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So long for now

"The bull story in a nutshell," said we late in 2013, "is that the Blackstone Mortgage Trust (BXMT on the Big Board) will grow up to pay a 9% dividend yield, which the market will dependably transform into a 7% or 8% yield through agency of a rising share price." Lo and behold: It has come to pass.

The Blackstone REIT's journey to fully valued from reasonably cheap is the topic at hand. A few months out of the 2013 starting gate, the shares traded at $25-and-change, essentially book value. Now they're quoted at $30-and-change, or 116% of book value. They yield 8.1%. Since our analysis of Nov. 29, 2013, the stock has delivered a total return of 14% per annum. There are better examples of excess in the beautiful Trump stock market than BXMT's slight premium to book. Still, "fully valued" is the amber light of investment. We are dialing back our bullishness.

When the 10-year Treasury note fetches 2.4%, you must manufacture yield with credit risk or leverage, or both. Blackstone employs both. At year end, its balance sheet showed a 2.3:1 ratio of debt to equity and a 2.9:1 "total leverage ratio" (which includes the leveraged effect produced by the sale of a senior loan and simultaneous retention of a residual, subordinated interest in that offloaded asset). The company's operational M.O. is to lend from a senior position at conservative ratios of value (average LTV last year was 61%) against the collateral of "transitional" buildings, i.e., ones in need of an infusion of capital and/or management to achieve their income-producing potential.

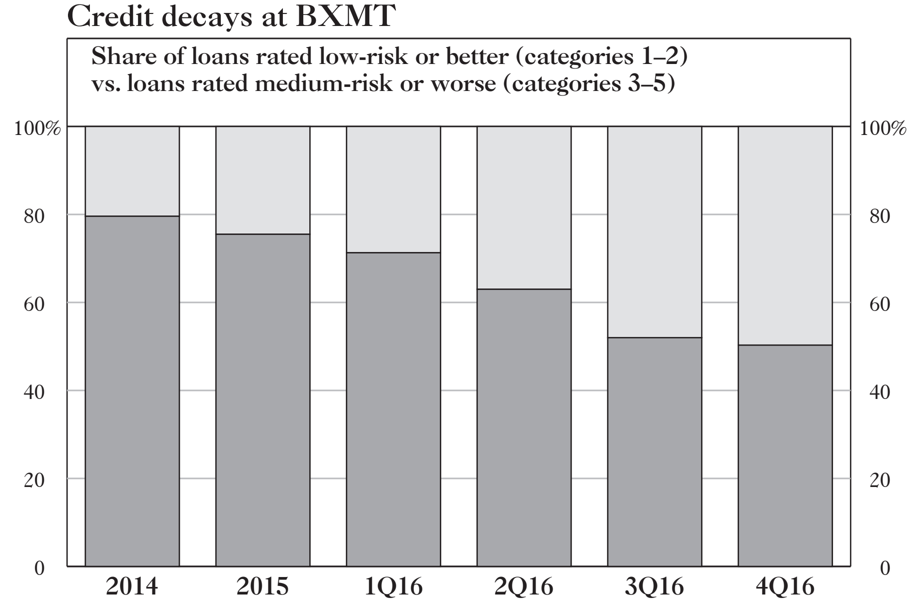
Mainly, Blackstone borrows at floating rates and lends at floating rates. And because of the excess of income-producing assets over interest-bearing liabilities (equity makes the difference), rising money-market interest rates confer a strong net benefit to BXMT's shareholders. The company pays in the neighborhood of Libor plus 2% on its not-quite $6 billion of floating-rate bank debt. It earns an average of 5¼% on its $10.7 billion of commercial mortgage loans.

Management posits that a one percentage-point increase in the reference interbank rate will lift yearly net interest income by 19 cents per share and that most of that bounty will fall to the bottom line. "If Libor went very high, we would have very high earnings and a very high dividend yield," Steve Plavin, CEO of Blackstone Mortgage Trust, tells colleague Alex Hess, who asked Plavin if there was an interest rate high enough to pose credit risk for BXMT's borrowers. "As it relates to credit quality," he replied, "we require borrowers to purchase Libor caps. It's essentially an insurance policy. . . . Those caps are collaterally assigned to us along with the mortgage. So we do have insurance protection on virtually all our loans."

