Starwood Property Trust

First Quarter 2024 Earnings Call Transcript
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Call Participants

EXECUTIVES

Barry Stuart Sternlicht
Chairman & CEO

Jeffrey F. DiModica
President & Managing Director

Rina Paniry
CFO, Treasurer, Principal Financial Officer & Chief Accounting Officer

Zachary H. Tanenbaum
Managing Director, Head of Investor Strategy

ANALYSTS

Donald James Fandetti
Wells Fargo Securities, LLC, Research Division

Douglas Michael Harter
UBS, Research Division

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

Richard Barry Shane
JPMorgan Chase & Co, Research Division

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

Presentation

Operator

Greetings. Welcome to Starwood Property Trust's First Quarter 2024 Earnings Call. [Operator Instructions] Please note, this conference is being recorded. At this time, I'll hand the conference over to Zach Tanenbaum, Head of Investor Relations. Zach, you may now begin.

Zachary H. Tanenbaum
Managing Director, Head of Investor Strategy

Thank you, operator. Good morning, and welcome to Starwood Property Trust Earnings Call. This morning, the company released its financial results for the quarter ended March 31, 2024, filed its Form 10-Q with the Securities and Exchange Commission and posted its earnings supplement to its website. These documents are available in the Investor Relations section of the company's website at www.starwoodpropertytrust.com.

Before the call begins, I would like to remind everyone that certain statements made in the course of this call are not based on historical information and may constitute forward-looking statements. These statements are based on management's current expectations and beliefs and are subject to a number of trends and uncertainties that could cause actual results to differ materially from those described in the forward-looking statements.

I refer you to the Company's filings made with the SEC for a more detailed discussion of the risks and factors that could cause actual results to differ materially from those expressed or implied in any forward-looking statements made today. The Company undertakes no duty to update any forward-looking statements that may be made during the course of this call.

Additionally, certain non-GAAP financial measures will be discussed on this conference call. A presentation of this information is not intended to be considered in isolation or as a substitute for the financial information presented in accordance with GAAP. Reconciliations of these non-GAAP financial measures to the most comparable measures prepared in accordance with GAAP can be accessed through our filings with the SEC at www.sec.gov.

Joining me on the call today are Barry Sternlicht, the Company's Chairman and Chief Executive Officer; Jeff DiModica, the Company's President; and Rina Paniry, the Company's Chief Financial Officer. With that, I'm now going to turn the call over to Rina.

Rina Paniry
CFO, Treasurer, Principal Financial Officer & Chief Accounting Officer

Thank you, Zach, and good morning, everyone. We reported a strong quarter with distributable earnings or DE of $191.6 million or $0.59 per share. Our results were highlighted by contributions across all of our businesses, with outsized performance in Property from the sale of our Master Lease Portfolio and in Commercial Lending from prepayment fees, which was partially offset by underperformance in our CMBS book. In all, DE includes an $0.08 net gain from these items. They also contributed to higher GAAP net income, which was $154 million or $0.48 per share. Undepreciated book value ended the quarter at $20.69, with GAAP book value at $19.85.

Beginning my segment discussion this morning is Commercial and Residential Lending, which contributed DE of $205 million to the quarter or $0.63 per share. In commercial lending, repayments of $909 million outpaced fundings of $128 million on pre-existing loan commitments. Our portfolio of predominantly senior secured first mortgage loans ended the quarter with a funded balance of $15.1 billion and a weighted average risk rating of 2.9. Jeff will cover our risk rating changes in greater detail.

Turning to CECL, we had no new specific reserves in the quarter and no new loan or REO impairments. Our general CECL reserve increased by $35 million to a balance of $342 million, of which 70% relates to office. This increase was

driven by our selecting the most pessimistic economic outlook of seven scenarios available to us in our third-party model for our office loans. Together with our previously taken REO impairments of $172 million, these reserves represent 3.4% of our lending and REO portfolios, and translate to $1.64 per share of book value.

Next, I will discuss our residential lending business. Our on-balance sheet loan portfolio ended the quarter at $2.5 billion, including $880 million of agency loans. We had $45 million of par repayments during the quarter and recorded a $2 million net negative mark-to-market adjustment for GAAP purposes. This mark includes a $38 million negative mark on our loans, offset by a $36 million positive mark on our hedges, which provided $25 million of cash during the quarter. In our $435 million retained RMBS portfolio, a change in market call price assumptions contributed to a $7 million negative mark in the quarter.

Next, I will discuss our Property Segment which contributed $59 million of DE, or $0.18 per share to the quarter. During the quarter, we sold our Master Lease Portfolio for $387 million. The transaction resulted in net proceeds of $188 million, a net DE gain of $37 million and a net GAAP gain of $91 million. Because the sale was completed in late February, our Q1 results include 2 months of income, or $0.01 of DE from these assets.

Our Florida affordable housing fund generated $14 million of DE in the quarter. Subsequent to quarter end, HUD released the new maximum rent levels, which were set 7.9% higher than last year. Certain properties were in geographies where the rent increases were capped by HUD, which resulted in 3.8% of incremental rent growth being deferred to next year. This would be in addition to any increase determined by the HUD formula in 2025.

And finally, in our Medical Office Portfolio, subsequent to quarter end, we refinanced the $600 million of outstanding debt on these assets, which was scheduled to mature in November. We entered into a new CMBS debt of $450 million and a mezzanine loan of $40 million, both with a 5-year term at a blended coupon of SOFR plus 252 basis points.

Turning to Investing and Servicing, this segment produced breakeven results in the quarter with the positive contributions from our conduit and special servicing businesses, offset by a negative contribution in CMBS.

