

Starwood Property Trust

Second Quarter 2024 Earnings Call Transcript
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Call Participants

EXECUTIVES

Barry Stuart Sternlicht

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President

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Presentation

Operator

Greetings and welcome to the Starwood Property Trust's Second Quarter 2024 Earnings Call. [Operator Instructions] Please note, this conference is being recorded. At this time, I'd like to hand the conference call over to Zach Tanenbaum, Head of Investor Relations. Zach, you may begin.

Zachary H. Tanenbaum

Managing Director, Head of Investor Strategy

Thank you, operator. Good morning, and welcome to Starwood Property Trust's Earnings Call. This morning, the Company released its financial results for the quarter ended June 30, 2024, filed its Form 10-Q with the Securities and Exchange Commission and posted its earnings supplement to its website. These documents are available on 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 in 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 will now turn the call over to Rina.

Rina Paniry

CFO, Treasurer, Principal Financial Officer & Chief Accounting Officer

Thank you, Zach, and good morning, everyone. This quarter, we reported distributable earnings or DE of \$158 million or \$0.48 per share. GAAP net income was \$78 million or \$0.24 per share. Across businesses, we committed to \$925 million of new investments this quarter. As a testament to the diversity of our platform, 62% of our investing was in businesses other than commercial lending, which now makes up to 57% of our assets.

I will begin this morning with Commercial and Residential lending, which contributed DE of \$189 million to the quarter or \$0.58 per share. In commercial lending, we originated \$353 million of loans, of which we funded \$284 million and an additional \$113 million on pre-existing loan commitments. Repayments for the quarter totaled \$606 million, nearly half of which were office. We had another \$624 million of repayments in July, for a year-to-date total of \$2.1 billion.

On the subject of credit, our \$14.7 billion loan book ended the quarter with a weighted average risk rating of 3.0, up from 2.9 last quarter. The vast majority of our borrowers continue to support their assets, investing nearly \$2 billion of fresh equity since the beginning of last year. In addition, 97% of our performing loans have some form of rate protection in place, either via rate caps, which have an average base rate of 3.2%, interest reserves, guarantees or a fixed rate of interest.

Jeff will cover our risk rating changes in greater detail, including two loans placed on nonaccrual in the quarter. One was a \$46 million multifamily loan in Phoenix that we downgraded from a 4 to a 5, and the other was a \$57 million multifamily loan in Fort Worth, which was downgraded from a 3 to a 4.

As we signaled last quarter, we foreclosed on two previously 5-rated loans. The first was a \$124 million senior mortgage loan on a vacant office building in Washington, D.C. that we are converting to multifamily. Although the appraisal resulted in a specific CECL reserve of \$9.8 million, we expect to recover in excess of our basis once the conversion is complete. Because we have begun the redevelopment process for this asset, we transferred it to our property segment for financial reporting purposes.

The second was a \$53 million first mortgage and mezzanine loan on a multifamily property in Nashville. We obtained an appraisal in connection with the foreclosure, which valued the asset at our basis. As a result, the property was recognized at the carryover basis of our loan with no resulting impairment.

On the topic of CECL, our reserve increased by \$33 million to a balance of \$380 million, of which 70% relates to office. Together with our previously taken REO impairments of \$183 million, these reserves represent 3.6% of our lending and REO portfolios, and translate to \$1.78 per share of book value.

Next, I will discuss Residential Lending, where our on-balance sheet loan portfolio ended the quarter at \$2.5 billion. Prepayment speeds increased this quarter and spreads tightened, leading to \$62 million of par repayments and a \$34 million net positive mark-to-market for GAAP purposes. This mark includes a \$49 million positive mark on our loans, offset by a \$15 million negative mark on our hedges, which provided \$25 million of cash during the quarter. Our retained RMBS portfolio ended the quarter at \$427 million, with the slight decrease from last quarter driven by cash repayments.

Next, I will discuss our Property Segment, which contributed \$14 million of DE or \$0.04 per share to the quarter, which primarily came from our Florida affordable housing fund, where we began rolling out the HUD maximum allowed rent level discussed last quarter, excluding the 3.8% holdback we expect to implement next year. The majority of these rent increases were implemented in June, so you will see just a partial impact to earnings this quarter. This portfolio's 3.7% blended fixed and floating rate debt with 3 years of average remaining duration continues to be an asset.

Turning to Investing and Servicing. This segment contributed DE of \$37 million or \$0.11 per share to the quarter. In our conduit, Starwood Mortgage Capital, we completed or priced 4 securitizations totaling \$363 million at profit margins above historic levels due to spread tightening in the quarter. Consistent with past practice, the two transactions that priced in June, but settled in July are treated as realized for DE purposes.

In our special servicer, LNR, our active servicing portfolio increased just over 30% to \$9.4 billion, its highest level since COVID. The increase was primarily due to \$2.5 billion of transfers into servicing, which will contribute to earnings in the future. Our named servicing portfolio also increased in the quarter, to \$98 billion, driven by new assignments of \$5.1 billion.

And on this segment's property portfolio, we foreclosed on a \$10.1 million hospitality asset that we acquired as a nonperforming loan out of a CMBS trust. Consistent with our original investment thesis and a recently obtained appraisal, we expect to sell this asset in excess of our basis in the near future.

Concluding my business segment discussion is Infrastructure Lending, which contributed DE of \$24 million or \$0.07 per share to the quarter. We committed to \$237 million of new loans, of which we funded \$226 million and an additional \$34 million of pre-existing loan commitments. Repayments and sales totaled \$313 million, bringing the portfolio to a balance of \$2.4 billion.

