GRANT'S
INTEREST RATE OBSERVER®

Vol. 36, No.14b — Two Wall Street, New York, New York 10005 • www.grantspub.com — JULY 13, 2018

Back together again

Looking for a few good yields, this publication has settled on one. It's the 7.6% yield paid by Blackstone Mortgage Trust, Inc. (BXMT on the New York Stock Exchange), a REIT that invests in senior commercial mortgages. Whys and wherefores to follow.

You would suppose, as Deputy Editor Evan Lorenz observes, that rising interest rates would widen the field of opportunity for income-seeking investors. It's done so only grudgingly in the long, post-2009 expansion. The 10-year Treasury yield's more than doubling in size, from its lows of two years ago, gives you, the deserving saver, less than 3% and a real yield of fewer than 10 basis points.

The still deflated level of nominal rates is just one problem for the starving creditor. Real-estate-related securities, which ought to offer some modicum of inflation protection (the rising tide of prices generally lifts rents, too), are trading like proxies for U.S. Treasurys, and not the inflation-adjusted kind.

The price action in REITs and government bonds fell into lockstep about six years ago. From 1998 till 2011, relates Green Street Advisors, there was no such correlation, but someone seemed to flip a switch in 2012. Ever since, a 100 basis-point jump in yields has delivered 1,400 basis points worth of underperformance by the REITs, and vice versa.

Ultra-low interest rates and EZ credit explain some of the shift in trading patterns. No sooner does new demand for rentable space present itself than a new building seems to pop up. The ease of construction, borne of the ease of financing, thus tends to cap the surge in rents. So long, inflation protection.

Commercial real estate is broadly flourishing. Industrial warehouses are actually booming, while excess supply weighs on the New York City hotel business. Shopping malls are in a sad world all their own (3.8 million of their square feet went vacant in the second quarter, the worst quarterly performance in nine years). But "OK-plus" approximately captures the views expressed from the rostrum of the June 5–7 Nareit REITWeek conference in New York, where 116 publicly listed property companies told their stories. "The mood tilted to the reasonably upbeat side as there were more comments suggesting slightly better than recently expected fundamentals," Green Street reports. Rents are increasing at close to the rate of inflation, and occupancy rates are quoted near all-time highs.

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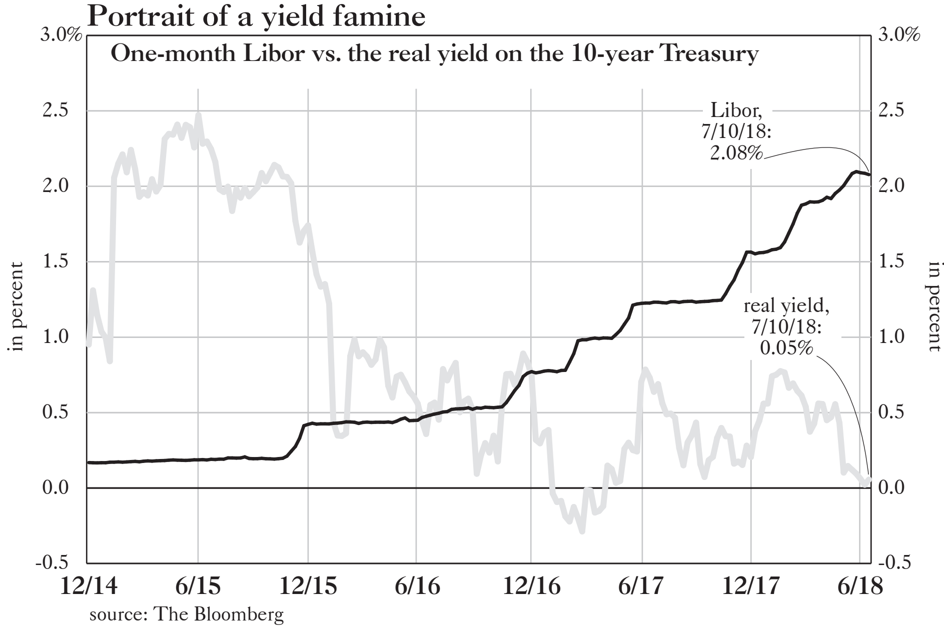
All of which is music to the ears of Blackstone Mortgage Trust. BXMT's forte is financing buildings in need of tenants or sprucing up, or both. Senior loans at 65% of appraised value is the management mantra—"We are making moderate-leverage, first-mortgage loans in markets that should be the last to lose liquidity but the first that will recover, should there be a downturn," Stephen D. Plavin, Blackstone Mortgage's 59-year-old CEO, tells Lorenz.