In our conduit, Starwood Mortgage Capital, we completed four securitizations totaling $212 million at profits consistent with historic levels. In our special servicer, LNR, our active servicing portfolio increased from $6.6 billion to $7.2 billion, primarily due to $1.1 billion of transfers in, more than half of which were office or contained in office component. Our named servicing portfolio ended the quarter at $96.1 billion, driven by $3.7 billion in maturities, offset by new assignments of $1.1 billion.

Finally, in our CMBS portfolio, as is typical for the first quarter, we received annual financial statement reporting on the assets underlying our bond holdings. One securitization in particular, had 3 nonperforming assets out of the remaining 73 in the pool. Due to lower-than-anticipated NOI and a lower-than-anticipated appraisal for these assets, we recorded a $17 million DE impairment on the bond.

Concluding my business segment discussion is our Infrastructure Lending segment, which contributed DE of $20 million, or $0.06 per share to the quarter. We committed to $120 million of new loans, of which we funded $96 million and an additional $42 million on pre-existing loan commitments. Repayments totaled $210 million, bringing the portfolio to a balance of $2.5 billion at quarter end. Subsequent to quarter end, we completed our third infrastructure CLO for $400 million at a weighted average coupon of SOFR plus 218, which Jeff will discuss.

And finally, this morning, I will address our liquidity and capitalization. We continue to have ample credit capacity across our business lines, ending the quarter with $9.7 billion of availability under our existing financing lines, and unencumbered assets of $4.6 billion. Our adjusted debt-to-undepreciated equity ratio ended the quarter at 2.3x, a decrease from 2.5x last quarter.

In addition to low leverage, our current liquidity position has increased to a record $1.5 billion. This does not include liquidity that could be generated through sales of assets in our property segment or debt capacity that we have via the unsecured and Term loan B market.

With that, I'll turn the call over to Jeff.

Jeffrey F. DiModica
President & MD

Thanks, Rina, good morning, everyone. We accessed the debt capital markets in the quarter, issuing $600 million of senior unsecured sustainability notes, leaving us with record liquidity today. This issuance was the first in our industry in over 2 years and was 7x oversubscribed with orders from 156 institutional investors, both records for our company. Record demand allowed us to tighten pricing by 75 basis points, and after swapping this fixed rate issuance to floating, we borrowed at a repo-equivalent of SOFR plus 312 basis points, in line with pricing we achieved throughout our history despite today's high rate and spread environment. After paying down bank warehouse lines, this issuance was leverage neutral, allowing us to maintain just 2.3 turns of leverage, a 2-year low for our company, and it will not affect our dividend paying ability. Creating excess liquidity in a leverage-neutral fashion will allow us to again ramp up our investment pace at the appropriate time. Market transaction volumes are picking up and our pipeline of actionable deals is as strong today as it has been in over 2 years.

As for the macro environment, commercial real estate continues to face headwinds created by higher interest rates that have driven cap rates higher, thus causing the reserve increases you are seeing in our sector for the last year. Partially offsetting that, 3/4 of our CRE loans have interest rate caps in place and 85% of our portfolio has embedded interest rate protection. Rates rose in the quarter since we last spoke and have now begun falling again after last weeks' weaker than expected employment number and the Fed's decision to slow the pace of quantitative tapering from $60 billion per month, to $25 billion per month, which in turn will reduce treasury bond issuance by $420 billion per year.

At the same time, we are seeing tailwinds in increased transaction volume, and credit spread tightening, which will help our borrowers as they seek accretive refinancing alternatives. Recent issued BBB- CMBS credit spreads, which are a good proxy for mezzanine CRE lending, have tightened by over 300 basis points in the last 6 months and are back to second half of 2022 levels today. Spread tightening has allowed us to issue unsecured notes, refinance our MOB portfolio in the CMBS market, and issue our third energy infrastructure CLO all inside market expectations at much tighter spreads.

We built a low leverage diversified business to withstand choppy conditions like this and to be in a position to go on offense when they create outsized opportunities, which, as I said, we expect to do in the coming quarters.

With regards to our Commercial Lending credits, like most banks, we use a third-party model called macroeconomic advisers in computing our general CECL reserve, which we again increased in the quarter. Our equity market cap of $6 billion is nearly 2x the second largest participant in our sector, but since we have 7 other businesses, we do not have the largest CRE loan book in our sector. We run a very low leverage business model and only 11% of our assets are on loans on U.S. offices, the asset class most disrupted since COVID, due to work from home, higher rates and the tightening of real estate credit conditions. That is half of what our holdings were before COVID began, and a fraction of our peer set average. Despite that, we have reduced book value with the largest general CECL reserve in our sector by dollar value, and the second highest by percentage giving us cushion for potential losses that could come on assets we have not taken a specific reserve for.

Our sponsors continue to support their assets en masse, and after receiving $1.3 billion of new sponsor equity commitments in 2023, we have already received an additional $483 million in 2024. Looking at our property types, our largest property type, multifamily, which is 21% of our company's assets, has an average remaining term of 2.7 years and continues to experience year-over-year rent growth with same-store rents up 3.4% in 2023. The sponsors for 60 of our 72 multifamily loans have committed fresh equity to their assets, including all of our 4 and 5 rated loans, and we don't foresee any issues getting paid off on the 12 that have not had to inject additional equity to date. I just mentioned office loans, our second largest property type, which comprise 11% of our company's assets. 87% of these are Class A, and 77% of them do not mature until 2025 or beyond. Our third largest property type, hotels, is 8% of our assets today, and this portfolio has an average in-place debt yield of over 11%. As we have been saying since the beginning of COVID, we do not foresee refinancing issues with these hotel assets.

