KKR Real Estate Finance Trust Inc. (KREF)

Updated February 16th, 2023 by Nikolaos Sismanis

Key Metrics

Current Price:	$15.29	**5 Year CAGR Estimate:**	12.6%	**Market Cap:**	$1.06 B
Fair Value Price:	$17.50	**5 Year Growth Estimate:**	1.5%	**Ex-Dividend Date:**	03/30/2023[1]
% Fair Value:	87%	**5 Year Valuation Multiple Estimate:**	2.7%	**Dividend Payment Date:**	04/14/2023
Dividend Yield:	11.2%	**5 Year Price Target**	$18.85	**Years Of Dividend Growth:**	N/A
Dividend Risk Score:	F	**Retirement Suitability Score:**	C	**Rating**	Buy

Overview & Current Events

KKR Real Estate Finance Trust is a real estate finance company that engages primarily in originating and acquiring transitional senior loans secured by institutional-quality commercial real estate ("CRE") properties. These senior loans are originally owned and operated by experienced and well-capitalized sponsors located in liquid markets with strong underlying fundamentals. The company has a $7.8 billion purpose-built portfolio of senior loans that's 77% secured by multifamily and office properties owned by high-quality sponsors. KREF generates around $185 million in net interest income and is headquartered in New York, New York.

On February 7th, 2023, KREF reported its Q4-2022 and full-year results for the quarter ending December 31st, 2022. For the quarter, total net interest income grew by 9.7% year-over-year to $51.9 million, with the company originating and funding $370.4 million and $207.4 million, respectively, relating to two floating-rate life science loans. These loans featured a weighted average appraised loan-to-value ratio and coupon of 58% and 8.0%, respectively.

Distributable earnings came in at $12.4 million, or $0.18/share, vs. $34.4 million, or $0.50/share, in Q3-2022. During the quarter, the company collected 100% of interest payments due on its loan portfolio, which, according to management, now has a weighted average risk rating of 3.2 (on a five-point scale). For the year, distributable EPS (DEPS) equaled $1.62, flat year-over-year. The company's floating rate loan portfolio is now benefiting from rising rates amid a rotation out of higher rate-floor loans. Accordingly, we expect FY-2023 DEPS of $1.75.

Growth on a Per-Share Basis

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2028
DEPS[2]	---	---	$1.95	$1.61	$1.30	$1.58	$1.67	$1.95	$1.63	$1.62	***$1.75***	***$1.89***
DPS	---	---	$0.73	$1.22	$1.62	$1.69	$1.72	$1.72	$1.72	$1.72	***$1.72***	***$1.81***
Shares[3]	---	---	8.6	19.3	45.3	55.1	57.4	55.6	59.4	69.1	***69.1***	***90.0***

Since the company's IPO, KREF has rapidly grown its loan portfolio by borrowing at lower rates and issuing shares with a lower cost of equity than the spreads it receives as net interest income from its loan portfolio. The previously low-rate environment constituted a fantastic environment for KREF to leverage its world-renowned manager's (KRR) access to low-cost financing. The company's term loan financing facilities also provide KRR matched-term financing on a non-mark-to-market and non-recourse basis. Hence, not only is the company borrowing on the cheap and securing better credits due to its manager's reputation but also, its liability structure is resilient from a mark-to-market viewpoint. This enhances KREF's ability to manage risk and its liquidity position during less favorable market cycles. While the strategy has worked successfully so far, KREF's future profitability is susceptible to changes in interest rates, with 100% of its portfolio attached to floating rates. Based on its current portfolio composition, a 0.5% and a 1.0% increase in one-month LIBOR would boost the quarterly net interest income per share by $0.10 and $0.20, respectively. The latter translates to

[1] Estimated dates based on past dividend dates.

[2] Distributable earnings per share modify GAAP net income (loss) by excluding (i) non-cash equity compensation expense, (ii) depreciation and amortization, (iii) any unrealized gains or losses. It's a proxy of dividend coverage for income-oriented investors.

[3] Share count is in millions.

Disclosure: This analyst has no position in the security discussed in this research report, and no plans to initiate one in the next 72 hours.

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around 12.3% of its DEPS on an annualized basis. Thus, the ongoing rising-rates environment could benefit KREF, assuming its own financing remains cheap. Consequently, we are forecasting a modest earnings growth ahead of 1.5% per annum. The company has grown its dividend accordingly with its increasing DEPS. However, due to the risks associated with mortgage REITs, earnings to be easily compressed, while there is only minor room for growth. Thus, we are assuming dividends will grow by just around 1% in the medium term.

Valuation Analysis

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Now	2028
Avg. P/DE	---	---	---	---	16.2	12.7	11.7	9.0	13.0	11.1	***8.7***	***10.0***
Avg. Yld.	---	---	---	---	7.7%	8.5%	8.8%	9.8%	8.1%	9.6%	***11.2%***	***9.6%***

KREF has historically traded with an average price-to-distributable earnings ratio of 12.3. However, we believe that investors are most likely to value KREF based on its underlying yield and book value due to the company's business model. With shares declining over the past year, the yield currently stands at 11.2%. We believe the stock is modestly undervalued here, especially given that KREF is benefiting from the ongoing rise in rates. At the end of the quarter, the company's book value per share stood at $18.00, implying shares are trading at a 15% discount to their net asset value.