At the end of the first quarter, the BXMT loan book totaled $12.1 billion, which sat on $2.9 billion of equity. Office, hotel and apartment properties

Portrait of a yield famine



source: The Bloomberg

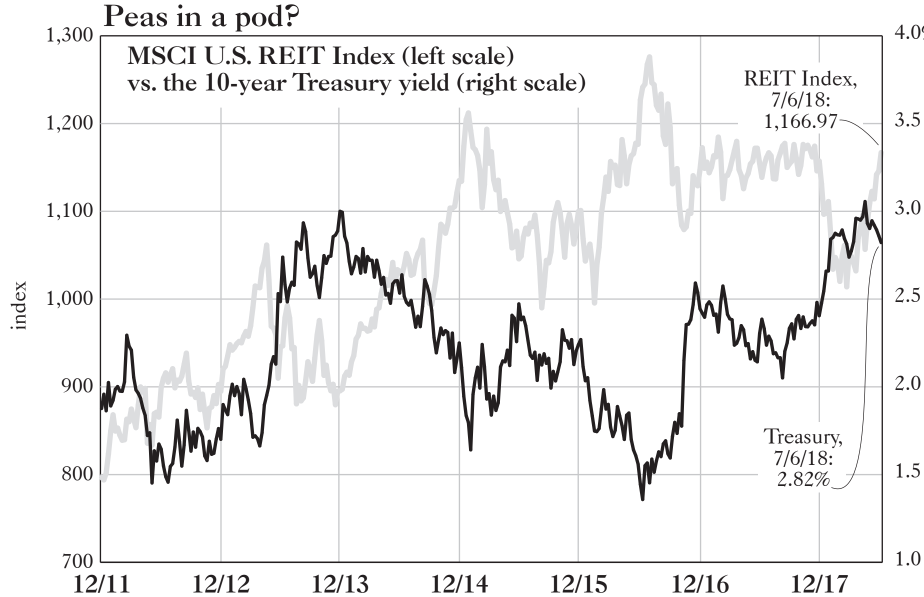
constituted 48%, 14% and 12% of the collateral. Fully 94% of these credits were floating-rate, most tied to a spread above one-month Libor; 19% were collateralized by buildings in Europe, primarily in Spain (10% of the portfolio) and the UK (7%).

The disparity in transatlantic short-term borrowing costs—minus 37 basis points in Europe vs. positive 2.1% in the United States—might tempt some to borrow in the land of Mario Draghi and invest, say, in the land of Jerome Powell. It does not so tempt Blackstone, Plavin indicated, as BXMT borrows in the same currency in which it lends. Nor, Plavin says, does the trust borrow short and lend long: "Our liabilities generally match the terms of our loans, so we don't have the issue that some of the others have in terms of having their liabilities come due before their assets. That doesn't matter in a good market but will matter a lot in a down market. Our asset/liability structure and our conservatism of how we lend are all important parts of the structure that will enable us to perform across the cycle."

BXMT, an offspring of The Blackstone Group, L.P.—mothership Blackstone owns 4.6% of shares outstanding; founder Stephen Schwarzman personally owns 125,361 shares—counts its affiliation with the parent's gigantic, global real-estate operation ($120 billion of investor capital, more than 450 real-estate professionals on the payroll) as a potent advantage for sourcing deals. Still and all, BXMT is not the only non-bank lender in search of big transactions against good collateral in the world's most desirable cities. Plavin calls the intensity of competition "probably the biggest challenge in the business now" and says that he sees it expressed, especially, in lending spreads. BXMT lends at Libor plus an increment, and that increment has been shrinking. "There has been a lot of spread compression in the market," he advises Lorenz. "We've maintained our earnings profile because of our ability to finance more efficiently, and because of increases in Libor so far. Libor was 20 basis points, and now it is 209 basis points. Those two forces have offset much of the spread compression."

In the first quarter, the average Blackstone loan yielded 5.8%. It's the magic of leverage that transmogrifies that portfolio yield into a 7.6% dividend yield and a 9.5% return on equity; 2.3 portions of debt per portion of equity is (for now) the corporate formula. Including securitizations, credits sold in collateralized loan obligations and the sale of senior loans wherein BXMT retains a residual, subordinated interest, total leverage weighed in at 3.1 times on March 31. On the first-quarter conference call, Douglas Armer, a BXMT managing director, told dialers-in that "there's room for sure in terms of debt to equity to be at 3 times or even 3.5 times," up from the level of 2.3.

Peas in a pod?



source: The Bloomberg

Overaggressive lending, say we, is rampant in the leveraged-loan market, among other places. It has not yet made its cyclical appearance in commercial real estate, Plavin insists: "Loan structure and leverage levels have held up well. We haven't seen the irresponsible lending that we saw in 2006–07, if that is an indicator of what the next cycle will look like. Most of our borrowers are private-equity sponsors with value-add strategies, and they are still investing significant equity in their deals. They have to deploy their funds. Our loan product is still well-suited to their investment strategy of buy, fix and sell a transitional asset. We finance a business plan and are generally repaid with a sell on the end in a three- to five-year time frame."