As for risk rating changes in the quarter, while our 4-rated bucket increased with three new additions, the dollar value of our 5-rated bucket was lower this quarter, following the upgrade of a $252 million office loan in Houston.

This Houston asset has seen incremental leasing activity, including the anchor tenant taking more space and extending lease term to 2036, and is sufficiently capitalized with runway to complete important CapEx projects in secure accretive new leasing. We downgraded 2 smaller loans to 5 in the quarter, an $82 million mezzanine loan on an office building in Los Angeles, where the borrower has remained current and we are working to extend term allowing time to complete accretive leasing, and a $52 million multifamily loan in Nashville that is in payment default and we expect to foreclose on. We will decide in the coming quarters whether to maximize value by holding and stabilizing this asset as we have in the past, or sell it at or near our basis depending on the short-term direction of cap rates.

We also downgraded 3 loans in the quarter from a 3 to a 4 risk rating. The first 2 are office, a $99 million loan in Atlanta, and a $92 million loan outside Minneapolis. We are working to close preferred equity investments on both that will carry the assets for 2 years giving our borrowers time to find accretive leasing that would create escape velocity should rates continue lower and markets continue to repair.

The final downgrade to 4 is a $45 million multifamily loan in Phoenix that is in payment default. This asset has been poorly managed, allowing occupancy to drop into the 70's%. Should we take the asset back, our manager Starwood Capital Group is one of the nation's largest owners of multifamily assets, and we hope bringing in new management and our expertise will allow us to bring this asset back to market occupancy of 90%, after which we will decide whether to hold or sell the asset.

In our Property Segment, Rina mentioned our affordable housing and medical office portfolios, and that we sold our master lease portfolio in the quarter. We originally purchased the 23 asset master lease portfolio in 2017 for $556 million. We sold 7 of the 23 assets in 2018 for $235 million and a DE gain of $23 million. This quarter, we sold the 16 remaining assets for $387 million and a DE gain of $37 million. We successfully doubled our equity investment on this sale over 7 years, producing an IRR of 15.7% for shareholders. These assets had 25-year leases at origination, and the lease term had fallen to 18 years. Our plan was to sell these with more than 10 years of lease term remaining, and given retail sales have slowed since their early COVID increase, we thought this was an opportune time to take our gains and further reduce our company's leverage while looking for opportunities to reinvest elsewhere.

In Energy Infrastructure lending, Rina mentioned we completed our third CLO. We now have 56% of our debt in this segment on term, non-recourse, non-mark-to-market financing, which further insulates our company's cash position. This business continues to benefit from lower lending competition and higher energy needs driven by AI and EV's. A significant portion of our holdings are on loans that have actively quoted trading markets, and prices on those loans are up almost 4 points in the last 12 months alone. LTVs on these assets continued to fall due to increased asset profitability and structural deleveraging over the life of these loans.

In the quarter, we committed to $120 million of new loans at an IRR of approximately 20%, and our post-2018 acquisition portfolio now makes up over 90% of our portfolio with expected levered returns in the high teens. We expect to continue to take advantage of these tailwinds by making outsized investments in this highly return accretive segment going forward.

With that, I will turn the call to Barry.

Barry Stuart Sternlicht
Chairman & CEO

Thanks, Jeff. I want to thank Rina and Zach. Good morning, everyone. I'm on the West Coast, so dialing in remotely into the team's call. I'm out at the Milken Conference, I would say that the question on everyone's mind is where are we in the cycle? Are we bottoming? Do we think it's going to get better? When will they get better? And I think it's pretty clear that for almost every property type, things are okay at the property level. And so it's really a question of how do you finance yourself? This is a balance sheet crisis in the United States, not a property level crisis.

Most of the asset classes while there are some decelerating rents in multifamily, most everyone sophisticated in real estate knows that the supply of new apartments is going to fall precipitously as soon as this wave completes, more or less in the middle of ’25, and then rents should reaccelerate. So, you are seeing buyers come out of the woods, particularly since the credit markets, the CMBS markets are wide open. Even diversified portfolios are getting done in the CMBS market spreads are in. So, the markets are repairing themselves. And even the tone of the banks, at least the large banks is getting slightly better as they grasp to get their arms around what they have, who's going to do what with what? It is remarkable how many sponsors are coming in and working to fix their capital stacks, buying caps, trying to push their loans into coverage ratios. And I think there's a lot of dry powder on the sidelines, and you've recently seen Blackstone's large take private of a multifamily, two of them in fact, one in Canada, one in the U.S. There are transactions taking place in the private sector. And we're kind of -- it's definitely the yellow flag, we're doing the caution race, you're out, you're going around the track, peak your head into the pit and do I have to come in and then repair the car and go back out on the track.

We are at an enviable position, I think, both with our footprint, both here in Europe where there's more activity, but also with our liquidity being -- going into this with this much dry powder gives us the opportunity to restructure, modify, take back, and basically do the thing that will maximize value for our shareholders. We are unique in our sector that we've always been an equity REIT. We've always owned 17,000 affordable housing units that are -- continue to be the gift that keeps on giving with significant rent growth and assuredly rent growth next year because we couldn't take all the rent growth, as Rina pointed out this year. So affordable housing is the one sector of real estate you can actually count on being full, and for rental growth for the foreseeable future, which is material to us and will help us. And the other thing that you probably don't know, is there has been significant margin relief in our cost structures, particularly for insurance, and we expect our insurance to be down year-over-year. As we budgeted the year, we did not expect that. We thought it would be up as it has been almost every year, but that should help increase margins, and improve, or support the value and the gains that we already have in our affordable housing book.