During the quarter, we completed our third infrastructure CLO for \$400 million, with a weighted average coupon of SOFR + 2.18% and an 82.5% advance rate, which Jeff will discuss in more detail.

And finally, this morning, I will address our liquidity and capitalization. This quarter, we successfully repriced our 2027 \$591 million Term Loan B facility, reducing the spread by 50 basis points to SOFR plus 275. We continue to have significant credit capacity across our business lines, with \$9.9 billion of availability under our existing financing lines and unencumbered assets of \$4.5 billion. Our adjusted debt-to-undepreciated equity ratio ended the quarter at 2.29x, a decrease from 2.33x last quarter, its lowest level in over 2 years.

Our current liquidity position is \$1.2 billion. This does not include liquidity that could be generated through sales of assets in our property segment, leveraging unencumbered assets or debt capacity that we have via the unsecured and Term Loan B market.

I also wanted to mention that this quarter, our credit ratings were once again affirmed by all three rating agencies. Despite challenging conditions in the CRE space, they collectively recognized our diversity, leverage profile, liquidity position, stable earnings and credit track record as key elements supporting our rating.

And finally, I would like to share that we were just awarded the 2024 Nareit Gold Investor CARE Award, which recognizes communications and reporting excellence in the mortgage REIT category. This is our 8th time receiving the award in the last 10 years, exemplifying our long-term commitment to both our stakeholders and transparent financial reporting. We are honored to once again be recognized by Nareit for this award.

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

Jeffrey F. DiModica
President

Thanks Rina. As we approach our 15th anniversary this month, we're the longest standing commercial mortgage REIT of our post-GFC peer group, and the only company who has never cut its dividend. We built a diversified low leverage business, positioning us to outperform regardless of market cycle. Our inception-to-date return of over 10% per year is higher than the equity REIT index, and more than double the mortgage REIT index in that time. Even though we have the best valuation in our sector, the market has only given us partial credit for this diversification and for the over \$4 per share in unrealized DE gains. As I will discuss shortly, those gains, which provide a unique safety net to ensure our dividend paying ability, are likely significantly higher. 15 years later, we aren't really a mortgage REIT anymore.

The 10-year has rallied 75 basis points since we last spoke, and forward SOFR is now indicating a 165 basis point reduction in the Fed funds rate by March, both of which are very good news for CRE credit as they provide relief both through cap rate compression, and improved Debt Service Coverage Ratios. As Rina shared, our sponsors have contributed nearly \$2 billion of fresh equity on our \$14.7 billion CRE loan book since last year. When rates move like this, we typically see borrowers step up and support their assets more aggressively, and I would expect that continues.

We have spoken often about loans on U.S. office, which are 10% of our assets. But this rate move will mostly help other sectors of our loan book more, like multifamily, which is 21% of our assets and has a blended 6.3% debt yield across 70 loans, and hospitality, which is 8% of our assets and has a blended 11.4% debt yield across 20 loans. Should this rate move hold, both these asset classes will likely stabilize. We have said since the beginning of COVID that we didn't expect any losses from our hospitality book, and I still believe that, and we have said on past earnings calls, that we view taking back multifamily assets from undercapitalized borrowers in this cycle as an opportunity to own solid assets at a significant discount.

When academics write about this cycle, the focus will be the stubbornly slow unwind of work from home, creating low net-effective rents in office that can't cover debt service post Fed hike. We are not immune from that stress, but with only 10% of our assets on loans on U.S. office, and owned property gains that are almost as big as the entirety of our office loan portfolio, this narrative won't define us as the cycle enters its final chapters. I will note we avoided the temptation to lean into life science construction and conversions, and have only made one loan in Boston Seaport District, that is our 13th largest office loan and included in our 10% U.S. office allocation.

With little to report on our legacy downgrades, I want to talk briefly about the loans we downgraded in the quarter. Our one new 5-rated loan and two of our new 4-rated loans are multi's that share a similar story and have the same syndicator sponsor on all three. As lenders, we are taught to learn from our mistakes, and we as an industry should have been more wary of syndicated equity structures who would have a difficult time calling capital in times of distress. We will be going forward. The multifamily assets we have downgraded mostly fall into this category. As rates rose and undercapitalized sponsors ran out of money, they underperformed their business plans, stopped upgrading units and allowed vacancy to creep up, forcing lenders to step in. Fortunately, this is what we do. Our manager, Starwood Capital Group, manages over 100,000 multifamily units, and we have the capital at STWD to take these assets back, finish renovations, insert new management, and ultimately increase debt yields. Upon stabilization, we will then decide whether to hold or sell these assets. The one new 5-rated loan is a small multi loan in Phoenix, and two of our four new 4-rated loans are in Texas and all fall into this subscription.

Our largest new 4-rated loan is on office in Dallas, very well located near uptown, where the sponsor recently told us they would no longer contribute capital to support the asset. As with the syndicated story in multis, office defaults have had a common thread also, the high cost of re-tenanting due to TI's and LC's is hard to justify at yesterday's basis as net effective rents fall. Someone with a strong balance sheet and a better basis that is willing to invest in re-tenanting needs to step in and show strength and conviction to the market to energize brokers and bring in tenants to well-located assets like this one. Our borrower's inability to convince the market they were in for the long run allowed occupancy to fall to 57%, and our debt yield to deteriorate to 6.4%. The team and I visited the asset again in July and given the great location, we believe there is an opportunity to invest capital into this project to stabilize the tenancy and will begin working through that business plan or potentially a partial conversion as we move forward.

