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Plugging for 9%

At America's big banks, the live-in regulators seem almost to outnumber the paid help. A risk-averse cadre are these government overseers. Good, safe loans are what they want—established borrowers paying rock-bottom rates of interest against undented collateral. In the Civil Service, contrary opinion doesn't take you far.

Which brings us to Blackstone Mortgage Trust (BXMT on the New York Stock Exchange), a new real estate finance company with designs on the lunch that banks no longer seem to have permission to eat. On this green and promising enterprise, *Grant's* is bullish.

With a late May IPO—25.9 million shares at $25.50 a share for net proceeds of $633.8 million—Blackstone Mortgage Trust could hardly be anything except green. That the share price is 50 cents lower today than it was on Day 1 tells you something about the newcomer's business. A real estate investment trust, BXMT has nothing to do with electric cars, social media or bitcoin. It, rather, originates floating-rate, first-mortgage loans for the purpose of paying out dividends.

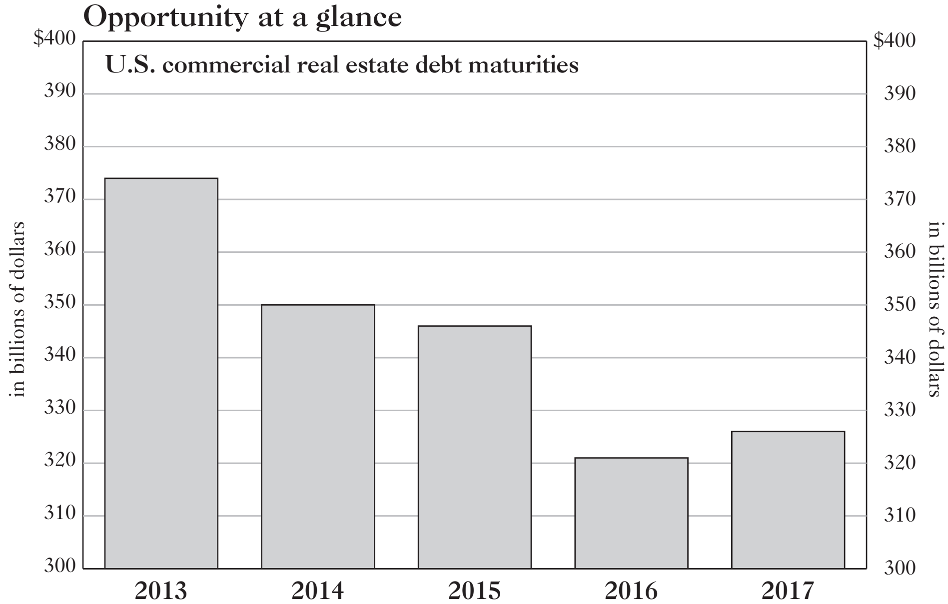
The motive power behind BXMT is The Blackstone Group L.P. (BX on the Big Board), the private-equity, real estate and asset-management giant (see *Grant's*, Oct. 7, 2011, July 27, 2012, and Feb. 22, 2013). A hovering kind of parent, Blackstone has done more than invest in its fledgling REIT; through an external affiliate, it also manages it.

The bull story in a nutshell is that the Blackstone Mortgage Trust will grow up to pay a 9% dividend yield, which the market will dependably transform into a 7% or 8% yield through the agency of a rising BXMT share price. Until then, the newbie REIT will likely continue to dwell in the shadow of, and to trade more cheaply than, the likes of Starwood Property Trust (STWD on the NYSE) and Colony Financial (CLNY, also on the NYSE).

The promoters brought BXMT into the world to fill a genuine need, not just their own, they say. Thus, according to the prospectus, $1.7 trillion of American commercial real estate debt will fall due by 2018, including $374 billion in 2013 alone. Another $1 trillion or so will mature in Europe by 2016. "Given our manager's access to Blackstone's real estate platform," the document states, "we believe that it is well positioned to value real estate collateral and evaluate market trends in order to help us identify value and generate attractive risk-adjusted returns in opportunities that competitors might reject."