I do like, continue to like, we talk about it every quarter for 10, 11 years, the multiple cylinders we continue to look at other cylinders that would offer new business lines for us and maybe not quite as correlated to the large loan real estate book, the energy infrastructure lending group is just such a thing, with a 20% target returns on the paper we've invested. We will go deeper there and accelerate that investing. We also are looking at other things. We've always looked at other things. And with the general stress, and we’ll call it stress on other companies in our sector and smaller companies that are -- probably will have some issues. I mean I think we will find some opportunities to be created on the capital market side and continue to look at different things, both here and abroad that will grow our enterprise and with the goal, of course, to achieve ultimately investment grade, which makes it’s for a perpetual flywheel of capital in our industry. And given the pullback of the banks, we would like to figure out that we should be the dominant player in this space, much as some of the private credit guys have done that in the corporate space. So, it's the largest player, that’s our job to execute there. I think our smaller loan business, the recent hires in our Starwood Solutions business, are just beginning to take root, but we hope they become small oaks instead of saplings in our portfolio and continue to contribute to higher ROE for our shareholders and a very dependable income stream to support our dividend.

It is such an unusual thing with rates this high, sitting on this cash is not nearly as punitive as it used to be. We just pay off our lines and then we can carry them out as we need to borrow again. So we're paying off lines that are written off of SOFR, which is 5.3% and spreads that are at least 200 something over. So you're talking about us paying off 7%, 8% debt is not a bad outcome for a short order. It's not that dilutive.

What is dilutive is the non-accruing REO assets we have on our balance sheet, but we're blessed to be able to support our dividend without having them accruing even though they are recovering, and we will continue to work through the portfolio and bring that capital back into an earnings position as soon as prudent. The only other thing I'd say is I do think the Fed has the wrong toolkit for this economy, and the faster they realize that, the better off certainly the banking system and the real estate complex will be -- it's not working. I mean interest rates at this level have not slowed job growth in many industries. It's not slowing down the tech innovation, the new announcements by Meta, Facebook, NVIDIA, Amazon, Microsoft in construction of data centers, the nearly $100 billion defense bill, which will power military manufacturing of weapons and armaments in the United States as a stimulative bill. Obviously, you see the administration laying out the money now for the CHIPS Act and $5 billion here, $8 billion there, $30 billion there, it's adding up.

We are turning on the infrastructure bill. So, the government is not getting any construction job losses, which you'd

normally see with a 500 basis point increase in rates. One of the first things you can kill is construction. On the other hand, half of -- almost 45% of the economic -- of the workforce today is in health care, education and government. And you can point out that those 3 industries have added 3.1 million jobs since he started raising rates in May of '22. So back, close the door, it's not working for health care. Nobody doesn't get sick because he's raised interest rates 50 basis points, nor does anyone not go to the hospital, not call their doctor.

The other big problem he had, inflation was driven partly by energy prices and food prices, and both of those have retreated, but he's not going to affect car insurance with interest rates. So, it's kind of a tool that is -- the collateral damage of which has been the banking system, the regional banks, and throwing into disarray the valuations of commercial assets all over the country and I'd say all over the globe because many people had to follow us. And that is not just an academic thing because the cities and municipalities are depending on the real estate taxes from these commercial assets to run their schools and police and waste management and all the other services that provide their communities.

So if you keep taxing and keep decreasing the NOI of your buildings, you decrease the property values and you can keep taxing, but the values keep going down. And pretty soon, you're in a spiral far worse than a 2.7% versus a 2% inflation rate. You have asset deflation, which has unbelievably bad implications across the country. So maybe the Fed will get ahead of the election and do something, I think he'd like to. But I don't think people should think that in this economy, the way it's configured with tech leading and productivity leading from the tech sector that without causing a serious recession, a hard landing he can get the job losses he wants to free up the labor force.

So I would say, we also would like -- we'll take advantage of the data center area and probably weigh into some lending opportunities where, as a private firm, we're the fourth largest data center player in the country. So, we are quite active on the build side. We have 50 people now doing data centers that will -- could be a very interesting place for us to continue our new vertical to lend against and one of the issues there is those loans are big, and they require a lot of capital, which is good news, bad news. But there are opportunities for lenders to achieve very nice returns in that sector, and it's very good credit. So that would be something that we'll look forward to doing in the future.

With that, again, I want to thank the team, and this is hand-to-hand combat. This is like hands on the steering wheel time. It's not a time to be out and twiddling your thumbs. It is -- the teams are working with borrowers and working on our entire investment portfolio to try to maximize returns for the shareholders. So, we are feeling pretty good in a tough world. But I think we're very confident in our ability to weather the storms emerges, I think the leader in our sector. So, thanks, everyone. We'll take questions.

Question and Answer

Operator

[Operator Instructions] First question comes from Jade Rahmani with KBW.

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

This quarter has been a tale of 2 cities. While there's been ongoing credit migration, we've seen some positive surprises from the banks in terms of there being no big shoes to drop. At the same time, with the commercial mortgage REITs, there has been pronounced deterioration and broad recognition of losses. Starwood clearly is performing much better than peers. So, I'm curious what you think explains the discrepancy, if it's the nature of the transitional assets or more so, as you alluded to in your comments, the liabilities? And if it's the liabilities, that should open up opportunities for Starwood to be a net acquirer of weaker players that have very constrained capital structures.

