be managed prudently when it really is at the discretion of the leadership of KKR and etcetera, so.

Jade Rahmani
Do you know if they have any concerns about the commercial real estate cycle and what may play out later this year with respect to trajectory of interest rates, and if that will influence how they're thinking about it?

Chris Lee
Yeah. No, we -- the firm is very, very constructive in terms of supporting the real estate business, and this is just one position of the broader approximately $1 billion of balance sheet allocated to the KKR Real Estate business. So, if you listen to any of the KKR earnings calls,

this is a strategic business for the firm. It's a business that is strategic in terms of growth in KKR's earnings outlook in the future. So, it is a business that the firm will continue to support and that will continue to allocate capital and resources to in the future.

Jade Rahmani
And, just a follow-up on that point. On their call, they did mention launching other strategies in real estate credit. Beyond B-pieces, can you elaborate on that and how KREF may play in that?

Chris Lee
Yeah, I mean, we can't talk about any in-progress fundraising. I think what I would continue to say is that KKR will continue to add adjacent products, products that are synergistic with our existing in businesses, that could be across real estate credit or in real estate equity, and most likely those new strategies will be supported by the balance sheet of KKR. But, we can't really talk about any other existing strategies, other than any strategies that we add will likely be synergistic and an additive to anything that we're already doing today.

Jade Rahmani
In terms of the earnings outlook with the spike in 1Q repayments and the decline in the portfolio that seems likely, do you anticipate fully earning the dividend out of net core earnings this year and do you see any potential for a dividend increase later in the year?

Patrick Mattson
Hey, Jade, good morning. It's Patrick. Thanks for the question. Just a comment on the dividend. As we've said, we set the dividend based on our expectation of taxable earnings for the year and obviously, we increased it last year based on that assumption as well as kind of our outlook for our origination pipeline. And, I think if you look at where we are on a leverage basis today, obviously, we've got some additional capital to deploy. But, based on a full deployment, we feel confident in the dividend that we've set today, and expect as we realize on this pipeline and the benefit of those loans or on the balance sheet that we'll be at a point where the -- we're in coverage of the dividend.

Jade Rahmani
Thanks very much for taking the questions.

Operator
And, our next question today comes from Steve DeLaney of JMP Securities. Please go ahead.

Steven DeLaney
Good morning, and thanks for taking the question. Leveraged moved up very nicely in the fourth quarter from 1.9 times to 2.6 times at year-end. Just curious if you could comment on how much higher you expect that to go in 2019? I assume the CLO contributed to the more robust leverages as well. But, thanks for any comments going forward, where that 2.6 times might move too? Thank you.

Patrick Mattson
Good morning, Steve, it's Patrick. I'll take that. You're right. As we've added some of the non-mark-to-market financing, including the CLO, we've been borrowing at a closer to four times leverage ratio. And so, we were 2.6 times at the end of the year. As we continue to gravitate more toward more of these non-mark-to-market financing, I expect us on a total leverage ratio to be in that north of three to four times range.

Steven DeLaney
That's very helpful. Thank you, Patrick. And, then just kind of tied into that, if you look at your balance sheet as we sit today, given the repayments and the one I think you had $100 million or so in loans, and $300 million come in. When you look at mature capacity right now, could you estimate the capacity to fund net new loans with the existing balance sheet?

Patrick Mattson
Sure. Estimate right now is about $1 billion of new loans.

Steven DeLaney
$1 billion, OK. Thank you, guys. That's all I have this morning.

Operator
And our next question today comes from Kaili Wang of Citi. Please go ahead.

Kaili Wang
Thanks for taking my question. Could you just talk about the spread dynamic? Are you seeing a moderation of the compression, or just how should we think about it going forward?

Matt Salem
Hi. Yeah, thanks for the question. It's Matt. I'll answer it, and maybe touch on couple of other points as well in terms of just the broader market and how it's impacting the portfolio. The market continues to be competitive, but it is disciplined, and to your point, we haven't seen the spread compression that we experienced in the first half of 2018. In terms of the impact of some of the competition in the first quarter, I think that the first quarter volumes will be a little low, but that's going to be due to really seasonality as well as some of that volatility that we saw in the fourth quarter of last year. And, as we look out in the pipeline, it feels pretty robust. We still expect 2019 originations to be in line with last year. I know there's been a couple of comments around repayments, and we are seeing a higher level of repayments as our portfolio seasons and our borrowers execute on their business plans. So, given the larger loan size both originations per quarter and repayments per quarter can be lumpy, but we expect repayments of call it $300 million to $500 million per quarter this year.

Kaili Wang
Great. And, could you maybe just talk about like general competitive market and where do you see the most attractive opportunities in terms of locations and property types?

Matt Salem
Yeah, I think, well, say number one, as we have gravitated higher in loan size, we think that's the most attractive part of the market. It offers the highest quality borrowers as well as real estate and at the same time has the least amount of competitors. So, I think from a size perspective, you saw us grow to around 16%, up to $140 million -- over $140 million this year in average loan size. So I think you'll continue to try to see us move higher to take advantage of those dynamics. I don't think from a markets perspective or a property-type perspective we're really looking into change much. If you look at our originations last year, I think if you look at this quarter, it will be focused predominantly on the multifamily and the light transitional lending and the office segment as well. And, we've always been more of a top 30 lender. We want to play in the more liquid, more transparent markets. We think over time that will prove out to be a higher quality credit. So, from that perspective, I think you'll just see us do a little bit more of the same.

