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ARI - Q4 2019 Apollo Commercial Real Estate Finance Inc Earnings Call

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CORPORATE PARTICIPANTS

Jai Agarwal *Apollo Commercial Real Estate Finance, Inc. - CFO, Treasurer & Secretary*

Stuart A. Rothstein *Apollo Commercial Real Estate Finance, Inc. - President, CEO & Director*

CONFERENCE CALL PARTICIPANTS

Jade Joseph Rahmani *Keefe, Bruyette, & Woods, Inc., Research Division - Director*

Richard Barry Shane *JP Morgan Chase & Co, Research Division - Senior Equity Analyst*

Stephen Albert Laws *Raymond James & Associates, Inc., Research Division - Research Analyst*

PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Fourth Quarter 2019 Apollo Commercial Real Estate Finance, Inc. Earnings Conference Call. (Operator Instructions) Please be advised that today's conference is being recorded. (Operator Instructions) I'd like to remind everyone that today's call and webcast are being recorded. Please note that they are the property of Apollo Commercial Real Estate Finance, Inc. and that any unauthorized broadcast in any form is strictly prohibited. Information about the audio replay of this call is available in our earnings press release. I'd also like to call your attention to the customary safe harbor disclosure in our press release regarding forward-looking statements.

Today's conference call is -- call and webcast may include forward-looking statements and projections, and we ask that you refer to our most recent filings with the SEC for important factors that could cause actual results to differ materially from these statements and projections.

In addition, we will be discussing certain non-GAAP measures on this call, which management believe are relevant to addressing the company's financial performance and are reconciled to GAAP figures in our earnings press release, which is available on the Investor Relations section of our website. We do not undertake any obligation to update our forward-looking statements or projections, unless required by law. To obtain copies of our latest SEC filings, please visit our website at www.apolloreit.com or call us at (212) 515-3200.

At this time, I'd like to turn the call over to the company's Chief Executive Officer, Stuart Rothstein.

Stuart A. Rothstein - *Apollo Commercial Real Estate Finance, Inc. - President, CEO & Director*

Thank you, operator. Good morning, and thank you to those of you who are joining us on the Apollo Commercial Real Estate Finance Year-End 2019 Earnings Call. Joining me in New York this morning is our Chief Financial Officer, Jai Agarwal.

I would like to begin the call by reviewing some of the highlights of a very successful 2019 and providing an update on the portfolio. I'll conclude with some additional color on the dividend announcement contained in yesterday's earnings release, and then turn the call over to Jai for an update on our financial results.

During 2019, we celebrated ARI's tenth year as a public company, and we are extremely proud of the success and growth of the company since 2009 as well as the strength of the platform we have built. Apollo's commercial real estate credit team has established a leading position in the market, predicated on extensive relationships and a well-earned reputation as a reliable, thoughtful and creative capital source. During the year, ARI committed to $4.2 billion of loan transactions, and the strength and breadth of the platform was evidenced by the diversity of deal types, property types and geographies represented in the book of business.

Highlights for the past year include a broadening of our geographic footprint throughout Europe as well as several sizable transactions, which we believe speak to the benefits ARI receives from the overall Apollo platform. Specifically, our European team had a breakout year in 2019, completing over $2.6 billion of transactions on behalf of ARI and successfully expanding our business into Germany, Italy and Spain. Apollo has been an active equity investor in European real estate, and the integrated platform enables the commercial real estate credit team in London to benefit from shared relationships, resources and real-time market information when originating and underwriting new opportunities.

I also want to add some color around our success in winning larger mandates this past year. I have frequently commented about our ability to use the broader Apollo platform to speak for larger transactions and create pari passu, or senior junior structures, which provide single-source solutions for borrowers and sponsors. Apollo recently closed the GBP 850 million construction financing for the white lease mixed-use development in London, and the approximately $800 million financing for the retail portion of the Crown building in Midtown Manhattan.

In each instance, Apollo won the mandate due to our ability to underwrite and structure a complex transaction, our willingness to commit to the full financing request and our reputation as a trusted financing partner. Importantly, by securing the whole loan mandates, Apollo was able to create attractive risk-adjusted investments for ARI, which include the GBP 675 million senior mortgage position on white lease and $318 million of the $587 million senior mortgage position on the Crown building, with affiliated Apollo capital subordinate to the ARI positions for both financings.

