Transcript of Ladder Capital Corp's Q4 2017 Earnings Call

February 27, 2018

Operator: Greetings and welcome to the Ladder Capital Corporation Fourth Quarter 2017 Earnings Conference Call. At this time all participants, are in a listen-only mode. A question-and-answer session will follow the formal presentation. [Operator Instructions] As a reminder, this conference is being recorded.

I would now like turn conference over to your host, Kelly Porcella, General Counsel.

Kelly Porcella

General Counsel, Ladder Capital Corp

Thank you and good afternoon, everyone. I'd like to welcome you to Ladder Capital Corp's for the fourth quarter of 2017. With me this afternoon are Brian Harris, the company's Chief Executive Officer; Pamela McCormack, the company's President; and Mark Fox, the company's Chief Financial Officer.

This afternoon, we released our financial results for the year ended December 31, 2017. The earnings release is available in the Investor Relations section of the company's website, and our annual report on Form 10-K will be filed with the SEC this week.

Before the call begins, I'd 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 these forward-looking statements.

I refer you to Ladder Capital Corp's 2016 and soon to be filed 2017 Form 10-K and our most recent Form 10-Q for a more detailed discussion of the risk factors that could cause actual results to differ materially from those expressed, or implied, in any forward-looking statements made today. Accordingly, we request to not to place undue reliance on these forward-looking statements. The company undertakes no duty to update any forward- looking statements that may be made in the course of this call.

Additionally, certain non-GAAP financial measures will be discussed on this conference call. The company's 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 or these non-GAAP financial measures to the most comparable measures prepared in accordance with GAAP are contained in our earnings release.

And finally, I wanted to briefly address the unsolicited acquisition proposal received from Related Fund Management and respectfully declined by the company earlier this year. For information on this matter, we refer you to our prior public filings. We will not be making any additional comments on this matter on this call.

With that, I'll turn the call over to our Chief Executive Officer, Brian Harris.

Brian R. Harris

Chief Executive Officer & Director, Ladder Capital Corp

Thanks, Kelly. Today, I'll begin with a brief review of financial highlights from the fourth quarter, and then I'll move into a recap of the year that was 2017. After that I'll walk you through how proper planning that began in late 2016 and careful execution of those plans throughout 2017 has put us in a position we are in today able to reap the benefits of that strategy not only in the fourth quarter, but in the years ahead. We're particularly well positioned to benefit from rising interest rates. Then I'll let you know how we see the year ahead and how we plan to profit from our improved capital structure to deliver strong returns on our investments for the benefit of our shareholders.

First, the fourth quarter. I'm pleased to report quarter earnings, a non-GAAP measure, of $60.4 million, or $0.47 per share. This is our highest reported earnings quarter since the beginning of 2014. We benefited from our rapidly growing inventory of balance sheet loans, ending the year at $3.28 billion at an average mortgage loan interest rate of 6.93%.

This balance is 64% higher than where we stood just 12 months previously. We also took advantage of positive conditions for securitization earning $30.6 million by contributing $851.1 million in loans into six different securitizations. We did not hold any portions of these securitizations to comply with risk retention regulations.

During the quarter, we originated $1.12 billion in loans comprised of $537.7 million in balance sheet loans and $577.7 million in loans held for sale. This total is 59% higher than the $716 million we originated in the fourth quarter of 2016.

Turning not to a recap of 2017, our full year core earnings were $178.8 million, or $1.54 per share, an increase of 13% over last year. Our pre-tax core return on average equity was 12.1% while our after tax core return on average equity was 11.5%.

I've already mentioned that our balance sheet loan inventory grew by 64% during the year. But also of note, our owned real estate portfolio also grew by 25.5% from a year earlier to $1.032 billion at the end of 2017. Our real estate acquisitions during the year grew from $62.5 million in 2016 to $236.9 million in 2017. The last item I'll mention for full year 2017 was a decrease in securities held at year end by $994.4 million to $1.11 billion, down by about 47%.

The reason that I highlighted the rapid growth of our balance sheet loans in commercial real estate holdings along with a substantial reduction in our securities book is because these changes were planned and mentioned on earnings calls in the past. In order to safely grow our asset base into higher yielding bridge loans and equity, we had to first carefully orchestrate a series of capital markets transactions on the liability side of our balance sheet while simultaneously selling down our lower yielding CMBS position.