Self-interested or not, the promoters have a point. The Blackstone Group's real estate subsidiary, led by Jonathan Gray, owns one of the finest records in the institutional property investment field. Since 1991, the company's global real estate funds have produced a cumulative net internal rate of return of 16.2% per year. By way of comparison, the National Council of Real Estate Investment Fiduciaries (NCREIF) real estate index generated a 5.5% annual return over

Opportunity at a glance



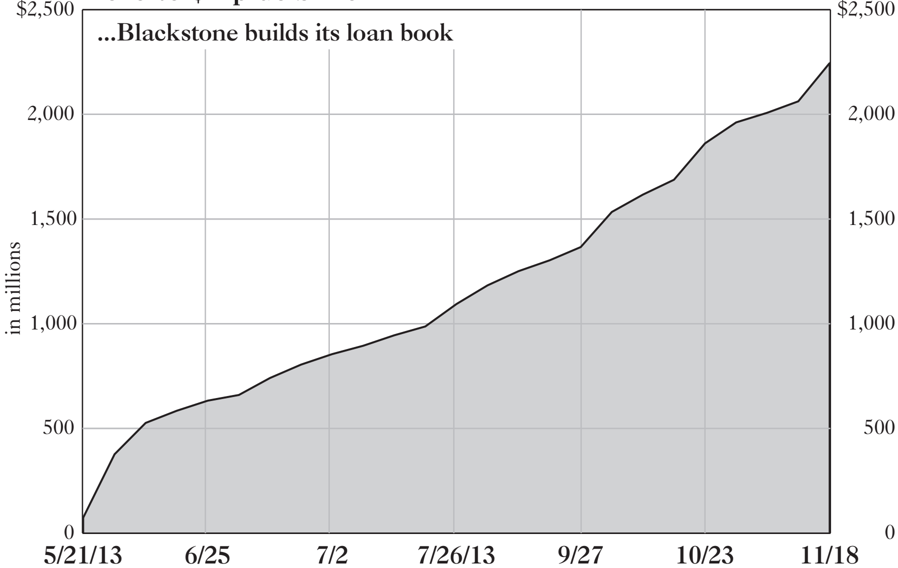
sources: Trepp LLC, company filings

the same period. To deliver a favorable discrepancy of 1,100 basis points, Gray et al. had to have thought more clearly and imaginatively about risk and reward than others. Especially is this analytical edge of value today when the "Too Big To Fail" banks do business with public servants hovering at their elbows.

Mike Nash, executive chairman of BXMT and chief investment officer of Blackstone Real Estate Debt Strategies, elaborated on this point with colleague David Peligal. "The regulatory environment for traditional banks has fundamentally changed," said Nash. "Basel III and Dodd-Frank have encouraged an effort to maintain a lower level of leverage for banks, to take on less risk, and this means that more risk has to be distributed in the capital markets. A lot of what we see in our business plan is that banks, while they are lending and at times lending aggressively, for their top-tier borrowers in the U.S. and overseas, risk aversion has become a function of this regulatory environment. The credit cultures of these banks were dramatically impacted by the credit crisis. For commercial real estate assets that need to be repositioned, released, re-adapted and require leverage by the owner for whatever reason, there is a point beyond which banks will not go. I would say that exploring this opportunity is 75% of our business plan. The rest is made up of the natural inefficiency of the marketplace and our ability to respond much faster to transactions."