There are a few additional trends with respect to our 2019 originations worth mentioning. First, our strategic focus on migrating the portfolio towards senior loans continued as 84% of 2019 originations were first mortgages. And we ended the year with approximately 70% of ARI's net equity invested in senior loans. While we still track the entire loan market and episodically come across interesting subordinate loans, at present, we are finding more compelling risk-adjusted returns for ARI in the senior loan space. In several instances this year, ARI opted to take a senior position in transactions, in which other institutional capital was junior to ARI's position. In those transactions, we were comfortable with the risk associated with the senior portion of the financing, and we had a high degree of confidence in both our relationship with and the expertise of the junior lender.

The other trend I would like to highlight was the fact that over 80% of the transactions we completed had borrowers who were financial sponsors, demonstrating how the amount of dry powder in closed-end real estate funds continues to support robust transaction activity. We do not see this trend slowing in 2020 as our pipeline builds in both the U.S. and Europe.

Finally, a few comments on ARI's capital markets success and the continued efficient management of our balance sheet and capital structure. During the year, ARI expanded its capital sources, extended the maturities of liabilities, and when possible, lowered its all-in cost of capital. ARI's equity capital base grew by $350 million during the year, principally through a common stock offering that was executed at a notable premium to book value. During the second quarter, we completed our debut offering in the Term Loan B market, with a $500 million, 7-year term loan. The loan was priced at LIBOR plus 275 basis points. And subsequent to closing, we swapped the floating rate loan to fixed at an all-in cost for 7-year money of 4.87%. The successful loan transaction initiated ARI's ratings and enables ARI to add non mark-to-market term leverage to its capital structure.

Turning to an update on the loan portfolio. At year-end, the portfolio totaled $6.4 billion, which is a 30% increase from the end of 2018. In general, credit quality remains stable. However, I want to provide an update on 2 of our larger loans. With respect to a predevelopment loan that we refer to as the Miami Design District loan, the borrower has elected not to move forward with the planned development. The $220 million loan was originated in 2016, and since origination, the loan has subsequently been paid down to approximately $180 million, which is roughly 50% of the borrowers cost basis. The property was recently brought to market with the intent to repay our loan as well as deferred interest and fees with the proceeds from the sale.

I also want to provide an update on our loans, securing the Steinway Building in New York City. This quarter, the senior and mezzanine lenders agreed in principal to modify and extend the in-place loans until September 1, 2020, in order for the sponsor to complete construction and begin unit closings. As part of the extension, the equity sponsors have agreed to contribute approximately $50 million of equity to the project. And in light of the construction and sales progress made to date, the lenders have agreed to a reduction in the interest rate, bringing in the financing more in line with current market terms. We expect that the in-place capital structure will be refinanced prior to the end of the year.

Lastly, I would like to discuss the dividend announcement we made yesterday with our earnings release. As noted in the release, ARI's Board of Directors considers multiple factors when setting the dividend, including the sustainable level of operating earnings. The current loan portfolio is expected to produce the achievable risk-adjusted returns on equity ARI can generate when we invest in capital and the appropriate level of leverage utilized in achieving these underwritten ROEs. Since 2017, achievable risk-adjusted returns in both the senior and subordinate loan markets have steadily declined due to a confluence of factors, including increased competition from capital seeking alternative yield, spread compression and a decline in short and long-term benchmark interest rates.

In addition, during the year, several of our older vintage, higher-yielding subordinate loans were repaid, and we know that several more will either be repaid or restructured in 2020, resulting in the capital being redeployed at a lower return.

We have consistently stated our commitment to delivering high-quality earnings and a stable ROE, without assuming excessive risk through increasing leverage or deploying capital into loans with a higher risk profile. We remain steadfast in our belief that we will not chase a nominal return and will continue to remain disciplined in both our approach to new investments as well as leverage.