I'll spare you the details of each of these transactions but we'll highlight that towards the end of the year we had succeeded in creating an enduring lower cost capital structure having $1.17 billion of unsecured corporate bonds outstanding with a weighted average maturity date of over five years. Because none of these obligations come due for several years, we are able to safely leverage this capital into investments that are higher yielding like balance sheet loans and real estate. At the end of last year we had more than half of our outstanding unsecured debt maturing within one year. So, we had to stay invested in lower yielding but highly liquid investment grade securities.

With our capital structure fortified into lower rate longer term fixed rate debt instruments, we proceeded to sell securities favoring balance sheet loans and real estate for investments. Because we employ higher leverage on liquid securities, we actually lowered our debt-to-equity ratio while increasing our requalified income streams.

The results have been very positive. And to illustrate the benefits, let me share a few comparisons with you. First, revenue from mortgage balance sheet loans was $144.8 million in 2017 versus $100.2 million in 2016, an increase of 45%. Second, our balance sheet loan inventory increased by 64% to $3.28 billion at year end versus $2 billion at the end of 2016.

Three, after two months in 2018, our balance sheet loan portfolio has continued to grow, now up more than $200 million more since year end. Today, the total stands at $3.5 billion at an average current interest rate of 7.08%. If short-term interest

rates rise in 2018, this portfolio will produce higher income streams. Fourth, total loan originations for 2017 were $2.9 billion, up 37% from 2016, and so far in the first quarter of 2018, we've closed an additional $590 million in loans with a robust loan pipeline presently under application.

As the rest of 2018 unfolds, we stand to benefit from rising interest rates. We don't need to prepare for any near- term capital events so we can focus on investing and creating strong returns. With the weakened U.S. dollar, a ballooning deficit and recent economic stimulus added to an already growing economy, we feel that interest rates will continue to rise, but at a modest pace. We have doubts about the Fed raising rates four times this year. That pace would hurt the housing market, and we don't think the Fed wants to do that.

The weaker dollar will encourage foreign investment and with some inflation likely, defaults in commercial real estate loan portfolios should be kept pretty low. Of course, technology will still create winners and losers in real estate and have a dampening effect on inflation. But we think that the increased cost of borrowing among central banks will put upward pressure on longer term interest rates.

The fourth quarter illustrated the value of having a securitization platform. Our gain on sale business added $20 million to core earnings in the second quarter and $30 million in the fourth quarter. This platform along with our real estate portfolio should be powerful additions to our core earnings throughout the year ahead.

On our last earnings call, I signed off saying I was optimistic about the quarters ahead. And today I'd like to leave you with that same sentiment. While I suspect we will see an occasional bout of volatility during the year, we think the backdrop for real estate lending and ownership is good enough to provide numerous sale and investment opportunities over the year. With our well covered dividend and a far more liquid stock these days, we're optimistic about our ability to deliver best-in-class returns for our shareholders.

I'll now hand you off to Marc Fox.

Marc A. Fox

Chief Financial Officer, Ladder Capital Corp

Thank you, Brian. I will now review Ladder Capital's financial results for the quarter and year ended December 31, 2017. As you noted, in the fourth quarter, Ladder generated core earnings of $60.4 million, core EPS of $0.47 per share, resulting in an after-tax return on average equity of 13.9%. Each of these performance measures compares to Q4 2016 results, when Ladder earned core earnings of $44.6 million and core EPS of $0.37 per share while generating a 10.8% ROAE.

In calendar year 2017, Ladder's core earnings of $178.8 million were almost 13% higher than 2016 core earnings. Core EPS of $1.54 per share was $0.06 a share higher than in the prior year, and the resulting 2017 ROE exceeded 2016's performance by 0.8%.

During the fourth quarter of 2017, core earnings were primarily derived from net interest income generated by Ladder's held for investment loan portfolio, net rental income from our real estate portfolio, and gains on the sale of securitized loans net of hedging.

On a GAAP basis, Ladder generated net income before taxes of $48.4 million for the three months ended December 31, 2017, and $133.6 million for the entire year. These results compared to net income before taxes of $72.4 million and $120 million reported in the quarter and year ended 12/31/2016 respectively, the largest gap to core earnings adjustment in the quarter related to real estate depreciation.

During the quarter, Ladder's portfolio balance sheet launch increased to $3.3 billion. With the continued growth in our balance sheet loan portfolio and favorable market conditions, we executed a second private CLO in December following our first CLO that we summarized on our last earnings call.