The final new 4 rating this quarter is a relatively small \$27 million loan on an office portfolio in Dublin, Ireland that is 76% leased and produces a 6.5% debt yield today. It is early stages, but the sponsor is evaluating a large single tenant lease, but should that not be executed, we will need to work with the sponsor on other stabilization plans. Should the sponsor choose to walk away in the future, we have the capital and a better basis to step in and help stabilize the assets.

As with our other higher-risk assets, we will share any major developments on these assets as appropriate.

Our Energy Infrastructure lending business continues to be a great performer with mid-teens levered returns on the loans made since we purchased the platform from General Electric in 2018. Importantly, after pricing our third CLO, we are earning these premium returns with 59% of our loan book financed in the CLO market, which gives us term non-mark-to-market financing. Our LTV's have continued to fall as the energy demand curve continues to shift higher. Our LTV's are the lowest since we bought this business. Last week, we got the results of the annual PJM capacity auction, which determines how much power plants are paid to provide excess power to the grid. The results came in well above expectations, which will allow power LTV to continue to decline.

In REIS, our CMBS conduit originations business has already made this year would have made in all of 2023, and as Rina said, our special servicer LNR saw a 30% increase in active special servicing this quarter alone, which will provide tens of millions of dollars of incremental revenue in the coming few years. As this cycle continues to play out, we expect the servicer to continue to outperform.

Moving to our Property Segment. We have discussed the approximately \$2 billion of embedded DE gains we have created in the 7 years we have owned our Florida low-income multifamily portfolio. As a reminder, we own approximately 80% or \$1.6 billion of these gains. Rina discussed last quarter the rent holdback of 3.8% that will be added to next year's formulaic income and inflation-based rent increases. Holding cap rate constant, formulaic rent increases over the 7 years we have owned this portfolio have increased fair value by nearly \$800 million. I will remind you rents cannot be mandated lower in this portfolio.

Now I want to talk about the next 8 years. If rents increase at just half the pace over the last 7 years, expenses grow by 2%, and you hold cap rate constant, our portfolio will be worth \$800 million more in that time. In addition to that, the first 5,300 units, representing 21 properties and 31% of the Woodstar portfolio will roll from affordable to market rate in that time period, as their affordability restrictions burn-off. This will allow us to begin to execute on our original investment, thesis to create incremental shareholder value by rolling our portfolio from affordable to market rate units.

When we purchased these portfolios we shared that we expected to maintain nearly full occupancy as units rented at the time for 70% of comparable market rate units, creating tremendous demand for these below-market units. In the 7 years since we have owned the portfolio, market rents in the major markets this portfolio is in, like Orlando and Tampa, have increased even more than contractual affordable rents have, leaving affordable rents at just 55% of market rate rents today and providing us more upside on a roll-to-market than when we originally purchased these assets. Although we will have to invest in the units when we roll them to market, this is more than offset by the revenue increase you get by rolling to market, creating significant incremental gains for shareholders.

To put this gain into perspective, once converted to market and assuming no rent growth from today, just this subset alone should create an additional \$200 plus million of book value and future gains. As the remaining 69% rolls in future years and assuming rents continue to trend higher, one could easily extrapolate the gains after rolling to market to be worth significantly more.

While some of these gains are already reflected in book value, there is a significant portion that will not appear in book value until rents rise or until the units are rolled to market. To sum this all up, we have three pockets of gains that are each a multiple of our loss reserves today: the gains that are reflected on our balance sheet today, gains yet to be reflected from increasing rents that cannot go down, and gains yet to be reflected from rolling affordable units to market.

We have invested in every quarter since our inception, and as Rina said, we invested \$975 million again this quarter across business segments. Our Board has shown confidence in our liquidity position throughout COVID and this higher rate Fed cycle. Our Board expressed confidence in our dividend-paying ability two weeks ago when it authorized our third and fourth quarter dividend early. The significant in-place and expected future gains in our owned property portfolio give us unique flexibility. As this multi portfolio, and our other non-CRE lending businesses like LNR and energy infrastructure lending continue to perform well, our company moves further and further away from being just a mortgage REIT. Unfortunately, the market has historically traded our stock with the mortgage REIT index. We will continue to execute on our low leverage diversified business model, which will hopefully move us away from peer comparisons, and we eventually become known as the only company in the diversified REIT index.

With that, I would like to thank our team for their incredible diligence and our board for their confidence. And I will turn the call to Barry.

Barry Stuart Sternlicht
Chairman & CEO

Thank you, Jeff. Thanks, Rina. Thanks, Zach, and good morning, everyone.

Interesting, where do you start a call in commercial real estate today. We just had a seminal event, sort of an earthquake in the credit markets and the financial markets with the jobs report coming in so much lower than most people thought. And I think most of you know, I've been super critical of Powell, we had inflation because we had too few goods on the shelf and too much money in consumers' hands, and that situation was going to clear itself and obviously have -- has.

And then we have an economy that's been hit by segments of employment growth that he can't impact in the 115-or-so thousand jobs created, 55,000 of those jobs were in healthcare. Since May of 2022, since he started to increase rates, those industries, healthcare, education, government, completely not impacted by his rate effort, added 3.25 million jobs.

So, what you're seeing now is why you have the selection set up the way it is. You have people not feeling good about an economy, even though people are employed, because what's driving GDP is a very narrow segment of the economy. Data centers at which Starwood Capital is a major player, are on fire, and alone sit as a stimulus package and unique to the United States and propelling our GDP growth faster than our peers, because of the scale of the AI investments both in chips and in infrastructure and power in data centers. And it is a quite an enormous effort, which sits on top of the CHIPS Act, on top of the Infrastructure Bill, and on top of the Climate Bill, which all contributed to the second largest category of employment increase last month, construction jobs, up 25,000. When in fact, private construction of multifamily has gotten cut in half. Logistics are down 70%. Probably the only office building being built in this country are

for build-to-suits.