Jeffrey F. DiModica
President & MD

Barry, you want me to start? I will start. Jade, we did foreclose on some things early. We've been advantaged by having a portfolio that's set up to perform better in this market. I hate to keep repeating it, but it's hard to hide from the fact that with 11% U.S. office and the lowest leverage at 2.3 turns, you would -- plus tremendous liquidity, you would expect better outcomes there.

The difficult thing for this market, I think, and it goes for the banks and the nonbanks, and all of us is looking at forward SOFR. If you go back to May of last year, forward SOFR in 2025 was going to be 2.6%. If you went back to October of last year, it was 4.6%. If you went to January of this year, it was back into 3.5% area. Well, today, SOFR is expected in the middle of '25, a year from now, to be 4.40% and a year later to be 4%. So we don't go below 4% for 2 years. We thought we were doing that a year from now by over 100 basis points. So I would say these reserve builds with SOFR having made a move significantly higher with the Fed being priced out and the spread versus the 10-year note, the 10-year note was 70 basis points above going back to the beginning of the year where forward SOFR was supposed to be in '25. Now it's below where forward SOFR is supposed to be.

So, the Fed being priced out is very difficult for transitional floating rate loans and to the extent the Fed continues to get priced out of the market, I think you'll continue to see reserves build. And to the extent that we flatten here and take some advantage from some of the weaker numbers we've seen recently. This QT move last week is good. We're seeing rates go lower today. I think these reserves will stop building. But it's difficult to say. On the good side, I think a lot of us have the staying power. Hopefully, our peers have the staying power to live to 2 years, 3 years, whatever that is down the line.

We have tremendous liquidity. We have massive access to liquidity, having just issued high yield. And so, I hope that our peers have the same staying power because ultimately, we will likely head to lower rates, and that will be very helpful. As for M&A, I'll give you my cell phone number. If you have anybody whose board would like to be acquired at 50%, 60%, 70%, 80% of book value and we can look at the assets, would love to, it's almost impossible in the sector. People don't want to have that discussion. We would love to consolidate and help consolidate the industry. We've had no luck doing that, and I don't expect that we'll have any luck in the near future doing that with management teams and Boards who aren't looking to do that and would rather try to defend their book value, see that...

Barry Stuart Sternlicht
Chairman & CEO

I'll be a little more optimistic about that. It's not fun when you have nothing to do, you can't issue stock, you're getting repo calls. But it's not a question if they want to volunteer, it will be more because they have to and merge with a stronger balance sheet. It is -- one thing that's interesting about the market is, yes, you've seen these, I call fairly

sophisticated borrowing or managers of books take hits in their book whether it's REO or just write-downs, almost everyone in the sector, I think, has experienced some form of one or the other. If you think of the regional banks that have $1 trillion nine of loans and maybe levered 8:1, you wonder what's going on, like how could they not be experiencing larger losses certainly in their office portfolios.

And it wouldn't take much to wipe out an 8:1 levered book and the equity of that book. So, they typically have went on smaller properties and tertiary markets, which don't have the liquidity of the option of being placed in the CMBS execution. So there is -- you continue to scratch your head. I do think it's an incredible opportunity for us. And will we be fortunate enough to go out and raise additional capital in this market, we could deploy it at extraordinary returns. And we continue to stay active in these markets with our private credit vehicles because we want to keep our people busy, but we're foaming at the mouth to get back in the game, but have to be prudent about it.

So we have paid down repos. We have the liquidity to do that, where banks have been wobbly, and there's been significant -- and still we remain with $1.5 billion of liquidity. So, I'm not of the camp that rates are going up. I think Powell -- forget about what the numbers say about inflation, he has the regional banking system that he's looking out of the corner of his eye. A bank is failing seemingly like every week now. And he also knows that, that's the best way to get capital into those banks is to lower rates, it will help the securities as well as the loans, back to our way of a bailout basically. And the second thing he's obviously focused on is the deficit. It's not free lunch. Everyone tells them to raise rates, well, the biggest victim is the federal government, which if you play this out, will earn a $1.5 trillion of interest expense. $1.5 trillion, 2x the defense bill, the entire defense spending in the United States. I mean, we were running $200 billion in '21. That's 7x of the interest expense. And then it becomes the negative flywheel, we just printing, printing, printing to pay interest. And he can't be that foolish, actually wants the United States -- especially in a world that has no huge engine of growth today.

They will lower rates in Europe in June, almost assuredly, Lagarde will lower rates, it will put pressure on the dollar, it will make U.S. exports less competitive. I mean, either you want to crack this thing over a rock before he says uncle? It's not working. I mean this economy is not doing what we all expected it to do, which was cave, and it's very simple why. Americans have jobs, their balance sheets are fixed, they have fixed rate mortgages, they got $235 billion of interest income from their cash that's sitting in money market accounts earning 5%. They have their jobs, they're -- while the growth rate in wages has slowed, it's not down. And there's no obvious sign of how you actually get people fired in business services. But you're seeing cracks, if you look hard enough, you see McDonald's, you see Starbucks, you see credit card delinquencies at the non-money center banks, you're beginning to see, as the average American lives out the stimulus savings, a slowdown in the broader economy. You saw Shopify's numbers this morning. I mean there are cracks. There are companies beginning and they are not able to pass on the price hikes that they were able to do before. So he won't wait. I don't think he'll wait till the election. I could be wrong because, again, I wouldn't have done what he did either. I wouldn't have listened to -- what do you call, back seat drivers who are saying “just raise rates”. One has to think about the implications of that across the capital markets in the globe. And we have managed by increasing rates the way we have, to put Europe in a recession. And Europe and China will not be the engines of growth to pull us out of this. So there's no huge -- nothing is going to get lit up if he drops rates 50 basis points. Nothing changes.