In this CLO, we contributed $431.5 million of first mortgage balance sheet loans at an advanced rate of 75% in a transaction that allows for adjusted pro rata pay downs for the first 50% of loans to the pay off before turning into a sequential

transaction. This feature causes the CLO trust to de-lever more slowly, so that the timing of capital returns to Ladder is more closely matched to the timing of loan payoffs.

By retaining a $107.9 million controlling interest in the CLO, Ladder remains positioned to continue to provide optimal service to our borrowers by maintaining control over the special servicer and major decisions on the loans. Our expected return on the retained position, assuming no credit losses, is 16% to 16.5%, again depending on the timing of payoffs and expansions.

Ladder's conduit loan balance declined to $230.2 million at the end of the fourth quarter. The lower quarter end conduit loan balance was directly attributable to the six securitization transactions through which Ladder contributed $851.1 million of principal balance of loans held for sale during the quarter. These securitizations generated $30.6 million in securitization gains net of hedging, reflecting a 3.6% profit margin.

We are enjoying collaborating with multiple partners with a series of smaller contributions into the securitization deals, which allows us to be highly efficient with our capital and increase our CMBS presence. We plan to continue to maintain the ability and flexibility to both execute our own securitizations that contribute to partner deals in order to optimize results while executing subject to a variety of prevailing market conditions.

As Brian also mentioned, our origination pipeline remained strong in 2018, and we expect to participate in additional CMBS securitizations in future quarters. Two-thirds of the way through Q1, we have closed $590 million of loans, almost evenly split between bridge loans and conduit loans and we have a robust loan origination pipeline. We also contributed $240.9 million in loans through a CMBS securitization that was executed in February.

Reflected in all of this lending and financing activity, includi0ng the efficient shifting of capital amongst securities, mortgage loans and real estate investments is Ladder's core strength, namely its ability to apply superior credit skills in the underwriting of commercial real estate debt and equity investments. Ladder expresses its view of the commercial real estate market and of specific opportunities within it by making loans, investing in debt securities, and acquiring real estate constantly fine-tuning that mix of investments and an ongoing effort to optimize risk- adjusted returns on equity.

As a result of the steady and methodical reallocation of capital to balance sheet loans and real estate investments, and away from lower yielding investments in CMBS during recent quarters, the composition of Ladder's income stream has evolved to become more read like with recurring sources of earnings including net interest income generated by loan and securities portfolios and net rental income from real estate investments accounting for approximately 78% of net revenues. More detail on this topic can be found in the current version of our investor presentation posted on Ladder's website in the Investor Relations section.

This increasing trend in recurring net revenues has supported three separate cash dividend increases in the past three years. Ladder has been very measured in its dividend policy with a focus on maintaining cash dividends at levels that will be funded by core earnings even without the benefit of gains on sales of conduit loans. Over the past seven quarters, there were three quarters of which Ladder elected not to execute any conduit securitizations. And in each of those quarters core EPS exceeded the cash dividend paid per share.

Turning to key balance sheet metrics, as of December 31, 2017, 96.6% of our debt investment assets were senior secured including first mortgage loans and commercial mortgage backed securities secured by first mortgage loans, which is consistent with the senior secured focus of the company. Senior secured assets plus cash comprised 77% of our total asset base. At 12/31/2017, total assets stood at $6 billion, 8% higher than at the end of last year, or 2016. Ladder ended the year with total equity of approximately $1.5 billion, and our core debt-to- equity ratio decreased slightly during the quarter to 2.48 to 1.

Total unencumbered investments including cash were $1.8 billion at year-end while unsecured debt outstanding stood at $1.2 billion. At December 31, 2017, our unencumbered assets to unsecured debt ratio was 1.56 to 1 reflecting the net pay downs of secured debt as we continued to shift capital between more levered investments to less levered first mortgage balance sheet loans.

The average coupon on loans held for sale originated in the fourth quarter was 4.77%, 22 basis points higher than on the prior quarter, primarily reflecting an increase in swap rates during the quarter. The average coupon on loans held for investment originated during the quarter reflected a weighted average spread of approximately 5.01% over the appropriate index.