All of this private investment has now shifted to public investment and is carrying the construction workforce, which lost 1 million jobs in 2007, 2008, but it lost no jobs because of the fiscal spending and the shift from private to public spending and infrastructure.

So, I think now you see clearly what we hoped everyone would see, was that inflation is below 2% when you take out the rent component of inflation. It's aggravating and I guess it is the nicest thing you can say that the Fed chooses to use data for this one component that is way lagging reality, it's why they missed raising rates in '21 when apartment rents are up 20%. And that's why they've missed lowering rates early because when rents are 1% or 2%, and they're still showing 5.5% to rent. It's on its way down, you've seen inflation get better, but it's not falling as fast as the default, they use real-time rents for the rent equivalent or the rent component of inflation, which is 1/3 of CPI. And it's coming down.

So, if you look at commodities, the commodity complex oils at \$73. I was just checking wheat and corn this morning. Corn prices and wheat prices are where they were in 2018 and 2016. So, we're going to see a fall of inflation. You're going to see that having 5.3% SOFR in a world of 2% inflation is going to look particularly dumb.

And we're hoping to see the traction, the biggest beneficiary from us will be CRE, which was probably the biggest -- got hit the hardest, we were the unintended consequence of trying to reduce employment growth, employment pressures and wage growth, 500 basis point rate is almost overnight in the commercial property sector, really knocked a lot of people on their butts.

Interestingly, for Starwood Property Trust, the rise in rates was good. We would make more money on our floating rate loans, but we have floating rate debt against it. But because we're much less levered than our peers going the other way, we will lose less earnings than many of our peers that are more highly levered.

So, you won't see us drop dramatically if interest rates do hit the 3% SOFR that you're seeing now in the chart from next June. And we'll have to monitor, but it will be less of an impact for us as it was on the way up. Also, we have 40% of our assets in other asset classes that are doing other things and not necessarily related to our loan book.

I did want to spend 1 minute on the asset classes themselves and talk about them and how they're faring at the moment, which I often do on these calls. The office markets are bouncing along with different experiences in different markets, where there are some lease-up, particularly internationally with one that is having an incredible first quarter and most of the continent of Europe, having a very good rental increases and low vacancy rates.

The one exception is Dublin, where you saw we have a \$27 million loan, that is somewhat of an issue. Dublin is running - looks more like America, they speak English over there, and they have a 20% vacancy rate, but it is absorbing -- they had a good quarter. The rest of the continent is pretty strong.

And in the United States, you have two markets. You have the A buildings and everything else. And the A markets are leased and eventually credit and their ability to refinance will come back. And then the B & C buildings, which will be at some point something else.

And we are gifted. We had an office building leased to a major borrower in one of the household names and we are taking that back. You've heard about it from Rina and from Jeff that we will turn into a multifamily. It's a beautiful building, and it's not earning anything today. So, when I look at our company and its earnings power and look at the amount of loans we have on nonaccrual, I look at that as a blessing, it's \$0.30 in earnings power, \$0.30, so we can turn those assets back around and we will, just a question of how fast and how we maximize the capital that's tied up in those assets. And we're blessed to be able to do that and take an asset like an office building and convert it to residential. It's not a complicated conversion.

And hopefully, as you heard from Rina, we will exceed this \$9 million CECL reserve that was attributed to that, as of it's appraised and recover more than our capital. So, looking forward to getting that capital back into an earnings form, we'll

be discussing many assets in that portfolio.

One of the loans in there is an apartment building in New York City, some units we took back. Beautiful building, and it's covered in scaffolding, so we can tell them now is just wait until the scaffolding comes down and we'll make a lot of money for the trust.

Our job, from the start, has been transparency, consistency and reliability. I'm honored that we've won that Nareit Award again on disclosure. Thanks Zach and team and all of our shareholders that might have voted for us for that.

One other thing I'd say is that, this is really good for the real estate complex. And we look forward to going on with some big offense. There are great lending opportunities because the big picture is, as you've seen in private credit for corporates. There is a reluctance of banks to lend, and we should be that player. We should be that big a player in the space, we're the largest in the country. And we should be the place that people come to finance real estate, both here and abroad.

So, with excess capital and access to capital, we think we can put the money to work extremely accretive and attractively to return, in a world that's probably going to get harder to find yield that's attractive. And I think we've proven that this business model, which is different than the others. And hopefully, our ultimate goal of becoming investment grade is not out of reach as we continue to perform and come out of this -- like was a 1, 2 punch. There's the -- or was it 16 punches from the Fed. I think you'll see that the company can really fire on all of its cylinders and not just rely on a couple that have had a good season.

One thing was noted by Rina, but I'll highlight it, Jeff did mention it again, is special servicing, which saw a 40% increase in its book. And I guess that was always our hedge that the special servicing business would take off again. And in fact, I think you'll continue to see assets roll into the book.

It is an interesting market though; you haven't seen as much distress in loan sales as you would have expected. And a lot of the banks, the commercial banks that are working with borrowers and extending for small paydowns. I think borrowers are going to become significantly more excited about investing in their assets when they can see what the forward curve looks like today and it did not look like this 30 days ago. So I think, speaking for a bulky borrower, I mean, he's like, "I know I got negative leverage, but I can look out on the horizon, I see 70% decline -- 50% declines in supply in my market. I just got to get to '26 or the back half of '25"

So I think sadly, I don't think we'll be able to take back that many multi assets that were brand new that we could buy at 65% of costs because that's what our loans were. But the good news is, I guess, that we will have an opportunity to refinance these people and they'll support the assets and they'll feel more inclined to continue to invest going forward.