We also want to reiterate the Board's desire, as much as possible, to set a consistent dividend level. Accordingly, the Board of Directors announced a $0.40 dividend per share of common stock for the first quarter of 2020, and expect to maintain that level for the remainder of 2020 subject to performance and the Board's approval and discretion. This new dividend level offers stockholders an approximately 8.9% dividend yield based on current stock trading this morning.

As we look to the year ahead, we remain confident in ARI's business model and market position. Our focus remains on finding investments, which generate attractive risk-adjusted returns within ARI's core business. 2020 is off to a strong start. Since January 1, ARI has committed to $560 million of new commercial real estate loans, and our pipeline remains healthy. We will remain steadfast to our credit first methodology while building ARI's pipeline, and we'll be prudent in our capital management in funding new business. We believe the combination of our platform, pipeline and financial flexibility will enable ARI to continue to generate attractive risk-adjusted returns on its invested capital.

And with that, I will turn the call over to Jai to review our financial results.

Jai Agarwal - *Apollo Commercial Real Estate Finance, Inc. - CFO, Treasurer & Secretary*

For the fourth quarter of 2019, our operating earnings were $70.9 million or $0.46 per share. GAAP net income for the quarter was $68.5 million or $0.42 per share. During the fourth quarter, we closed 9 loan transactions, totaling over $2.2 billion, $1.2 billion of which were funded during the quarter. We also funded an additional $143 million for previously closed loans. Repayments during the quarter totaled $1.2 billion, resulting in net portfolio growth of 4%. All of the new loans were floating rate mortgages. At the end of the year, our portfolio was comprised of 72 loans and had an amortized cost of $6.4 billion, a 30% increase over last year.

The portfolio had a weighted average unlevered yield of 7.4% and a fully extended remaining term of just over 3 years. We have approximately $1.9 billion of future funding commitments, roughly $850 million of which we expect to fund in 2020. Approximately $1.5 billion of U.S. loan portfolio has LIBOR floors that are currently in the money. These loans have an expected remaining term of just over 1 year, with weighted average LIBOR floor is 2.1%.

With respect to liquidity and leverage, as of quarter end, we had over $750 million of available capital in the form of cash and availability on our credit lines. And we ended the quarter with a 1.4x debt-to-equity ratio. As the portfolio migrates towards first mortgage loans, our leverage will gradually increase.

During the quarter, we entered into a repurchase agreement with Barclays Bank, bringing total financing capacity to $4.3 billion, with 6 counterparties.

Lastly, I would like to mention the upcoming accounting guidance on current expected credit losses, or CECL. We expect our January 1, 2020 additional CECL reserve to be approximately $31 million or 50 basis points of our amortized cost, which will have a $0.20 impact to book value per share. For further information, please refer to our Form 10-K filed last night.

And with that, we'd like to open the line for questions. Operator, please go ahead.

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QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question will come from the line of Stephen Laws from Raymond James.

Stephen Albert Laws - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Appreciate the comments. Stuart, I guess, first, if you can start with the Miami asset and talk about where the process goes from here and timing of how you expect, to the point you know at this point, any outlook on timing of resolution of that loan?

Stuart A. Rothstein - *Apollo Commercial Real Estate Finance, Inc. - President, CEO & Director*

Yes. At this point, brokers have been retained. Brokerage is out to the market. NDAs have been signed and are still being signed. I think there's north of $50 million at this point. So there's significant investor interest. It's obviously a somewhat complex project, given the redevelopment nature of it, and there's effectively 2 different parcels. I would expect we'll learn a lot more in the next 6 to 8 weeks as we start to get feedback back from investors, and people dig in and ask questions and I think, realistically, we'd certainly expect that when we're doing this again 2 months from now, there should be a lot more color on the process and sort of more information with respect to potential scenarios and likely outcomes.

But the deal is in the market now. The initial response is what we would have hoped for in terms of investor interest. And then we'll let -- we'll know a lot more 6 to 8 weeks from now after people have a chance to underwrite, dig in and do their diligence. But it's off to the ratios at this point.

Stephen Albert Laws - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Jai, a couple of questions. First, on leverage. It makes perfect sense. We increased as the mix of senior loans increase, is there -- mathematically, how should we think about it? Or where is -- is there a target for where you would run leverage if it was 100% senior loans as we kind of think about ramping to get there as the mix of mezz continues to decline?