Safety, Quality, Competitive Advantage, & Recession Resiliency

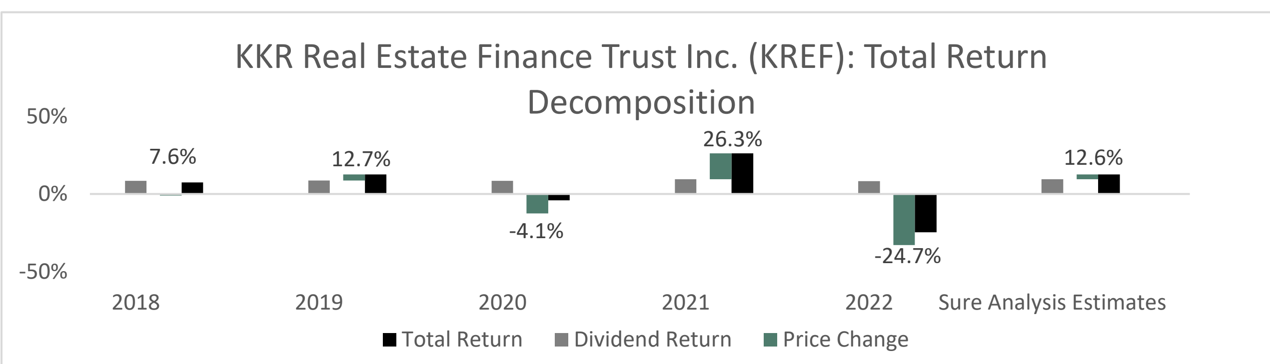
Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2028
Payout	---	---	37%	76%	125%	107%	103%	88%	106%	106%	***98%***	***96%***

KREF's dividend is barely covered by the underlying distributable net income, and there is only a thin margin to prevent a dividend cut in a scenario that would pressure the company's profitability. Hence, we don't consider it highly reliable. That being said, the company enjoys several qualities, including being managed by a leading global investment firm, KRR, which boasts $496 billion of assets under management. The company is also led by a world-class management team of around 50 investment professionals who carry decades of experience in the mortgage industry. However, we can't ignore that the company operates in a highly competitive industry with various institutional lenders and investors. Further, a prolonged recession that could result in its borrowers missing their payment schedule or an increase in interest rates could significantly impact the company's scheduled collections and overall investing spreads.

Final Thoughts & Recommendation

Despite the underlying challenges that come with a treacherous macro environment, KREF's loan portfolio is benefiting, with 100% of its loans linked to floating rates. We forecast annualized returns of 12.6% in the medium-term, powered by KREF's 11.2% yield, our growth estimates, and the potential for a 2.7% annual valuation tailwind. KREF, therefore, earns a buy rating. We caution that investors need to be wary of the risks attached to mortgage REITs, nonetheless.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Revenue	---	---	---	20	35	65	99	100	126	152
SG&A Exp.	---	---	---	2	2	5	8	11	14	14
Net Profit	---	---	---	17	31	59	90	90	54	137
Net Margin	---	---	---	85.1%	88.4%	90.5%	90.4%	90.2%	43.3%	90.1%
Free Cash Flow	---	---	---	11	25	54	77	92	115	---
Income Tax	---	---	---	0	0	1	(0)	1	0	0.7

Balance Sheet Metrics

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Total Assets	---	---	---	4,717	6,265	7,395	5,232	5,057	4,966	6,703
Cash & Equivalents	---	---	---	27	96	103	87	68	111	271
Accounts Receivable	---	---	---	1	3	8	16	16	15	15
Total Liabilities	---	---	---	4,431	5,760	6,335	4,097	3,933	3,920	5,342
Accounts Payable	---	---	---	5	3	4	12	10	10	14
Long-Term Debt	---	---	---	122	439	1,046	2,975	3,892	3,879	5,295
Shareholder’s Equity	---	---	---	281	498	1,059	1,132	1,122	1,044	1,361
LTD/E Ratio	---	---	---	0.43	0.88	0.99	2.62	3.46	3.71	3.89

Profitability & Per Share Metrics

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Return on Assets	---	---	---	---	0.6%	0.9%	1.4%	1.7%	1.1%	2.4%
Return on Equity	---	---	---	---	8.0%	7.6%	8.2%	8.0%	5.0%	11.4%
ROIC	---	---	---	---	4.6%	3.9%	2.9%	2.0%	1.1%	2.4%
Shares Out.	---	---	---	8.6	19.3	45.3	55.1	57.4	56.0	56.9
Revenue/Share	---	---	---	0.38	0.68	1.44	1.80	1.73	2.24	2.68
FCF/Share	---	---	---	0.22	0.48	1.19	1.39	1.59	2.05	---

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.