All of these markets in U.S. The hotel market is okay. Here, I think you're seeing the need to avoid some of the blue states where the unions have been super strong. And it's not so much the rent, it's the costs that are going up. In the industrial markets, there seem to be slightly reaccelerating in the United States against the backdrop of a 70% decline in supply.

And then as I mentioned, the office -- apartment markets are facing -- are looking at nearly 50%, in some cases, greater decline in supply, and today have record absorption. So, while there are some concessions in the market that's still a very healthy market and affordability of homes, which will change as rates come down, homes will get more affordable. You'll probably see starts to accelerate.

Of course, if the Fed doesn't relent and doesn't cut rates fast enough now, he could break the egg. And you can't use this weapon on this economy without seriously disrupting the service sectors. And I'm kind of a fan of Rick Rieder over at BlackRock, who actually said that keeping rates this high is creating \$250 billion of interest income for savers, which they're spending on services, which is the part of the economy that continues to have too high inflation. So maybe he's right, maybe this high rate is actually causing inflation and a more normal 3% or 3.5% SOFR curving a more upward sloping curve of a normal economy will actually take some pressure off the service inflation that we see today.

So in general, we're feeling pretty good about where we sit and we have problems in the loan portfolio, there isn't a lender in the United States that probably doesn't. But we are on top of them and we're managing through them, and we look forward to coming out the bright side of this storm. We can actually see it. I think for the first time, we can see the sun and the clouds breaking apart, that is probably if the Fed will relent and realize, again, they were just as late to lower rates as they were to raise rates into the booming inflation we had in the pandemic era.

So hopefully, they'll be paying attention, they will knock off lag in rents and do like they do for oil and insurance and airlines and car prices and every other food prices, every other component inflation is real time except for rent.

Thank you, and we'll take questions.

Question and Answer

Operator

[Operator Instructions] Our first question comes from the line of Rick Shane with JPMorgan.

Richard Barry Shane

JPMorgan Chase & Co, Research Division

Look, ultimately, credit is always a function of willingness to pay and ability to pay. And I'm curious, given the quality of the sponsors underlying your loans, if the shift that you're looking at right now is about willingness to pay? And is this really sentiment-driven, given the really radical shift in terms of forward rate expectations as we move into '25?

Barry Stuart Sternlicht

Chairman & CEO

I think it's too early to tell. This just happened. So I mean people are being constructive. But ourselves as an equity player, when we're looking at restructuring or carrying an asset, I mean, we will -- we're looking at a forward curve that has moved dramatically, and the 10-year has moved dramatically and nobody expected that. Most people expect the 10-year to sit at 4% with our deficits as far as the eye can see.

I don't know if that's a technical trade or actually the new reality of people certain [indiscernible] short end is super important for our borrowers. And I'd expect that this will, on the margin, help materially in their desires to stay alive until '25. I think you can -- like I said, you can now see -- don't forget, like you go back 2 months and heads of the major banks were saying no rate cuts this year at all. They're also saying some people, of small minority, we're talking about rate hikes.

So, this is the emperor has no clothes. You've seen that this economy is super narrow. The GDP is being driven by data centers and spending on stuff that the average person doesn't feel. So, they don't feel like this economy is working for them. Their wages are marginally above inflation now, like 3%, and falling, and none of us feel pressure in the job market the way we did in the craziness of the pandemic.

And immigration, both legal and illegal, has helped the picture on the employment side, and we'll see what happens. I mean obviously, the election itself will have some conflict of interest for the labor market if there are deportations and things like that. So, we'll have to see how that plays out.

Jeffrey F. DiModica

President

And Rick, I'll add that our CECL reserve is up to \$380 million. So, our optimism on rates, and it's really the last couple of weeks that this optimism has taken shape, as Barry spoke about, is not really reflected. We're still looking at every asset. There are a lot of knife fights out there, and we are not going to put optimism into our reserve expectations, and our CECL reserve has still gone up. Clearly, what we've seen in the last couple of weeks, if that holds, you could see things turn around. But, we're not baking optimism into our financials today.

Barry Stuart Sternlicht

Chairman & CEO

It's so nuanced, by the way, because if you have an office building and it's a 7%, 6% debt yield and it's 55% to 60% leased, if you're looking at higher rates and negative returns as far as the eye can see, you're not going to invest in the office space. And that's the biggest issue in your office markets. Are you going to put the TI in for the tenant that wants to move in? And how sure can you be of the exit cap?

And every office borrower in the country is looking at their assets, maybe not the REITs because they don't sell assets and they just want to keep them alive. But all the private owners of real estate, including the household things you talked about, like the best borrowers, everyone has decided and there isn't a -- real estate PE firm in the country that hasn't walked away from an office building.

I mean everyone, ourselves, Blackstone, Brookfield, every single person has walked away from properties, saying there just this throwing good money after bad money. But the market will bifurcate exactly like the mall market did, where the B's and C's had a tough time getting financing, sell at 12% cap rates and the good malls are still getting financed in the CMBS market using 5% or 6% cap rates now in the malls, and they're actually performing. They're performing as we saw those stocks earnings yesterday.

But, the office markets will become obvious that the best buildings in the best -- in the right cities are full, even in the United States, and they're commanding decent rent, One Vanderbilt for example, an SL Green asset. And then there are buildings in New York that are completely empty that are trading for \$100 a foot because, one was on the ground lease, but others are kind of like you got to do something. It's just steel value and land value. That's on the residual scrap metal. These buildings have to come down. So -- or find some use that nobody's figured out yet. And it's going to be -- in the office market, it's going to be a while. It's going to take time and it's not just rates. I would say rates impact every other asset class in real estate, office has a different situation in the U.S., different in for every situation in America.