Stuart A. Rothstein - *Apollo Commercial Real Estate Finance, Inc. - President, CEO & Director*

Yes. I think, Stephen, the way we think about it is at a high level, to your point, if we ran the goalpost, right? There'd be effectively 0 leverage if we were all mezzanine loans. And most first mortgages today are being financed somewhere between 2.5x to 3x on an individual deal basis. I think it's important as you think about that as a goalpost, and I'm not sure we ever get to the extremes of -- yes, either a goalpost.

The other thing that I think is particularly relevant is as leverage moves up, so does the mix of that leverage, whether it is repo-specific leverage or whether it's non asset-specific term leverage, which we've actually approached the market several times successfully, either on the convertible note side or on the term loan side. We ended this quarter at 1.4x, so there's a long way to go as we start thinking about those goalposts.

But the way I would think about it on an individual deal, we're probably at no more than 2.5 to 3 terms leverage on an individual repo-financing. And from a corporate finance strategy, our desire will always be to mix both repo as well as non asset-specific term leverage.

Stephen Albert Laws - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Great. Those comments are helpful. And last question for me regarding CECL, our last topic. As I think about CECL and how the reserve shifts from here, I know it's not broken out, but how will the 50 basis points trend as the mix shifts the senior loans? And additionally, regarding the Miami development, is there a specific reserve there? Or how big of a component is the general reserve related to the new 4-rated asset?

Jai Agarwal - *Apollo Commercial Real Estate Finance, Inc. - CFO, Treasurer & Secretary*

Yes. There's no specific reserve on that asset just yet. And then going to your first question, as we shift our portfolio mix, right? So mezz loans generally have higher CECL reserves in terms of percentages. So -- and mortgage loans have a smaller percentage CECL reserve. So if our portfolio is a bit -- were to become 100% first mortgages, say, our percentage CECL reserve would go down, so that 50 basis point number would go down significantly.

Stephen Albert Laws - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Okay. Can you quantify that impact? Or is it still too early in this process to know exactly where that would shift?

Jai Agarwal - *Apollo Commercial Real Estate Finance, Inc. - CFO, Treasurer & Secretary*

It's still -- yes. It's still too early given the future funding components might change. Loan expectations might change. Credit quality might change. Macroeconomic views, et cetera, might change. So it's still too early to quantify that.

Stephen Albert Laws - *Raymond James & Associates, Inc., Research Division - Research Analyst*

But is it safe to assume, given the focus on increasing the mix of senior loans, we're likely not going to see any increase in the CECL reserve run through the income statement? Or how should we think about the reserve on a go-forward basis?

Jai Agarwal - *Apollo Commercial Real Estate Finance, Inc. - CFO, Treasurer & Secretary*

That's fair. If we were to just shift the portfolio, then you would not see an increase in the CECL reserve. But if we were to just simply grow, right, then you would see an increase in the CECL reserve.

Operator

And our next question comes from the line of Rick Shane from JPMorgan.

Richard Barry Shane - *JP Morgan Chase & Co, Research Division - Senior Equity Analyst*

I just want to follow-up on the CECL question and related to the unfunded commitments. Our understanding is you guys do have to take CECL reserve against unfunded. The ratio on the balance sheet between funded and unfunded is at a relatively high watermark for you guys. Curious sort of how you think about that going forward in a CECL environment? Because there's $1 billion there that won't be funded until next year based on the comments we heard, but you'll have to take a reserve for it today.

Jai Agarwal - *Apollo Commercial Real Estate Finance, Inc. - CFO, Treasurer & Secretary*

Yes. I mean, look, there is a "CECL penalty" on these unfunded commitments. But we don't think that impacts our business. We also -- the CECL penalty, if you will, is not 100% of the unfunded commitments because you do have to sit there and estimate a time-weighted component of that. So if we have unfunded commitments of $2 billion, the CECL reserve could theoretically be on, say, half of that.