In the first quarter to-date, weighted average spread on balance sheet loans already originated is 5.81%, in line with prior quarters. The weighted average loan-to-value ratio of the commercial real estate loans on our balance sheet at 12/31/2017 was 66.6%, in line with weighted average LTVs in recent quarters. 79.1% of our securities positions were related AAA or backed by agencies of the U.S. government as of quarter end, almost all were rated investment grade. The weighted average duration of our securities portfolio was 36 months, lower than the average duration of 43 months at the end of the same quarter in 2016.

Before moving to financing developments on our Q1 dividend announcement, I'd like to touch on two topics of note that have affected our industry recently: risk retention accounting and the recently enacted tax reform legislation. With regard to risk retention accounting, during the fourth quarter, the SEC provided clarifying direction to the mortgage securitization industry. In accordance with that direction, the GAAP accounting treatment applied to the latter securitization transaction executed during Q2 2017 has been revised to reflect sales treatment rather than the financing treatment originally applied.

More detail on this can be found in our press release and in the 10-K. While this GAAP accounting change will reduce assets and liabilities and Ladder's equity balance and income statement will reflect the profit earned. And now recognized under that sale, there will be no impact on core earnings, core EPS or core leverage ratio statistics as we have always treated the transaction as a sale in those computations.

With regards to the recently passed tax reform legislation, Ladder expects to benefit from the reduction of the federal corporate tax rate from 35% to 21% that's applied to our TRS pre-tax income generated primarily from our conduit business. Our shareholders will benefit from the 20% deduction applied to reap dividends. And prior to factoring in the impact of the lower federal corporate tax rate, Ladder's deferred tax liability was approximately
$8.3 million, resulting in an impact of less than $3.5 million on liabilities, tax expense and equity capital. There is no impact on core earnings and core EPS.

On the financing side, we continue to enhance our maturity profile, while maintaining a diverse set of funding sources. As of 12/31/2017, we had $3.7 billion of core debt outstanding and committed financing availability of $2.5 billion for additional investments. Our FHLB borrowing stood of $1.37 billion at the end of the year.

As I mentioned previously, we successfully executed our first two CLO transactions in October and December as we issued a total of $689.6 million of non-recourse, non-mark-to-market, matched-funded debt while freeing up over $160 million of net capital in the process. In addition, we expanded the size of our long-term committed syndicated revolving credit facility to $241.4 million in order to achieve greater financing flexibility for a line that does not require the pledging of investment assets as collateral.

With regard to equity, during the fourth quarter, we repurchased 189,897 shares of Class A common stock at a weighted average price of $13.61 per share, as average daily trading volume during the quarter was almost 840,000 shares. Finally, we raised our quarterly cash dividend rate by 5% to $0.315 per share in the fourth quarter and today announced a declaration of a $0.315 per share first quarter cash dividend. For the 2017 calendar year, Ladder earned core EPS of a $1.54 per share and paid $1.215 in dividends resulting in a solid 1.27 times dividend coverage ratio.

Summing up in the fourth quarter of 2017 and in the calendar year, Ladder generated $60.4 million of core earnings, $0.47 per share of core EPS and earned an after-tax return on average equity of 13.9% in the fourth quarter. Ladder earned $178.8 million of core earnings for the year, $1.54 per share of core EPS resulting in an 11.5% core after-tax ROE for the calendar year. This calendar year results reflect core earnings, core EPS and ROAE increases versus the prior year.

Ladder maintained solid dividend coverage during the entire year and raised the fourth quarter dividend by 5% to
31.5 cents a share, the third dividend increase in the past three years. Ladder originated a total of $2.9 billion and securitized approximately $1.5 billion of loans during 2017, once again reflecting increases over 2016 performance levels.

Ladder broadened its funding sources by accessing the CLO market for the first time as we issued $689.6 million of non-recourse, non-mark-to-market, match-funded debt in two transactions in which Ladder contributed a total of $888.4 million of principal balance of loans held for investment. And finally, Ladder continued to apply a disciplined approach to the use of leverage, to the allocation of capital in the face of the risks we encounter, and to the selection of longer term investments in loans and real estate.

At this point, it's time to open the line for questions and answers. As a reminder, the purpose of today's call is to discuss the earnings results. We ask that you please keep your questions focused on that topic.

QUESTION AND ANSWER SECTION

Operator: At this time we will be conducting a question-and-answer session. [Operator Instructions] Ourfirst question comes from Ben Zucker, JMP Securities. Please proceed with your question.