Richard Barry Shane

JPMorgan Chase & Co, Research Division

Look, it's an interesting distinction versus what you said about multifamily, where you basically said, "Hey, we'd be happy if everybody sold us everything at our basis right now. So, I suspect there's going to be a pretty huge divergence between what you see going forward on the properties?"

Barry Stuart Sternlicht

Chairman & CEO

Huge, huge divergence exactly.

Operator

Our next question comes from the line of Stephen Laws with Raymond James.

Stephen Albert Laws

Raymond James & Associates, Inc., Research Division

I wanted to start with originations, noticed a pretty strong quarter. CRE loans up, infrastructure loans up a good bit from Q1. Can you talk about the pace of originations moving forward as you put your excess liquidity to work? And also, where you're seeing the best returns? Do you expect to see opportunities elsewhere, maybe banks more willing to sell now that some of their investments aren't as underwater as maybe 3 or 6 months ago? And kind of how you think about allocation of your excess liquidity into new investments?

Jeffrey F. DiModica

President

Barry, want me to start. We're seeing consistently higher returns in our energy infrastructure business, and the LTVs are moving in our favor as the demand for power has continued to increase. So, I would say that we expect to continue to lean in there.

As I look at our -- and I believe the next couple of weeks, we're really going to see with this rate move. We're going to see the pipeline for CRE lending pick up even more. But our pipeline has, I would say, tripled over the last three quarters of actionable deals on the CRE side.

So, there are things to do, things are becoming unglued and unfrozen, I should say. And I believe that we have the ability to put out a run rate that's probably 2x to 3x the run rate you've been seeing at accretive returns in a similar sort of 11.5% to 13% levered return on the CRE side and significantly higher than that on the energy infrastructure side.

We've talked before about the fact that property is very difficult to buy today with negative leverage and cash returns that are mid-single digits. You're betting too much on the Excel spreadsheet allowing you to push rents up, etc. So we're probably not increasing much there. We haven't increased the resi book. There are some trades in the resi book that we think are potentially getting closer to interesting. So, you could see us put money back to work there at some point. We have been buying a few CMBS B-pieces where we think there's great value, and that's also supporting our CMBS originations business.

So, the two likely places are going to be Energy Infrastructure, where we're going to continue to lean in and CRE, where we're seeing a bigger pipeline.

Barry, I don't know what you would want to add to that.

Barry Stuart Sternlicht
Chairman & CEO

Yes. I think our originations team thinks we have more than \$1 billion of actionable CRE loans we could do if we want to do them. It's -- we're just balancing our needs to actually fix our REO assets up against a whole bunch of other stuff, but we're doing it with a company that's materially lower leverage than we've been, 2.2x, and we're trading lower than, I think, than most any of our peers.

And also, it's a little nuanced, but we've cut our forward funding obligations from a peak of \$3 billion to \$1.2 billion. So, we're much more in much better shape there that we don't have to fund stuff that we don't want to fund. And that's sort of a nuance, but it's important to the overall picture of how we put out capital.

So, I think transaction volumes are down like 70%, and the CMBS market has been the only place to finance real estate really at scale in the last 6 months. Most of our peers and ourselves have been cherry picking around the edges and private debt and some of the insurance companies are making some loans, and we have our own private debt funds.

But because there just aren't that many big transactions to finance there just haven't been that rich a population set, so we've had a really hard time finding actionable deals. There's more liquidity or more trades and more lending in smaller assets. But if you own an apartment building, you don't want to sell it. It's very public that we lowered redemptions or lowered redemptions materially in our \$25 billion SREIT property company, and in that \$25 billion [indiscernible] of industrial asset, we said we're not going to sell them into a distressed market, when we were convinced rates would come down and add enormous liquidity and make our dividend more valuable and all those things hopefully seem to be -- will come true and then we'll continue to sell assets.

But we're not like anyone else, everyone -- we're just like everyone else, everyone else is, I don't want to sell this, and there's no trade, there's nothing to refinance, so there's no new loan. So, you will see the market come un -- I hate to say unglued, and then you correct it unstuck. There will be more transactions, you're seeing that already.

I actually think you'll see a pretty strong buying appetite for this asset class. The volatility in equity markets reminds people of the compounding nature of real estate, the world's largest asset class. We're not going away. People will have to live somewhere. Most people will travel on vacations and this asset class is a material component of the world's capital markets, and it's obviously had a different risk profile than a new chip that may or may not live forever or get taken down and go into the way of the dodo bird. So just a different asset clock and it will find favor in a different market.

Jeffrey F. DiModica
President

And Stephen, to repeat something Rina said earlier about things becoming unfrozen. We had \$606 million of capital returned in Q2, but we had \$620 million of capital return just in July. So, you're definitely seeing a trend with more capital starting to be returned, which means they have the ability to refinance assets away from us, and that is a good part of the unfreezing of the markets, but you're certainly seeing a trend line that is constructive.

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

Yes. I appreciate the comments. Just a quick follow-up. Barry it has been pretty well covered, slowing rent growth that will likely accelerate as the new supply slows. But last quarter, you mentioned something that was interesting, that insurance costs across multifamily were coming in lower than expected. Can you maybe update us on that? And generally, kind of how you're seeing expenses run in the multifamily side?

Barry Stuart Sternlicht
Chairman & CEO

Yes. The pressures on multifamily expenses have come off a bunch. We were down year-over-year on insurance property insurance. And I'm not sure that was across the United States or given our scale that we pool our \$100-plus billion of assets together to get insurance. And I know that at least one other large person had similar insurance, but I can't speak to what small guys are borrowing at. We don't think they have our insurance.