Richard Barry Shane - *JP Morgan Chase & Co, Research Division - Senior Equity Analyst*

Got it. And how -- from a capital perspective, how do you manage this? How much visibility do you have? Do you get sort of 2 quarters of visibility from the developers about what the draw is going to be a year? How does that work?

Jai Agarwal - *Apollo Commercial Real Estate Finance, Inc. - CFO, Treasurer & Secretary*

Yes. I mean, it depends on a loan-by-loan basis but somewhere between 6 months to 1 year visibility.

Stuart A. Rothstein - *Apollo Commercial Real Estate Finance, Inc. - President, CEO & Director*

But just to be fair, Rick, we've got a -- on any construction deal, right? We've got a construction consultant working on the Apollo side of the equation as well, right? So we're part of the monthly, call it, construction draw, cost estimate process and have reasonable visibility, as Jai says, looking out 6 to 12 months in terms of what's coming. It's not just getting an estimate from the developer. It's a more active process. And we're very much sitting at the construction table, getting a sense of what's coming in the future.

Richard Barry Shane - *JP Morgan Chase & Co, Research Division - Senior Equity Analyst*

Got it. So you're -- this is also based on sort of your own assessment of milestone achievement?

Stuart A. Rothstein - *Apollo Commercial Real Estate Finance, Inc. - President, CEO & Director*

Yes.

Jai Agarwal - *Apollo Commercial Real Estate Finance, Inc. - CFO, Treasurer & Secretary*

That's right.

Operator

And our next question comes from the line of Jade Rahmani from KBW.

Jade Joseph Rahmani - *Keefe, Bruyette, & Woods, Inc., Research Division - Director*

To start with the revised dividend, does that take into account the lower Steinway yield and the nonaccrual on Miami?

Jai Agarwal - *Apollo Commercial Real Estate Finance, Inc. - CFO, Treasurer & Secretary*

Yes.

Jade Joseph Rahmani - *Keefe, Bruyette, & Woods, Inc., Research Division - Director*

Can you give some color as to the Steinway loan and what the revised yield is, what your -- what ARI's exposure is at this point and if the additional equity went to pay down any of the debt?

Stuart A. Rothstein - *Apollo Commercial Real Estate Finance, Inc. - President, CEO & Director*

In no particular order, the additional equity didn't go to pay down debt. It was to basically ensure that there is, in sort of any reasonable eventuality, more than sufficient capital to complete the development.

Without being overly specific on where ARI's return went, we were sort of plus or minus 20% on our old capital. And we are, call it, plus or minus, 10-ish percent, 11% on our new capital. The overall capital commitment, as of today...

Jai Agarwal - *Apollo Commercial Real Estate Finance, Inc. - CFO, Treasurer & Secretary*

It's about $260 million.

Stuart A. Rothstein - *Apollo Commercial Real Estate Finance, Inc. - President, CEO & Director*

$260 million of a mix of both senior and junior mezz. And as we said in my comments, yes, this was basically us and the other lenders sort of putting into place a capital structure that gets this thing to completion, gets it to the point where they've started closing some additional units and fully expect, but as they move towards that, will be taken out with some sort of inventory refinancing towards the latter part of this year.

Jade Joseph Rahmani - *Keefe, Bruyette, & Woods, Inc., Research Division - Director*

I think Commercial Mortgage Alert reported that they were looking for a refinance. So does it suggest that there was an interest from other lenders at this point?

Stuart A. Rothstein - *Apollo Commercial Real Estate Finance, Inc. - President, CEO & Director*

I would say, I'm not going to be in a position of speculating on the accuracy of things that are in Commercial Mortgage Alert.

Jade Joseph Rahmani - *Keefe, Bruyette, & Woods, Inc., Research Division - Director*

Okay. And do you have an update as to what percentage of the units have been sold?

Stuart A. Rothstein - *Apollo Commercial Real Estate Finance, Inc. - President, CEO & Director*

They have been -- I -- we have information. But they haven't released anything publicly, so I'm not at liberty to sell.

Jade Joseph Rahmani - *Keefe, Bruyette, & Woods, Inc., Research Division - Director*

Okay. On the Miami Design District Loan, JZ Capital, which is a partner with RedSky Capital on February 10, published an update in which they said that those -- the Miami Design District loan and the Fulton Street loan, the -- not the loan, their equity in it, would be completely written off. In other words, they don't expect any recovery in value. So do you expect any impairment on either of those loans?

