Investment Perspectives

The investment case for Safehold

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QUAYglobal INVESTORS

A Bennelong boutique

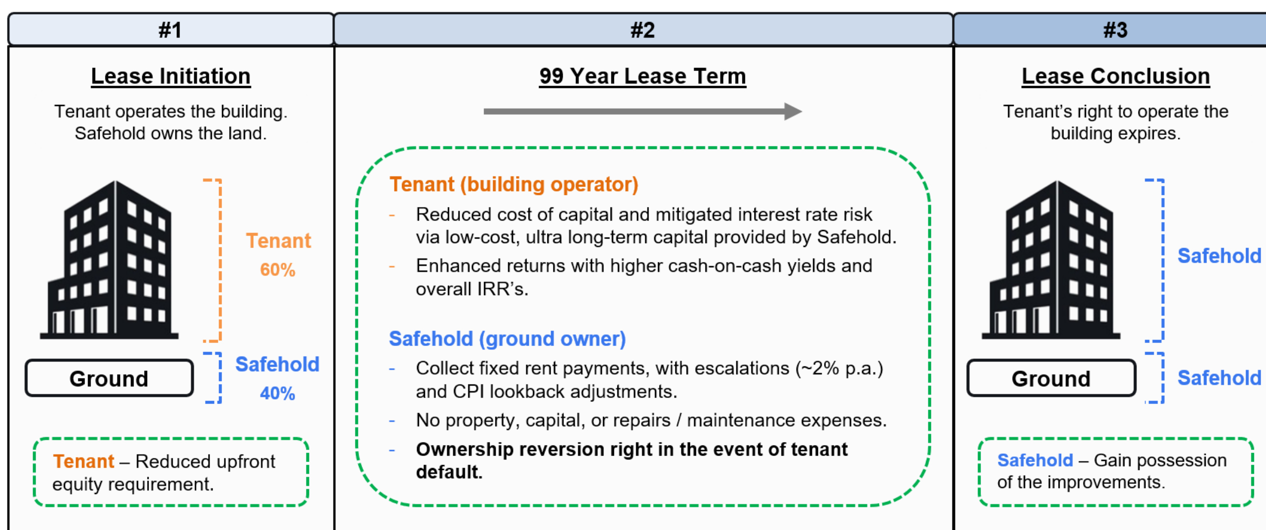
Safehold

Quay's index unaware global investment mandate affords us the opportunity to analyse unique companies that are not available in the local market. While uniqueness alone is not enough to warrant investment, the right company, at the right price, can meaningfully improve portfolio diversification and enhance total returns. We believe one such company to be Safehold (SAFE).

Pioneers

Listed in 2017, SAFE is the world's only publicly traded company that is dedicated to the ground lease sector. That is, owning the land beneath which commercial real estate assets are operated on.

Historic ground leases have a mixed reputation, owing to egregious terms and hidden stipulations that have generally eroded value for the lessee. SAFE reinvented the sector with a standardised ground lease solution that offers mutual benefit to the landowner and building operator. The key terms of a SAFE ground lease are set out in the diagram below.



Source: Company Disclosure, Quay Global Investors

By virtue of the 99-year term, SAFE are selective in the assets that they are prepared to underwrite with a ground lease. Key features of the investment criteria are listed below.

Geography	Top 30 USA markets
NOI Coverage	3.0x – 4.5x
GL to Property Value	30% – 45%
Transaction Size	US$15m – US$500m

Photos on cover courtesy of:
1935 Manhattan, © Corbis
Modern Manhattan, © Evan Joseph/Pavillion Books