So -- but I would say, overall, our experience has been good. And you can see that some of the expenses like -- it's interesting, I was looking at some of the SFR companies. They're all over the place, and we own some of that single family for rentals too. They are all over the place, the states are in different positions with tax increases and real estate tax increases. So I do think you have obviously two states that are running a surplus, a big surplus, Texas and Florida, and two states running a massive deficit, Illinois, New York and California. And so pressure on real estate taxes is materially different in specific situation of each of the states.

So -- and in fact, Texas lowered taxes. They went in and lowered their tax, which is -- doesn't happen because -- you would have to set up a gong. I think I've seen that once, twice in 35 years. So, it's just state by state.

And there is -- even the new construction. So all over the place. The East and West Coast have less construction, the Northeast in New York and California, because the growth was in the smile states. The Texas', the Georgia's, the Tennessee's and the Florida's. They got the bulk -- Raleigh, North Carolina, they got the bulk of the new construction, and that's where people are moving.

And so the rents are higher and materially different in some places. I think one of our towns in Kentucky is up like 5%. I think DC is up materially. The other markets are down double digits in rents. So we talk about a national rent profile. There's really no such thing. It's just an average of all of the major markets.

The problem, of course, that Powell has is that by reducing the stock of single-family homes and apartments so significantly, he's setting us up for another inflationary cycle in rent. And that's the negative of pounding, keeping rates this high and artificially reducing the supply of new homes, which has shifted market share dramatically to the major and national homebuilders away from smaller builders that can't get money because the regional banks don't want to lend to them.

So he's created quite an interesting new dynamic in the markets, and it won't -- it shouldn't -- I mean, as an apartment owner, I'm hoping we can get these big apartment rents, but as an American, he'll be late to the game again. If he keeps the way he's looking at this with his 400 PhD's coming up with a model that makes no sense. And if they keep this lag in the rent component of inflation, they'll miss it again on the way up.

Operator

Our next question comes from the line of Don Fandetti with Wells Fargo.

Donald James Fandetti

Wells Fargo Securities, LLC, Research Division

Yes. Commercial real estate has been hit so hard through this cycle and as you talked about, Barry, kind of unintended consequence. When the Fed does cut, are you thinking that this is sort of a trickle of capital coming in? Or do you see more of a meaningful sort of shift in sentiment and cap rates, where a lot of players might be just kind of waiting to get confirmation of cuts?

Barry Stuart Sternlicht

Chairman & CEO

The equity side of real estate is pretty complex. And the areas of the world that had -- that were investing heavily in PE and real estate funds, and north through the Middle East. But with the position of oil and some other issues back home, they're a little less on the margin. They're still investing, but I think not at the pace they were before, as domestic needs have overwhelmed some of their international desires to invest offshore.

I think the Koreans and the Southeast Asians who are major players in the market, I think they'll be induced to invest more heavily.

And the U.S. market, I'm talking institutional market, will depend on where the stock market is. If this stock market craters, its obviously a denominator, and the portfolio allocations come into play, and they'll be overweight in the property sector. So I do think you'll see individuals show up and high net worth, and they are a major force in the market in real estate.

But in fact, through this entire cycle, the people most likely buying individual properties with no competition were families. And they were saying, "I'm owning this at a 6 or 7 cap rate. And yes, I know -- but I could never get it in a better market, and I'm buying it for 30 years." So, you've seen guys add real estate exposure -- high net worth. And you're talking mini institutions, some of these people have enormous balance sheet.

So on the whole, I'd say there's a ton of dry powder and there's enough money there to propel the markets higher and create tremendous demand. The REITs will probably, as you can see, the stocks are rising, they may get back into the acquisition business. And I'd expect that by the time some of the dry powder is used up, the buckets will be refilled and there'll be more money coming to the asset class.

We're always competing as an asset class against other asset classes. And you have 6 stocks carry the stock market. So I mean, if you're in them, you were up a lot in and if you weren't in them, you weren't up that much. So anything that - it's like, okay, we're boring. We produced a 10%, 11% consistent return, which, of course, meets every actual need of every institution in the United States, every endowment, but it's not -- we're not venture.

So I think, troubles in other asset classes throughout my career have always helped real estate, and they come back to - it gets a bid again, and real estate is going to get a bid again. The office market is going to work itself out. And it's unbelievable the federal government hasn't gone back to work, Washington is decimated. And it's like they haven't mandated workers to come back to the office in Washington D.C. It's something. So that's not the case in Miami, where the REIT is based, and we have 80% occupancy on a -- physical occupancy in office buildings today. People are back in the office. But it's not true in L.A., or San Francisco or Austin, and we will see.

A good recession will change a lot of things, I think, on the office front. I mean I think people will go back to the office, I just think we're better together.

Operator

[Operator Instructions] Our next question comes from the line of Jade Rahmani with KBW.

Jade Joseph Rahmani

Keefe, Bruyette, & Woods, Inc., Research Division

Can you give any update on Starwood Solutions? Have you gotten any traction with that? And just the CMBS market, your comments about the banks. I see that market as having the potential to be meaningfully bigger in size, post all of this, than it was with the banks shrinking. Do you agree with that? And do you see an opportunity to meaningfully grow both the conduit and the special servicer?

Jeffrey F. DiModica

President

Yes. Thanks, Jade. We've had our first couple of clients in solutions. The revenue is still fairly small. We are talking to the potential big players on the government side in a number of ways about potentially helping out there, and those could be the needle movers that we're really playing for, and we'll keep you posted as that goes. I think we've had something like 300 meetings in solutions, and it is starting to grow. So that is good.