No jobs are going to get filled. Maybe the housing market, maybe it gets a little bit stronger. But if he wants to solve inflation, he should look 1.5 years down the road at the ever-larger deficit of homes he's creating, as builders don't build, and then prices will accelerate and take off again because he's creating a shortage of housing today. So, I mean, you can do what you want, and he is, but pretty clear -- and people give them applause. Well, he was the gentleman that told us that rates would stay lower longer through in December '21, and right through May of '22 bought corporate bonds. So I wasn't -- he wasn't right then, and I don't believe he's going to - right now. He has to be super careful because his tool his toolkit is flawed. So this economy is not your grandmother's economy. It's not an economy that can knock millions of jobs out of manufacturing when we only have 13 million jobs in manufacturing. It's a small industry in United States today. So we'll see. But we're very well poised and we're waiting, we're chomping at the bit to turn the heat on now.

You're not seeing that many transactions still. So there's not that many things, and you'll see less construction. So, in order to lend, we need transactions and not just modifications. So one of the things that's happening, and one of the reasons the data set is not as large as it ought to be is because of the ability of banks who are well capitalized to modify and restructure loans and hope for a low rate environment in the future. So it's not like -- you see the volume of commercial transactions, I think, it is down to the levels of 2011. So we are -- people are not trading assets. Everybody is waiting for Powell to relent. Hopefully, he will. And the economy will take a step forward. Thanks.

Operator

Next question, Don Fandetti with Wells Fargo.

Donald James Fandetti
Wells Fargo Securities, LLC, Research Division

Yes. Can you talk a little bit about the outlook of migration of office loans from 3 to 4 rated. Last quarter, there was a pretty big increase. You've got a few this quarter. Are we just looking at a handful of loans each quarter? Are we getting closer to the end? And what's driving those movements this quarter?

Jeffrey F. DiModica
President & MD

Yes. Clearly, this SOFR move that I talked about is putting stress on people and I think the ability and desire to continue to put in capital -- and in my prepared remarks I said we had borrowers put in $1.3 billion last year and almost $0.5 billion already this year. If the forward SOFR curve continues to go higher, people are going to be less aggressive in doing that and as they are less aggressive in doing that, and we have to have discussions about potentially carrying the loans or helping carrying the loans, or potentially cutting rate by a little bit, or anything that requires us to really be involved in the loan is potentially going to go noncurrent. We want to be in front of that and move it from May 3, which signifies something that is fully current and being supported to a date.

We're not making any concessions to a 4 where we feel if this economic environment stays and SOFR stays higher, we could end up having to commit more capital to help support an asset. And so, you saw 2 assets in the office space go from 3 to 4 this quarter, neither one was huge, I spoke about both earlier, the other one was an apartment. But Don, I think if the forward curve goes, is much higher in the next quarter as it did this quarter versus where it's been, I think that's a type of migration that shouldn't be unexpected in a $20-odd billion balance sheet, it's not huge. It's sort of normal course, but SOFR certainly is going the wrong way in the quarter and we're being conservative given we may have to put capital in to help support assets. So, I think this credit migration, it will follow SOFR and hopefully, it slows down in the coming quarters as we turn it around.

Donald James Fandetti
Wells Fargo Securities, LLC, Research Division

Got it. And Jeff, what's your appetite for residential mortgage credit, portfolio, it's sort of flattish. If you think about non-QM, I mean credit is still pretty good. Are you seeing opportunities or just not a ton of deals out there?

Jeffrey F. DiModica
President & MD

On resi mortgage credit, was that the question? I apologize, I was just looking at some notes on something else. And would we go back into the investment side? Is that your question?

Donald James Fandetti
Wells Fargo Securities, LLC, Research Division

Yes. Just kind of how are you thinking about the asset growth there. Credit has been pretty good. I mean are you seeing opportunities? Or are you going to sort of keep the portfolio flat until you get more on offense?

Jeffrey F. DiModica
President & MD

It's interesting. We talked a lot about credit tightening across markets. Credit has really tightened on the resi side as well. There is certainly a bid, it's driven by insurance companies for bonds that are highly rated. We're seeing two AAA securitizations this week, Veris and one other that are in the 130, 135 area for AAAs. What's more interesting to me is

that BBB's on those deals are 200 over. I don't remember a 70-basis point spread between BBBs and AAAs anytime recently, and that is really tight.

So, the credit curve is collapsing, where the insurance bid and others for the much smaller classes of BBBs. You know we've tightened those in significantly. So, with an active securitization market there, it is pretty interesting. You look at a lot of the non-QM type of assets, the type of things that we have on our books. There are 8 plus coupons, gross WAC coupons, being produced today. And if you can securitize at those type of spreads in the 130 over for senior notes, you can make a tremendous return on an 8% gross WAC resi mortgage, but you are very levered to prepayment speeds. And so, the discussion we've had internally about whether to add or not, has really been around what do we think happens to speed? Barry's baseline and our baseline is that rates do go lower. And I think a lot of people who take out an 8% to 8.5% gross WAC coupon residential loan, if rates go 100 basis points lower and they just got their financials ready for the last one, they're going to be very quick to repay.

I think you could see historically quick repayments on those. So, you're going to have something that's high 20s IRR that could turn into a significantly lower IRR if rates rally a lot and obviously, rates going lower is not great for our earnings. It's good for credit. So, to lever into a prepayment negative convexity trade at this time, even though the carry is so enticing, and we've looked at it a bunch, it is not something we're looking to do. We're very happy with the performance over the last couple of years. We increased our hedge. We moved our hedge more to the front end. It's outperformed. Our hedges have significantly outperformed our resi book.