Steve C. DeLaney
Analyst, JMP Securities LLC

Thanks. This is Steve on for Ben. I'd like to start with the $200 million of balance sheet loans that have been originated so far in the first quarter. Could we just get a little color on the average loan size, property type, LTB, that type thing? And can you clarify that all these loans were senior floating rate loans? That would be helpful. Thank you.

Brian R. Harris
Chief Executive Officer & Director, Ladder Capital Corp

Sure. Yeah. Steve, this is Brian. They...

Steve C. DeLaney
Analyst, JMP Securities LLC

Hi, Brian.

Brian R. Harris
Chief Executive Officer & Director, Ladder Capital Corp

...to my knowledge, they are all floating rate loans. I don't know the actual make up of them. I do know there were a couple of reasonably large ones in there. Marc Fox is furiously summing through some things right now, while I'm talking to you. Give me one second here if you don't mind.

Steve C. DeLaney
Analyst, JMP Securities LLC

Okay. Well, one of the things, Brian, we're about all the spread compression and where – on these other – we're on other call and we're hearing like LIBOR plus 400 or LIBOR with 300 handles. So, just kind of curious how you're able to continue to find these attractively priced LIBOR plus 500 types of loans?

Brian R. Harris
Chief Executive Officer & Director, Ladder Capital Corp

Sure. I think, let me take the question generally.

Steve C. DeLaney
Analyst, JMP Securities LLC

Sure.

Brian R. Harris
Chief Executive Officer & Director, Ladder Capital Corp

First of all, they were all first mortgages.

Steve C. DeLaney
Analyst, JMP Securities LLC

Thank you.

Brian R. Harris
Chief Executive Officer & Director, Ladder Capital Corp

And there is a couple of ways you can respond I think to because the reemergence of the CLO market has really effectively turned the floating rate transitional market into a bit of a securitization business for those who can participate in whole first loss pieces for a couple of years. And what that's done really is created a lot of competitors in the space. And so I think that there's a couple of dynamics at play there that need to be dealt with. One is that the overall cost of funds in the repo world where we pledge loans to banks and they give us financing, those rates have not really come down much at all in the last eight years. Probably, the only spread product that hasn't come down to my knowledge. And what happened was when the unsecured corporate bond market opened up, those spreads have come down quite a bit and so has the CLO market.

So you're seeing a lot of borrowing in that market instead of what I would call the repo market.

Steve C. DeLaney
Analyst, JMP Securities LLC

Understood.

Brian R. Harris
Chief Executive Officer & Director, Ladder Capital Corp

And the way you respond to more competitors is you either work harder or compress spreads to keep volumes in place. But we're of the opinion because, so many companies have been set up in this space that's pretty lucrative that and there have been billions of dollars put into the space to create competitors that rather than address it from the standpoint of just compress spreads and try to protect market share, we actually decided to make our left and right goal posts wider.

So we are confident enough that the refinance activity will be so robust in the years ahead because of all the capital raised in the space that's causing that spread compression in the CLO market. We're so convinced that the refinance probabilities are much higher now than they were last year, that we're probably getting into a little bit less liquid categories, but also we do some structuring. So for instance we did a rather large loan where a Fortune 500 company was selling a property and they signed a lease for 12 years. And we provided fairly heavy financing on that transaction, but it's a three-year loan.

So because of the nine-year hangover at the end of the maturity, we're convinced that even though we provided a lot of LTC and a lot of leverage to the borrower, we feel like we're quite safe because we've got nine years of cash flow from a Fortune 500 company at the end of our maturity date. So, we felt like we could go up higher in leverage and charge a little bit more for it. And that's the theme I wouldn't want to necessarily point to one individual loan, but our spreads are not tightening, in fact, they're widening.

Steve C. DeLaney
Analyst, JMP Securities LLC

Interesting. And my quick follow-up here, we all understand the positive benefit of higher LIBOR on senior floating rate loans. Can you also comment on your net lease portfolio in this broader environment of strong economic growth, higher inflation along with the higher rates? How do those – that type of market condition impact your returns on your net lease portfolio with respect to – I'm really not clear as to what type of escalators or something might be in those loans, so thank you.

Brian R. Harris
Chief Executive Officer & Director, Ladder Capital Corp

Sure. We do have a variety of triple net lease properties and leased streams. But I believe we are 100% occupied. And our average lease term, Marc might know it better than me, but I believe it's over 10 years.