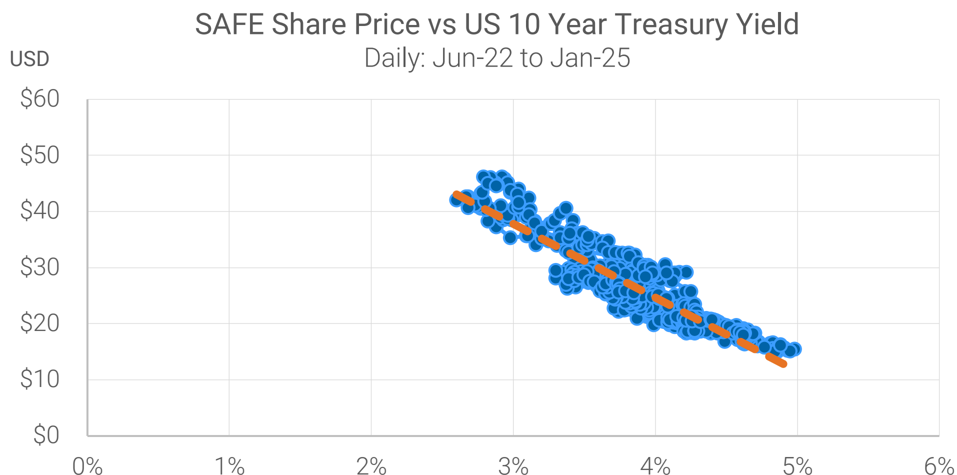
These well-defined lease terms and investment criteria drive the fundamentals of the SAFE business model. Several components of which, align deeply with Quay's investment philosophy:

- Cashflows accruing to SAFE are free of maintenance CAPEX obligations.
- SAFE's cash flows are at the utmost position of the capital stack, minimising downside risk.
- SAFE fund 60-65% of property acquisitions using leverage, significantly enhancing equity returns.
- SAFE's structure enables them to access this leverage with the protection of an 'A style' credit rating.
- SAFE's land holdings have an outsized exposure to the most economically and politically important cities in the US including Manhattan (22%), Washington DC (10%), Boston (8%) and Los Angeles (7%).

Price action

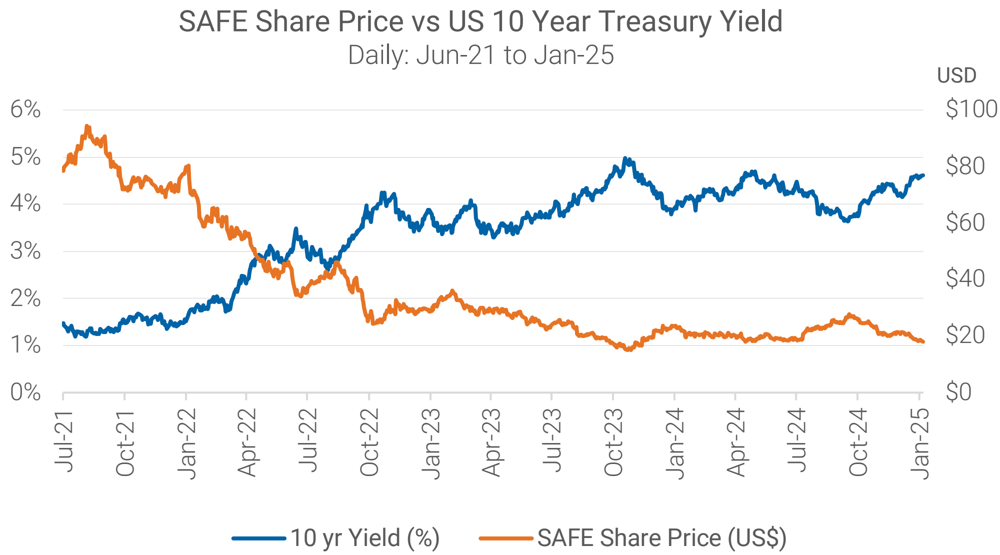
We believe that the mechanics of the ground lease are being overlooked by the market. This view is substantiated in-part by management anecdote, whereby the majority of investor meetings still require basic education on the sector.

A shallow understanding of SAFE pigeonholes investors to value the stock as a long duration interest rate play. This 'low information' approach has driven the stark inverse correlation between SAFE's share price and the US 10-year treasury yield.



Source: St Louis FED, Factset and Quay Global Investors

Accordingly, there was a mass exodus of the stock in response to the FED's hiking regiment and the widely adopted 'higher for longer' interest rate expectation. Once trading at $94 per share, today SAFE stock can be bought for $17.