Blackstone's REIT has grown and grown. The May 2013 prospectus showed a total loan portfolio of $824 million. By the end of 2013, those holdings topped $2 billion. Today, the Blackstone vehicle owns a $9.8 billion portfolio and manages the aforementioned $10.7 billion loan book (with an average maturity of about three years), both on- and off-balance sheet.

The single biggest growth surge came

Credit decays at BXMT



source: company reports

with the second-quarter 2015 acquisition of 77 loans for $4.7 billion from General Electric. They accounted for 44% of the Blackstone loan book at the time. Now they amount to 17%. How might the gradual paydown of the GE assets affect Blackstone's capacity to pay dividends? One analyst framed the matter on BXMT's Feb. 15 call, thus: "It really feels like this is the inflection point that you guys have anticipated in terms of dividend policy following the GE acquisition. And you know, two quarters ago you were getting questions about why not to raise the dividend, and now the core earnings just sort of converge with the dividend."

"[W]e did set the [quarterly] dividend at 62 cents with an eye towards what was supportable in the sort of long-term floating rates senior-mortgage business ex[cluding] the GE portfolio," replied Doug Armer, BXMT's head of capital markets.

So safe and sane growth is the issue. Without a rise in Libor, to keep earnings in line with the annualized dividend at $2.48 per share might require a return to leverage levels close to 3.1 times equity—a level last reached in the second quarter of 2016. It would also likely require the company to keep the size of total loan exposure well over $10 billion as the GE loans mature.

How to achieve this objective? Last year, loan issuance weighed in at $3.28 billion and loan repayments at $3.44 billion, for shrinkage of $158 million. Then, again $865 million of the outflow stemmed from a single series of manufactured housing loans, a category in which Blackstone doesn't compete. Exclude those assets from the $3.44 billion repaid, and the company's $3.28 billion in newly issued loans would have exceeded repayments by $707 million. At the least, we think, it suggests that management has the wherewithal to replace the volume of loans that will likely vanish this year.

What could go wrong? Credit, to start with. "When we originate a loan, it's generally originated at a three," Plavin tells Hess—three, that is, on a scale of one to five, with one being the best. "We love to see great things happening—the assets refinance and migrate from a three to a two, or a two to a one, but that often means we're going to be repaid. Loans [that] get to be a one and out of call protect[ion], the sponsor will always have a more efficient loan from someone else. Our business is the business of two's and three's." Last year, the company reported exactly no defaults on 106 or more loans outstanding.

Still and all, from the point of view of creditworthiness, these are the good old days. Sooner or later, interest rates will rise and defaults tick up. Great things do happen, just as Plavin attests, but not in every phase of the cycle.

"Credit quality in the loan book has fallen, if the company's publicly disclosed internal risk ratings are on the beam," Hess observes. "BXMT's loan exposure carries a weighted-average risk rating of 2.5 as of December 2016, using a scale of one (the best) to five (the worst). That was up from 2.2 at the end of 2015. While that may not seem like a big change, consider that as of Dec. 31, the distribution of risk ratings, based on the GAAP book value of the loans, shows a downward trend in credit quality over the past two years. The share of these loans rated at least 'medium-risk'—that is, three or worse—rose to 49.7% in 2016 from 24.5% in 2015 and 20.4% in 2014."

Insiders have been net buyers over the past 12 months, owing to executive chairman Michael Nash's 40,000-share purchase for $967,600 last February, when BXMT shares traded at $24-and-change. Since then, they have sold stock in the amount of $412,753.

We, too, liked Blackstone at the year-ago prices (*Grant's*, Feb. 26, 2016). We like it less at current prices—and with the current credit profile.

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