Marc A. Fox
Chief Financial Officer, Ladder Capital Corp

14.

Brian R. Harris
Chief Executive Officer & Director, Ladder Capital Corp

It's 14 years. So, from our perspective, we really look at it from the credit staying in place, so we do a lot of credit homework. We have to believe that they're going to stay in place because you don't want 100% vacating in your building. But you also have to look at how well they're going to perform in various environments. So, we'll sometimes have flat leases or else will have loans that adjust every five years or so. And so the ones that adjust every five years, you really don't need inflation to do better because what you do is you buy a year one cap rate, and then you ultimately do better over time.

However, some of the reason some people don't like flat leases, we're actually okay with them because if you believe that inflation is on the horizon and we do, then these are the assets that you might have looked at and said, I own that box at $200 a square foot. But if you put 3% inflation on it for 10 years, that $200 a foot, it's sort of like when your parents' house price when you heard what they paid for their house when you were 25, it sounded like it was pretty cheap at the time. So, you do want to have some exposure to an inflationary market where you'll benefit. And one of the places that benefits greatly is the actual real estate ownership market.

Steve C. DeLaney
Analyst, JMP Securities LLC

Got it. So it's not coming through as a current income but the inflation is driving a higher property value that will be there at the end of your lease term, is the way we should think about it?

Brian R. Harris
Chief Executive Officer & Director, Ladder Capital Corp

It's both. It's both. If there's a flat lease, the value will come in at the end.

Steve C. DeLaney
Analyst, JMP Securities LLC

Right.

Brian R. Harris
Chief Executive Officer & Director, Ladder Capital Corp

But keep in mind, we've rate locked all of our financing on those assets. So we've got 10 years of financing on most of them at a fixed rate. So we're fixed against fixed, so our cash flows won't change on flat leases and they will increase on variable lease payments.

Steve C. DeLaney
Analyst, JMP Securities LLC

Great. Appreciate the color. Thank you, Brian.

Brian R. Harris
Chief Executive Officer & Director, Ladder Capital Corp

Sure.

Operator: Our next question comes from the line of Jade Rahmani with KBW. Please proceed with your question.

Jade Rahmani
Analyst, Keefe, Bruyette & Woods, Inc.

Thanks very much. With the interest rate expectations at least in the market seemingly having increased, what are your views around cap rates and in terms of the deals that you're participating in on the lending side, are you seeing buyers of real estate alter their cap rate underwriting assumptions?

Brian R. Harris
Chief Executive Officer & Director, Ladder Capital Corp

I think longer term, interest rate rises will certainly affect cap rates because interest is a raw material in the purchase of a product called real estate. So, if you have to pay more for it, it's just like steel going up in a construction project. On the other hand, because of inflation, which oftentimes accompanies rising interest rates and that's the reason for the rate rise, you do hit a point where the real estate begins to look more commodity-like. And I'll point you back if you care to go that far back into the 1980s, Jimmy Carter days where interest rates were 12%, 13% but cap rates were not 12% or 13%.

So what you do – what real estate owners have, is they own effectively a bond-like instrument and they don't like to adjust their expectations lower as interest rates rise because they feel like the economy is doing better so my real estate should be doing better too. And it's a very bond-like instrument that ultimately is falling in value as interest rates rise. But then when rates rise rapidly for an extended period of time then I think it switches over to a commodity-like product and it starts – yeah if you – if the 10-year – you were to go to 10%, I don't think cap rates would go to 10% because it starts to trade like a commodity as I said.

But we have not seen cap widening for that reason we have seen cap widening in retail for other reasons. We've seen some cap tightening in the hotel business because the hotel business has the most elastic pricing and in a reasonably healthy economy especially with foreigners coming back into the gateway cities, hotels are doing much better now than they were doing before. So, we are seeing tighter cap rates being paid for some hotels but not all.

I don't know if that answers you, but obviously it has to do with supply and demand mostly.

Jade Rahmani

Analyst, Keefe, Bruyette & Woods, Inc.

And in terms of the outlook say over the next 6 to 12 months, what do you think is reasonable to expect as far as an adjustment in cap rates?

Brian R. Harris

Chief Executive Officer & Director, Ladder Capital Corp

Can you help me and tell me where you think the 10-year is going to be in that period of time?

Jade Rahmani

Analyst, Keefe, Bruyette & Woods, Inc.