This bullish review marks the end of a kind of journalistic trial separation between BXMT and *Grant's*. "So long for now," said the headline over our bearish Feb. 24, 2017 reappraisal of the Blackstone Trust, a longtime pick-to-click. At 116% of book value with an 8.1% yield, the shares seemed fully valued, and we thought that management would be slow to replace the rapidly maturing $4.7 billion portfolio of loans it had purchased from General Electric Co. in 2015. Then, too, we observed, the cycle was aging and the quality of Blackstone's loan portfolio might be slipping.

In fact, management handily replaced the maturing GE assets, though they virtually doubled the size of BXMT's portfolio on the day of acquisition. Neither has credit quality deteriorated—nor, of course, has the expansion expired.

At 120% of book, Blackstone Mortgage Trust shares are no cheaper today than they were a year-and-a-half ago. It would be nice if they were (it would be nice if passbook savings accounts paid 5), though wishing won't make it so. Waiting might—it's not hard to imagine a return to book value per share in the fires of a credit liquidation—but many investors need income, and some need it right now. Thus, the relevant question seems to be, "Does BXMT deliver a competitive yield with a reasonable assurance of a stable net asset value over the course of a full credit and real-estate cycle?" We judge that it does. "That 7.6% dividend is almost twice the 4.2% yield on the MSCI U.S. REIT Index and more than the 6.4% on offer from U.S. high-yield bonds," Lorenz observes.

Since its inception in May 2013, according to Plavin, BXMT has suffered not one missed interest payment. A proper recession would put that record to the test, of course. At least Plavin, who during the late 1980s did time as a regional-mall construction lender for the old Chemical Bank, has seen how pitiless such tests can be. "Our loans do not participate in the upside," he notes. "We are very mindful of the downside risks in the assets we finance."

After the close of the first quarter, BXMT signed a $1.8 billion loan with Tishman Speyer to fund the construction of a sky-scraping office tower in the Hudson Yards district of Manhattan's Midtown West. It seemed a mighty big commitment for a company with $2.9 billion of equity, as one analyst remarked on the first-quarter call. In response to his observation, Plavin pointed out that the funding obligation for the senior portion of the loan "doesn't begin until 2020, about two years after closing, so we've really got a long runway to . . . finance that or syndicate."

In some ways, the loan is an example of BXMT's *spécialité de la maison.* The anchor tenant, Pfizer, Inc., has signed a 20-year lease; the developer, Tishman Speyer, is committing $1.9 billion in equity to what is said to be a $3.7 billion project; and the building itself—"The Spiral" is its name—will rise to 1,005 feet before cascading back down to the Manhattan pavement in the shape of landscaped terraces and hanging gardens.

In another way, The Spiral represents a new corporate direction. The BXMT loan is a construction loan, not a first lien on a finished property. The Spiral will be the third such loan that Blackstone Mortgage Trust has issued to Tishman Speyer; the first was signed in 2014. Construction loans entail more risk than do loans to completed buildings, something that Plavin, recalling the commercial real-estate collapse of the late 1980s, must know as well as anyone. Pfizer's lease, Tishman Speyer's equity and BXMT's loan-to-value ratio—49%, well below the average LTV ratio for completed buildings—help to mitigate the risk, though, of course, they do not erase it. Everyone is reaching for yield.

Blackstone Mortgage Trust ranks its loans on a scale of one (the best) to five (impaired and/or likely to make a loss). Three is the typical starting point, as loans against commercial fixer-uppers is the rule. If all goes according to plan, loan quality migrates to the upside until, at around year four or five, the threes become twos. The ones, overachievers, tend to refinance. Thus, in periods of high origination, ratings average closer to three than to two. On March 31, after several quarters of brisk originations, the overall portfolio was ranked at 2.7.

"We focus on ratings migration," Plavin tells Lorenz. "We've had very little negative migration in our portfolio. In the Blackstone history of our business, we've had two four-rated loans in our portfolio. Both were part of the GE transaction. Both ended up having underlying property performance a little worse than we anticipated. We managed each to a successful resolution. Both have repaid. The most recent one was at the end of the first quarter. It was a hotel at the Pittsburgh airport." Today Blackstone has no loans above three.

"The Hudson Yard deal will propel Blackstone Mortgage Trust's loan growth in the coming quarters," Lorenz winds up. "Theoretically, a 1% rise in Libor would boost the Trust's earnings by 24 cents—for reference, the annual dividend is $2.48 per share. You'll recall that the rise in Libor over the past year has been neutralized by lower lending spreads off Libor. So, let us say that BXMT is a call option on less easy credit markets. In the interim, the stock pays that 7.6% dividend. If you need it, you need it—call it 'yield at a reasonable price: YARP.'"

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