Our resi book is lower coupon. It's not -- we could securitize it today, but given we're as liquid as we are, we're saving most of 100 basis points in financing costs by keeping it in bank debt financing rather than securitized financing that will roll in 3 or 4 years anyway. So, we're staying the course on the resi side. We are seeing a tiny bit of resi credit disruption. I wouldn't say that the 90-plus days are troubling in any way. The reality is most of our book was written 5, 6, 7 years ago, and you've had a lot of HPA. So, absent fraud and some places like that, the resi credit for the time that we wrote our loans should be awfully good. If we were writing -- if we were correct and writing 65 LTV loans, they should be 50 LTV loans today.

So, it should really only be ones where we have a fraud situation, which unfortunately does happen in the space. The newer loans will obviously have less home price appreciation to support them. So,
you'll probably have more resi credit issues over the next couple of years on the higher coupon, newer loans. But our book is more 2018 to 2021 or '22 at the latest.

Operator

Next question, Rick Shane with JPMorgan.

Richard Barry Shane
JPMorgan Chase & Co, Research Division

Just one thing. I'm curious behaviorally with really a significant change in sentiment in terms of rate outlook starting in January, higher for longer, if either within your portfolio or within the special servicing portfolio, you saw some sort of behavioral capitulation borrowers who thought they were going to get relief have an opportunity to buy caps cheaper, refinance in more attractive markets, start to throw in the towel even more aggressively than we've seen.

Jeffrey F. DiModica
President & MD

Yes. Listen, it's a really good question. It's only been a couple of months since we've seen this move. Volatility is not up. So, the cap expense is still not quite as bad as it was when volatility was a little bit higher, but caps are expensive. You will find borrowers who may decide not to support, as I said earlier, on our multi -- this is really the multifamily side, where somebody is going to make a decision based on their need to buy a cap, and they're going to make a decision based on their view of cap rates, which are going to follow interest rates.

So, this is really a multifamily borrower. I think I said earlier, 60 of our 72 borrowers have committed more capital out of pocket. The other 12, we are not worried about those loans. So, we've continued to have people commit capital out of

pocket to support their loans. The 4 loans, I think the multifamily that we have rated 4 or 5, are probably not going to continue to support them, and they're coming up against that decision. So that decision that you're, that you're talking about is the decision to continue to support today. And a lot of that's going to depend on the type of equity that you have. If you are a syndicator and unfortunately, there were a lot of syndicators in 2018, '19, '20, 21, and even early '22. And you have to pick up the phone and call 100 different wealthy guys to have them put in $5,000 a piece to be able to make a pay down on a loan, you're probably not going to call all 100 guys, and you're going to not have the capital to continue to support your loan, and that's the most likely person to stop paying. We -- Barry said in the past, we're looking at that as an opportunity.

These are -- the debt yield of our multifamily book is over 6%. We would expect that if we own those at effectively a 6 cap going forward and we hit the rate cycle that we think we'll hit over the next 3 or 4 years, that we'll have an opportunity to make money on that and get our capital back, first of all, for shareholders, which is our job and potentially have these as good investments. I think the larger, well-capitalized people are going to be much more likely and have been more likely to continue to put money in on a over 6 debt yield because it's effectively selling a 6 cap. And if you have some money to hang in, you will probably hang in. So, I think that capitulation trade will be the syndicators and we've seen that, and the rest of real money we'll hold on, and we're happy to step in for the syndicators and be the real money, and wait for a better cycle. Barry, anything to add to that?

Barry Stuart Sternlicht
Chairman & CEO

No, I just caution anyone to think the forward curve is right. It changes with the breeze. I really think people were a little surprised to that last jobs report at 175 and the downgrades to the prior reports. Again, hoping the jobs report 100,000 jobs in healthcare. I mean, again, it's the power of this economy, the service economy and the interest rates are not changing that. So, I do think if the cracks open and you can start seeing them, obviously, he will be worried about breaking the economy, is not really a sign of it today. I mean it's small cracks. But -- and so I don't -- I think a lot of people -- and I think a lot of high net worth, I'm at a conference with a lot of capital out in the West Coast. You're seeing a lot of interest in the property sector from regions of the world that we probably are not overweighted. And they're even interested in the unlevered yields, that they know that probably treasuries of 4.5 may go lower. But even if their 5 having an asset at a 6, 7, 8, 9 unleveraged, isn't unattractive if you have a lot of capital. They don't need 22 IRRs. They're happy to get 10. And as you know, every endowment in the world tries to get an 8. So if you can get even an office building that's well leased with WALT, and your purchase price is significantly below replacement costs to protect you on the way out, you probably will see some major trades as you've seen in the hotel industry and the apartment sector. People are sort of taking advantage of this opportunity when there are fewer shoppers and taking a long-term position that they're positioning themselves for the inevitable recovery of the multi-sector and the reacceleration in the industrial markets and in the office market, you're -- you can see exactly what's happening. The entire office market in the United States is being covered with one brush. Banks do not want office exposure. They do not want to have to explain at the OTC. They don't want the buildings back. But on the other hand, if you have the right buildings and even cities like New York and San Francisco, they are 100% full, and there are no rent concessions. People are going to buildings that they like and they're fully occupied. In our headquarter building in Miami, our lease came up, and a sublet from a smaller tenant on the other side of the tower from our offices, and it was sublet in 2 weeks at $20 higher rents, which is a 20% increase. In New York City and our offices in the meatpacking district, a floor came up for lease. It's very expensive. They relet it within a month at the asking rents. So, the markets are broad brush, there is a huge issue with BNC office, most of which will come down, and get converted to something else. It's not trading cheaply enough for people to scrape it yet, but it eventually will and/or the governments will come forward with credits and concession packages to turn mid-block buildings that have no conversion opportunity to anything into residential, probably by tearing them down.