I mean, let's just say that it moves in parallel with LIBOR.

Brian R. Harris

Chief Executive Officer & Director, Ladder Capital Corp

Okay. So, if a lot of people think the Fed will move four times then we'll call it 100 basis points in LIBOR. Financing cost-wise, that's fairly significant. I would think that would move most real estate at 25 basis points to a 50 basis points on cap rate.

Jade Rahmani

Analyst, Keefe, Bruyette & Woods, Inc.

And I guess, I mean, you mentioned that you think that the Fed won't raise four times and it sounds like in your answer to Steve on the types of loans you're doing, you're willing to take a bit more credit risk. So, I guess, how would you weigh the risk of higher cap rates with the refinancing activity you expect and your willingness to take a little more credit risk?

Brian R. Harris

Chief Executive Officer & Director, Ladder Capital Corp

Well, yeah. I want to correct that I don't think we take a little more credit risk. I think we take a little more liquidity risk in – that product that we fund into may be very structured – and we don't compromise credit standards at all. But to the extent that we do a higher LTC with a different kind of structure like a cash flow sweep, yeah I would say we're taking more liquidity risk because I don't think that that's a very easy item to replace immediately.

But I've seen enough of these cycles that as time goes on and you keep pouring billions of dollars into the financing system because of CLOs, it'll get a little out of hand on the credit side. And I suspect we'll be experiencing some rapid prepayments with penalty fees. So that's really what we're setting up for. So we feel like we're able – we always felt we could land safely into certain spaces, but we didn't feel the need to take the marginal step in liquidity given the returns that we were dealing with. But with a LIBOR plus 500 to 600, yeah, there is a little bit more liquidity but because of our ability to do a CLO and sell the – and finance the A note really and hang onto the B note with our credit risk. We're pretty comfortable with that.

So, I don't – with interest rates rising I think that'll happen because of inflation as well as worldwide economic growth. I don't think the worldwide economic growth will be what a lot of Fed officials think it will be because that yield curve is telling me because it's so flat that the long end of the curve doesn't believe inflation as much as the Fed would have you think. But I'm fairly convinced we've got a reasonably growing economy right now with unemployment where it is and stock markets now rebounding up to their near highs again.

So it's a good environment for real estate for commercial real estate lenders. The biggest problem to a commercial mortgage lender is a default. It's not lower interest rates and I think a default will be kept at bay here. And I suspect as a result of that, the credit standards will erode over time and that's usually – it probably takes a couple of years before that happens.

Jade Rahmani

Analyst, Keefe, Bruyette & Woods, Inc.

And in terms of the gain on sale business, what's your view of the outlook there? Have you seen any spread volatility with what's happened in fixed rates? You – are you, say, more confident in that business being a little more steady this year than last year?

Brian R. Harris

Chief Executive Officer & Director, Ladder Capital Corp

Yeah. I think the one tip-off, really, for the correction in the stock market was you really didn't see credit spreads widening. High yield moved a little bit, but mortgages didn't move at all, which kind of told you that technical correction. It was technical, and not credit. And so, that, that's always a reassuring sign.

And so, I'm not overly concerned about spread risk right now. Although, typically in short-term time frames, there is always a problem around the 4th of July when there's too many deals being done right before the, you go into the summer. So, I suspect you'll see a spread movement again, but spreads have been tightening pretty much consistently for the last year or so, maybe two.

And I just think there is a basic supply and demand issue here because as the stock market rises, every day the stock market goes up 300 points. So, a certain amount of money moves into the bond market and comes off the table. And I do, I do sense that there's a fair amount of demand right now for spread product.

And I am a little surprised, though, with the 10-year, where it is that the yields, the absolute yields you receive, and you can buy a 2-year with a $225-million yield from the government. A 10-year mortgage, it just doesn't seem to be that much better. So, I think spreads should be wider, but I think that they're typically tighter at this time of year, as new allocation come in, especially when you've got a high stock market, they rebalance the portfolios and you get more demand in the initial months of the year in the bond market. And that's what we're experiencing.
That's why I think you see spreads tightening. And they held in very tighter even when the stock market corrected.

Jade Rahmani

Analyst, Keefe, Bruyette & Woods, Inc.

In terms of the two CLOs completed, when do you think we should expect the cost of funds for those two to increase as a function of the deleveraging?