For a glimpse into the TBTF credit culture, look no further than the pricing of jumbo residential mortgages. Redwood Trust (RWT on the NYSE; *Grant's*, Nov. 16, 2012), a maker of loans too big to qualify for federal credit support, says it's beset by competition from the heavily regulated banks. "During the third quarter of 2013," says Redwood's Nov. 6 shareholder letter, "some banks were offering 30-year fixed-rate jumbo mortgages more than 25 basis points below GSE-conforming rates [i.e., rates virtually guaranteed by the U.S. government via Fannie Mae and Freddie Mac]. As a historical point of context, jumbo loans are generally offered 25 basis points higher than conforming rates. In our many years of experience, we have never witnessed jumbo loan pricing quite like this. It is a bit of a head-scratcher as to why banks would so aggressively put potentially very long duration assets on their balance sheets at this point in the interest rate cycle. Our guess is that excess liquidity in the banking system, together with a desire for loan and interest income growth, trumps the potential consequences from the asset/liability mismatch down the road." That would be our guess, too.

Zero to $2-plus billion



source: company filings

In this, its teething phase, Blackstone Mortgage Trust paid its first quarterly dividend on Oct. 15; the rate was 27 cents a share. Management made its first substantive quarterly report, for the third quarter, on Oct. 29; it said it had lent, or committed to lend, $2.2 billion with a weighted average loan-to-value ratio of 64%. "Transitional" assets will be the corporate focus, that is, property in need of capital or tenants or both. "Stabilized" assets, i.e., fully leased buildings occupied by investment-grade tenants, yield too little to bother with. BXMT is on the prowl for loans running from between three and five years and of $50 million or more (preferably much more, it says). As of Sept. 30, office—at 44% of the portfolio—was the top loan category; retail, with 3%, was the smallest. In between, in order of importance, came apartments, hotel and land.

"As to the arithmetic of lending," Peligal explains, "BXMT leverages its portfolio three times. Approximately, it lends at 5% and borrows at 2.5%. Multiply this positive spread, i.e., 250 basis points, by the leverage ratio, i.e., three. Result: 7.5%. Now add the unleveraged return on the loan itself, i.e., 5%, which equals 12.5%. Next, subtract the cost of doing business. Take away the management fee, 'liquidity drag,' i.e., the opportunity cost of undeployed cash, and general and administrative expense, a.k.a. G&A. Most of the G&A is fixed, meaning that BXMT will achieve greater efficiency on a bigger base of business. As more capital is deployed over the next 12 months, one could reasonably expect a dividend yield on the order of 9%, more than twice the yield indicated on a Bloomberg screen—provided, of course, no financial markets' crisis intervenes. Needless to say, very few stocks trade at a 9% yield today without cause."

Blackstone Mortgage Trust expects to present a good balance sheet, albeit a leveraged one. "When you employ leverage at the company level against financial assets that have some aspect of credit risk," Nash tells Peligal, "we believe that a safe and less volatile asset base creates a more sustainable model." Hence Blackstone's single focus on institutional first mortgages, in contrast to Colony Financial and Starwood Property Trust, which lend at the mezzanine level, too, and invest in the equity of single-family houses. (Starwood is expected soon to spin off its single-family residential and nonperforming residential mortgage loans' business into a new public REIT.)

Not the least appealing feature of the company to us is that interest rates float on both sides of the balance sheet. BXMT borrows at a spread to the London interbank offered rate, and it similarly lends at a spread to Libor. Starwood and Colony each deploy a similar structure, but Blackstone's is unique in that it's match-funded.

John Khoury, managing partner of Long Pond Capital, who kindly called BXMT to our attention, says that the fact that the stock trades at book value, cheaper than Starwood and more or less on a par with Colony, is an opportunity as well as an anomaly. Blackstone management, after all, is a proven and accomplished steward of other people's money. He contends that BXMT "has the best platform, deal flow, structure and the safest collateral. . . ; all this should lead to the best valuation in the public markets. However, as we stand today, as the business is ramping, BXMT is trading at the worst valuation of its peer group."

Khoury adds—and we agree—that Blackstone's "asymmetry is extremely compelling. If the world falls apart, you own a portfolio of first mortgages underwritten by the best credit guys in the business below par value while getting paid approximately 9% on the stabilized dividend. If it plays out as we expect, BXMT's 9% dividend prices to a 7% yield, which reflects the strength of the platform and the integrity of the collateral and the total return is in excess of 35%."

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