I would say on the CMBS side, it's been a really interesting market. The banks are very happy to do agent business, like CMBS, that comes on and leave their balance sheet fairly quickly. They're more reticent to do portfolio loans. So, I don't think that the large banks have pulled back and the smaller banks were never big CMBS conduit originators. So, our conduit originations pace of \$1.5 billion or \$2 billion a year, probably maintains in what is today still a smaller market than what it has been.

We've seen a shift in the CMBS market. You had a significant bid for 5-year loans, investors at yesterday's higher rates did not want to lock in 10 years of a high interest rate and so they really pushed to 5-year loans. Those 5-year loans are available on the fixed rate side through insurance companies. You're seeing a lot of insurance company growth in 5-year fixed rate loans.

And the CMBS market has become probably 80% 5-year loans. That was 10% a couple of years ago. So, the borrowers have moved in the curve, where we're very willing to provide that capital. It's a little bit of a different B-Piece that ends up coming out. It's a higher dollar price B-Piece that has less time to accrete back to par. But, it is something that is moving at similar rates to where they were over the last couple of years.

So with the B-Piece buyer in place and demand for 5-year, we do expect 5-year CMBS originations to continue to grow as a percentage. And with rates coming in here, I think you will see an increase over the coming couple of months on a lot of things that have been pent up. People have refinancings coming up. They're willing to move now as they see the lights of the eyes of a 3.70% or 3.80%, 10-year note, and that's going to bring things back in.

Spreads are a little bit wider in the last week as rates made this move, but that will settle in. If we go back to yesterday's spreads at today's interest rates, I think the CMBS market picks up a bit. As I said in my opening remarks, we've made more money in the first 6 months this year than we did all of last year, and last year was a decent year. Part of that is spreads had been tightening.

But I think that our place in that market where we write smaller loans, \$10 million to \$12 million loans, is probably still the place where we will play. We have a couple of larger loans in the pipeline, but we sort of prefer that smaller, mid-market loans there, and that is something that I think could get up to \$2 billion or \$2.5 billion. But it's probably not likely much bigger than that and the overall CMBS market, probably doesn't grow significantly, although a rate move like this will move forward a bunch of supply. So we're optimistic that, that business continues to perform well.

Barry Stuart Sternlicht
Chairman & CEO

Yes, I think the CMBS market is going to grow. But the thing is for our borrowers, it doesn't work for transitional loans. They have to be cash flowing assets, and they also have to be at a certain scale to make them worthwhile given the cost, the borrowers of the transaction fees.

So the private loans will always sit alongside the CMBS execution. And I do think I've been remarking on some of the deals done that I think have been quite aggressive in the CMBS market, both in coverage ratios has been very tight. And -- but it's been the only way to finance that large portfolio is really to the banks, as Jeff's point, they're happy to act as conduits, but they're not happy to have this stuff sit on their balance sheet. And they are under a lot of pressure from the OCC as we've been for 2 years, 2.5 years to reduce their real estate exposure, which hasn't helped anything, especially with us, and other borrowers in our sector who like to get refinanced out, who's going to take you out? Who takes you out on an office loan today? Who's going to finance it?

I think when I mentioned the markets, I didn't talk about the debt markets for those asset classes. And obviously, a Fannie and Freddie still in the apartment market, but like in the hotel market, you're seeing 400 over, 450 over, those are loans we want to do. And they're not -- a borrower that wants to borrow that. But if you have a very stable cash flowing hotel, we just refinanced an asset at 240 over. But I think it was like -- if I remember correctly, it's probably a 12% or 13% debt yield.

So when things are really safe, there's money for us today. And I think this key change, and it has to be a key change in the real estate markets on a lower rate or almost a certain lower rate profile in the future, at least the near future till next June, is going to end a lot of issues and be good for the whole industry and for the country, frankly.

So you didn't want the regional banks to collapse. That wasn't -- and they were a victim of the Fed. Three things benefit: real estate, the treasury because they have to pay less interest expense on \$34 trillion -- \$35 trillion of debt, and the regional banks, which every drop in rates is an equity infusion into their balance sheet. So there's a triple header of wounded ducks that will be better off, and I just hope he hurries.

Jeffrey F. DiModica
President

And Jade, I'll add that on the solutions side, you saw this quarter, I think Rina quoted that our servicing portfolio increased by \$2 billion, but we did have \$3 billion transfer out. So, we actually added \$5 billion of servicing this quarter across 6 deals, and that's a big part of that as a result of the number of meetings that we've been having on the solutions side, which opens the door for other businesses there.

And my last thing, when I did talk about conduit -- CMBS before, I was talking about fixed rate conduit and not SASB. Certainly, there will be growth in SASB. We were seeing growth in SASB. I think that's what Barry is speaking to as well, and I would expect that to continue.

Barry Stuart Sternlicht
Chairman & CEO

That's right.

Operator

We have reached the end of our question-and-answer session. I'd like to turn the call back over to Barry Sternlicht for any closing remarks.

Barry Stuart Sternlicht

Chairman & CEO

So I thank everyone for joining us today. It's interesting. We don't often have that much to talk about. But it was -- I think we're very happy given all the issues that the industry face. We're pretty happy we are. And again, I thank our shareholders, the Board, and our really hardworking team for executing through this really difficult time that we had nothing to do with.

And I'm optimistic about our future, and I look forward to getting on all the cylinders working again to pull forth and continue provide outstanding returns to our shareholders. Thank you so much.

Operator

Thank you. This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation, and have a wonderful day.