And that'll start another cycle. So, real estate is a long-lived and long asset class, and it's not a day trading asset class, but it is the largest asset class in the world and it's not going away. And if you pick your spots, you'll make money both on the lending side and on the investing side. Sorry, I'm losing my voice.

Operator

Next question is Stephen Laws with Raymond James.

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

I appreciate the commentary so far, Jeff, you talked a little bit about upcoming original maturity dates or where cap expirations may be providing some opportunity. Looking at the other way on rates, what would increase transactions? Is there a clearing level on rates? If it goes back to 4.25 or 4, are there people that maybe were hoping for 3.5 early this year that all of a sudden move quickly because it gets back to 4, they missed their window. How do you think about a clearing level for rates of what creates more transaction opportunities?

Jeffrey F. DiModica
President & MD

It's interesting. I think it's going to be cap rate dependent as well, right? You're seeing some multifamily trade in the low 5s. We've just seen some recently. You're seeing some office trade at cap rates that are tighter than you think, they are sort of one-off. I believe if you get to the point where people can get some equity out where they weren't sure yesterday if they could get equity out that, everybody gets deal fatigue and people want to move on from things. And if they can start repatriating some equity and turning to do something else. I think that that's where a deal flow really starts to pick up, which you're not far from today, but you probably need -- every 50 to 100 today means more than it's ever meant as I look at it.

As I look at it, we all started by lending at 70% LTV and with cap rate expansion that we've seen to date, that cushion has been eaten into. So as that cushion gets eaten into, every basis point where we end up and Barry is 100% correct. The forward curve has not been right for 30 years. So, let's just assume that we don't know where it's going to go. But given some of our spending cushion has been eaten up by cap rate expansion, every basis point actually matters more than it has historically because lenders in that, are closer to the equity than they were when they made the loan. So, I would say 50 to 100 basis points forward curve or 50 to 100 basis points in the 10-year, I think transaction volume starts to pick up very significantly. I don't think you need a large move, but you need to sustain it. We were there in January and had we sustained January rates, volumes, I think, would be tremendously higher today, both on the lending side and the equity side. We've just been unable to sustain anything. It's been a very choppy market. It's trended 50 basis up, 50 basis points down every 3 months for the last sort of year, 1.5 years and it's difficult. By the time you get to those rates, you start setting something up 3 months later, rates are the other way and I think that's why you haven't seen the volumes. But if we get 6 months sustained back at sort of January's rate, 50, 70 basis points lower than this in the 10-year, and 75 basis points lower than this in forward SOFR, I think you'll see a lot of transaction volume. I think there's a lot of people who would like to trade if they see that stability. And that's an exciting opportunity for us. We have significant capital today to deploy. Our pipeline, I touched on it briefly, but we saw for a couple of hours yesterday, it's as big of a debt pipeline as I've seen here in a couple of years. If we decided to use all of our liquidity, we could use almost all of our liquidity in the next 6 months between our Energy and our CRE lending businesses. we're going to choose the best of those, but we're starting to see opportunities. Some of those are refis. It's not to your question, where transactions really happen, but refis where the previous lender is where you're up against a final maturity and the previous lender has deal fatigue. So, they're going to look for somebody else. So, I'd say the majority of what we're seeing is that over the transactions Barry was talking about, but we have a decent pipeline from a lender's perspective. The equity pipeline will pick up, I think, with a decent rally. Barry, I don't know if you have anything to add to that.

Operator

Next question, Doug Harter with UBS.

Douglas Michael Harter
UBS Investment Bank, Research Division

Hoping you could talk a little bit more about the refinance on the medical office building, looks like your debt against the property came down a little over $100 million, thoughts on that? And does that imply anything about the value of the properties?

Barry Stuart Sternlicht
Chairman & CEO

Less about the value and more about the service coverage -- but go ahead. Go ahead, Jeff.

Jeffrey F. DiModica

President & MD

Yes, Barry. I think you know that the properties continue to perform, but they're performing against the higher cap rate today, so the valuation is lower. It's not an income problem. It is a higher cap rate problem and the agencies are going to allow you to take a little bit less debt. Now, the good news against that is against that, we tightened 25 basis points. The market felt really good about this. The agencies gave us good enhancement levels. We don't need -- like we're sort of happy to underlever this asset. So yes, we did put $100 million of equity in, but it's a decent return for us of cash, and we're sitting on a lot of cash and so we got a really good rate at 252 over on what we did take, which in this market feels pretty good, given high yield, we just issued at SOFR for 312 over.

Barry Stuart Sternlicht
Chairman & CEO

No, I was just going to say that we could have taken more leverage, but the junior classes are dilutive to the dividend. So with -- not the spread, it's just where base rates are. So, it wasn't so much the cap rate. It's really a debt service coverage to get debt that's attractive enough to take it. The 250 over was pretty decent debt and if we increase the leverage levels higher, which we could have, it was silly money and we want to buy it, not borrow it. So, we just cut the proceeds to a level that we thought was attractive and accretive to the company, and that's it.

Operator

I would like to turn the floor over to Barry Sternlicht for closing remarks.

Barry Stuart Sternlicht
Chairman & CEO

Well, thank you, everyone. We appreciate you listening in, and good luck to you, and we hope your loans pay off. Take care. Thanks, team.

Operator
This concludes today's teleconference. You may disconnect your lines at this time, and thank you for your participation