Kaili Wang
Okay. And, in terms of the timing of the deals in 4Q, were they quarter-end weighted or were they just spread throughout the quarter?

Patrick Mattson
We did -- this is Patrick, they were spread out through the quarter, but they were more oriented toward the back end of the quarter. So, we didn't get the full impact of those originations until the first quarter.

Kaili Wang
Got it. Okay, that's it for me. Thank you.

Patrick Mattson
Thank you.

Chris Lee
Thank you.

Operator
And, ladies and gentlemen, as a reminder, if you'd like to ask a question, please press star (*) then one (1) at this time. Today's next question is a follow-up from Jade Rahmani of KBW. Please go ahead.

Jade Rahmani
Thanks. Based on the elevated level of 1Q repayments, do you anticipate early prepayment income in the first quarter?

Chris Lee
Yeah, this is Chris. We expect it to be a little bit episodic. We will have a combination, sometimes prepayment income will be associated, but what we will see is the acceleration of any unamortized OID. So, you should expect to see that become a little bit more normalized when we get on a more normal repayment schedule like Matt mentioned earlier, and that will sometimes be lumpy, depending on the size or the tenure of the loan that gets repaid, but it will become a little bit more normalized in 2019.

Jade Rahmani
When were the 1Q repayments originated? Just generally speaking.

Chris Lee
I think we had, some is 2016, '17...

Matt Salem
'16 and '17.

Chris Lee
'17.

Jade Rahmani
Okay. So based on that, there shouldn't be much acceleration of unamortized fees?

Multiple voices

Chris Lee
No, there'll be some, especially on some of the 2017 because you have -- these are usually three-year initial based terms. So, you'll have some unamortized over -- if the loan gets paid off in two years and the amortization period was three years, you will have some.

Jade Rahmani
Okay. Separately, are you seeing any concessions that lenders are making on origination fees and/or structure?

Matt Salem
Hey, Jade. It's Matt. I don't think we're seeing anything material that hasn't kind of been in the market on the fee side, let me start there. I don't think -- there's not really any change over the last few quarters. Our fees ranged from -- our upfront fees will range from 50 basis points to a point generally, as an origination fee, and it's just individual deal dynamics determine that range. And, on more the structure side, I don't think we're seeing anything different over the last few quarters. The market feels disciplined to us. Some of the loan term -- some people are giving longer base terms, but again, we play and invest and really that -- really light transitional part of the market. So, these -- a lot of the properties are largely stabilized. So, you can see a little bit more base terms, but outside of that and I wouldn't say there's anything material.

Jade Rahmani
Did any of the volatility that played out in December impact the market? Did you see a pause, do you anticipate that impacting 1Q volumes? Has there been any impact on the pipeline?

Matt Salem
Yeah, I mentioned this I think earlier. I do think it slowed things down for the first quarter. I mean, the first quarter is always a little bit slow just given clearly holidays and some the conference schedules, but I do think that will have an impact and push our total origination volume more weighted towards post first quarter or towards the end of the first quarter. So, I do see an impact from that. But, outside of just a delay, a slight delay in the timing of our originations, I don't see -- I don't think it really had a material impact on where we stand today in terms of spreads and market dynamics.

Jade Rahmani
Thanks for taking the questions.

Chris Lee
Thanks, Jade.

Operator
And, our next question comes from Don Fandetti of Wells Fargo. Please go ahead.

Don Fandetti
Hi, good morning. I was wondering if you could dig in a little bit more on, you know, as you talk to large private real estate buyers of transitional properties, given the volatility, then the Fed pausing, which could arguably create more deal velocity, I mean, what are you hearing from the private side? Are they spooked by what happened? Are they still confident? What's sort of your expectation over the next 12 months in terms of the behavior of the buyers of these

properties?

Chris Lee
Hey, Don, it's Chris. I think what we saw at the end of the year, I think gave people a little bit of pause, but I think coming back and the Fed changing their tone has clearly settled down the market a lot. We number one see a fair amount of dry powder that's still sitting on the sidelines and it is -- it's actually allocated to the value-add and opportunistic space. We are in that business as well. So, you have a dynamic of people who are in the market looking to buy properties, but I think the second part is you have legacy funds where people need to sell properties as well. So, we saw last year was a very healthy real estate capital market, and we expect this year to be quite healthy when you think about the combination of equity dry powder, you have a healthy debt capital markets, whether it's in the banking or in the transitional lending space, and then you have active sellers on the other end as well. So, we expect this year to be pretty target-rich from a deployment perspective. And, I'd say the last comment is because spreads have compressed over the last couple of years, you have a lot of existing owners that are looking to refinance properties that are outside of their call protection period. So, some of the loans that we are making are bridge loans to take out a construction loan, or sometimes another bridge lender, and we're also seeing that where some of our take-outs are not necessarily sales of properties, but someone taking us out to execute a maybe a safer or less risky stage of the business plan. So, we actually think this year with, sets up quite well for the transitional lending segment.

Don Fandetti
Thanks, Chris. That’s helpful.

Operator
And ladies and gentlemen, this concludes our question-and-answer session. I'd like to turn the conference back over to Sasha Hamilton for any closing remarks.

CONCLUSION

Sasha Hamilton
Thank you again for joining us on the call this morning. If you have any follow-up questions, feel free to reach out to me directly. Thank you.

Operator
And, thank you. Today's conference has now concluded, and we thank you all for attending today's presentation. You may now disconnect your lines and have a wonderful day.