Stuart A. Rothstein - *Apollo Commercial Real Estate Finance, Inc. - President, CEO & Director*

Based on the accounting treatment we used this quarter, the answer would be no. Again, I'm not at liberty to comment on why they did or what they didn't did. But sitting here today, we believe that both loans are value protected in terms of our loan basis.

Jade Joseph Rahmani - *Keefe, Bruyette, & Woods, Inc., Research Division - Director*

And in terms of the -- how those -- or how the Miami project will be marketed, since I don't believe there has been much leasing and so there's not much cash flow, on what basis will the project be marketed? Is it going to be priced on some dollar amount per acre or per square feet of developable space? What's going to be the [proper] value there?

Stuart A. Rothstein - *Apollo Commercial Real Estate Finance, Inc. - President, CEO & Director*

It's a redevelopment site, no different than any other redevelopment site that gets marketed. There are existing buildings there that were intentionally emptied out but still sit there as buildings. So anybody's pro forma could assume they might want to re-lease for a period of time and develop on 1 parcel versus another parcel. But it is existing real estate that is owned for significantly more density, adjacent to an existing area whose metrics in terms of sales per square foot of their current tenancy are increasing rapidly and the acceptance of the Design District as a true submarket or as a true commerce area, the metrics are getting better every day. So it's being marketed as a redevelopment site. There's also flexibility in terms of what people decide to put on the site. And obviously, based on what they determine in terms of asset type, whether office, hotel, retail, will have impact on how they think about value.

Jade Joseph Rahmani - *Keefe, Bruyette, & Woods, Inc., Research Division - Director*

Okay. In terms of this quarter's earnings, $0.46, I believe, included about $0.02 of prepayment income. So $0.44 should be the run rate. There were some back-end weighted originations and you also noted originations to date. We know that the blended yield on incremental deals is 5.6%. And we can make an assumption on what's paying off. And then the modification in Steinway, which, I believe, Steinway was running at around 20% of the company's earnings, and then the Design District nonaccruing interest. Is it reasonable to assume from a modeling standpoint that earnings will meet or exceed the dividend, perhaps exceed the dividend in the early part of the year and then run lower through the back end of the year, depending on the cadence of investment activity?

Stuart A. Rothstein - *Apollo Commercial Real Estate Finance, Inc. - President, CEO & Director*

I actually think about it the reverse way, Jade. To be clear, when we talked about the dividend, predominantly most of our dividend discussions with the Board focus on annual performance, not quarterly performance, which we've talked about many times before. But as you look at how 2020 is shaping up and some of the comments that you made leading into your question and then, obviously, some knowledge we have about the timing of when we expect things to repay, when we expect certain future fundings to take place as well as some other things in the pipeline, we would expect the trend for the year actually to be more upward sloping in terms of earnings to sort of be at a low point in the early part of the year and then moving up throughout the year, and then potentially some upside beyond that, depending on the pacing and timing of some of the assets that you referred to getting resolved.

Jade Joseph Rahmani - *Keefe, Bruyette, & Woods, Inc., Research Division - Director*

Okay. And on a full year basis, covering the dividend? Meaning you're exceeding the dividend?

Stuart A. Rothstein - *Apollo Commercial Real Estate Finance, Inc. - President, CEO & Director*

Yes.

Jade Joseph Rahmani - *Keefe, Bruyette, & Woods, Inc., Research Division - Director*

And on the repo facilities, given the mix towards Europe, where is the all-in cost running at right now?

Jai Agarwal - *Apollo Commercial Real Estate Finance, Inc. - CFO, Treasurer & Secretary*

The all-in cost is close to L plus 2 -- slightly over L plus 2 with fees.

Operator

And I'm currently showing no -- any further questions at this time. I'd like to turn the call back over to Stuart for any closing remarks.

Stuart A. Rothstein - *Apollo Commercial Real Estate Finance, Inc. - President, CEO & Director*

Thank you, operator. Thanks for those of you participating this morning.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.