Brian R. Harris
Chief Executive Officer & Director, Ladder Capital Corp

You mean if we do another CLO?

Marc A. Fox
Chief Financial Officer, Ladder Capital Corp

No.

Jade Rahmani
Analyst, Keefe, Bruyette & Woods, Inc.

No. Just in terms of the sequential pay structure, there is some replacement period that you mentioned but once the once you start receiving repayments, I guess when would you anticipate the cost of funds that you recognize to go up? Would it be, like, in the second half of this year or later than that?

Brian R. Harris
Chief Executive Officer & Director, Ladder Capital Corp

Well, I think there's a couple of forces at work there that may be being overlooked. So, I would say obviously as shorter – as prepayments pickup, your cost of funds goes up because you get rid of your AAAs. But these are only to your instruments anyway, in our opinion. So, it's really 24 maybe a 30-month cycle, and there's a call feature to the extent that there's a lot of prepayments.

And don't forget also that as loans prepay, you actually have a pickup because we have exit fees in our loans. So, that just means you're front loading the exit fees and you're amortizing the origination fees over a shorter period of time. So, I don't really expect to see a cost of funds increase over the next two years because I think any rapid prepayment will result in much greater fees at much earlier time periods.

Jade Rahmani
Analyst, Keefe, Bruyette & Woods, Inc.

And assuming the availability or that market's liquidity remains strong, which I think a lot of people expect, would you anticipate replacing those CLOs with follow-on issuances?

Brian R. Harris
Chief Executive Officer & Director, Ladder Capital Corp

Maybe. Yeah. I certainly – we'll use it. We did it twice. The first one was more of a bond deal, the second was a private, and that has to do with expenses. But what it really does – all it really does is raise some additional capital for you by raising your financing rates. I mean, it lowers your financing rates and raises your advance rates. But we've got bonds outstanding too. We always like to keep a conservative level of leverage in the company, generally between two and three times. There's no need for cash now.

And so to the extent that we wanted to raise some cash, I think the first thing you'll see us do is get through the rest of that securities pile that we have, which is just about $1 billion. That will raise cash. And then the second thing we might do is another CLO, but I don't see any pressing reason to do one in the near term. And when you see the conduit deals, we did six conduit deals in the fourth quarter. That also adds to retained earnings because that takes place in a TRS and not in the REIT.

Jade Rahmani
Analyst, Keefe, Bruyette & Woods, Inc.

Thanks very much for taking the questions.

Brian R. Harris
Chief Executive Officer & Director, Ladder Capital Corp

You're welcome.

Operator: As a reminder, we are now conducting a question-and-answer session. [Operator Instructions] Our next question comes from Jade Rahmani, KBW. Please proceed with your question.

Jade Rahmani
Analyst, Keefe, Bruyette & Woods, Inc.

Sorry. One thing I didn't catch was the average interest rate on the balance sheet loan originations during the fourth quarter. Do you have that number?

Brian R. Harris
Chief Executive Officer & Director, Ladder Capital Corp

Yeah. I think, Marc, I'll give that you.

Marc A. Fox
Chief Financial Officer, Ladder Capital Corp

Yeah. Yeah.

Brian R. Harris
Chief Executive Officer & Director, Ladder Capital Corp

And you can also give him the first quarter.

Marc A. Fox
Chief Financial Officer, Ladder Capital Corp

Yeah. Exactly. Exactly. What we said during the script was that during the fourth quarter it was 501 basis points over the index and through the month – this month we're talking about 581 basis points over. And so that's more in line with where we've been historically.

Jade Rahmani
Analyst, Keefe, Bruyette & Woods, Inc.

Okay. Thanks very much.

Brian R. Harris
Chief Executive Officer & Director, Ladder Capital Corp

Yeah. Typically, Jade, when you see lower LIBOR spreads, it's usually because there's more apartments and multi-family loans in there. Okay?

Operator: Ladies and gentlemen, we have reached the end of the question-and-answer session, and I would like to turn the call back to Brian Harris for closing remarks.

Brian R. Harris

Chief Executive Officer & Director, Ladder Capital Corp

Just thank you, everybody, for staying with us tonight and listening to us. It was a very strong quarter and we are looking forward to a very strong year with our liabilities in place now at fixed costs for the most part. And I look forward to talking to you again in a couple of months. Thanks again.

Operator: This concludes today's conference. You may disconnect your lines at this time. Thank you foryour participation