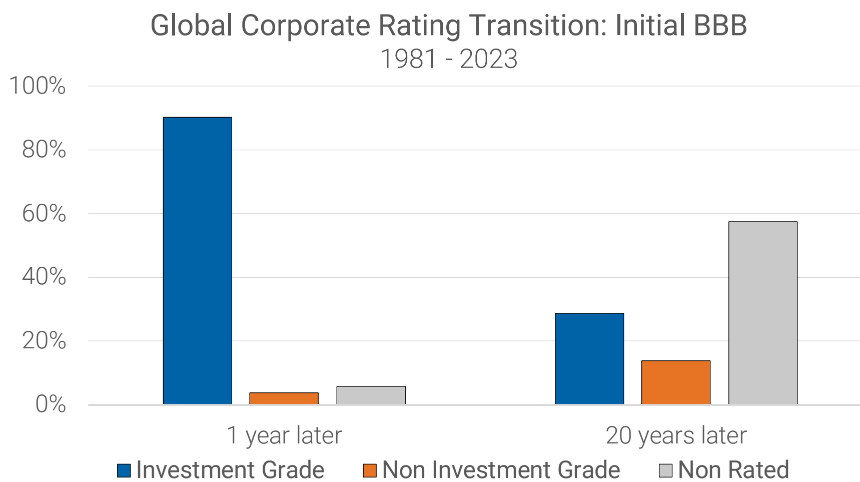
Source: St Louis FED, Factset and Quay Global Investors

This rigid price action is insensitive to the long-term value of the SAFE business model and is a signal to us that the ground lease niche is not yet widely known or properly understood. Below we will discuss three components of the SAFE investment story that we think the market is missing.

Asymmetric downside protection

We have long held the view that "the longer the lease, the lower the risk" is one of the greatest misconceptions in real estate. As lease duration extends, traditional real estate risk is replaced with credit risk i.e. cost of delinquency.

Importantly, over an extended horizon, credit rarely remains static. As the chart below highlights, over 70% of BBB rated credit today is likely to be rated non-investment grade or unrated over 20 years.



Source: Standard and Poor's, Quay Global Investors

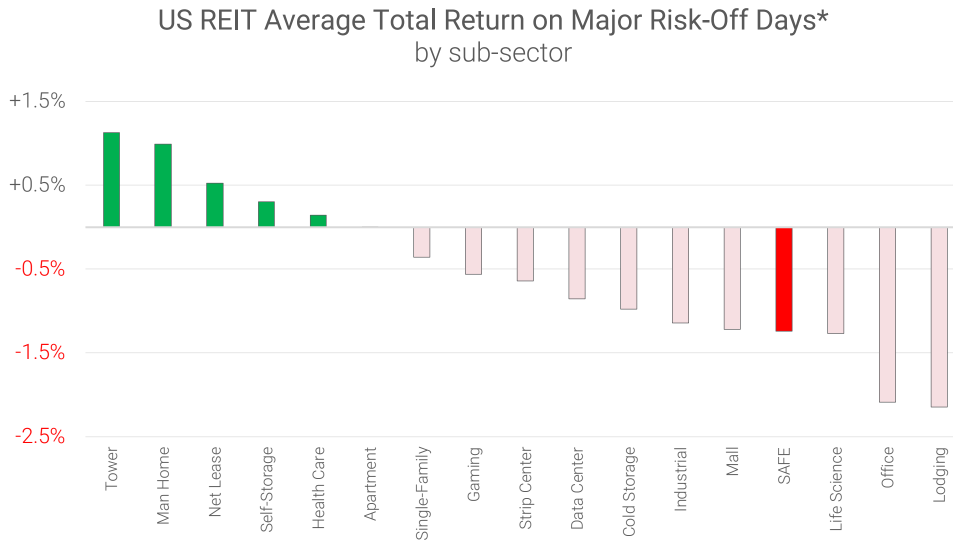
SAFE has a typical lease term of 99 years, which is five times longer than the chart above. However, unlike most long WALE real estate investments, SAFE's credit risk is near 0 due to the fact that they own the most senior position in the capital stack.

In most credit scenarios, the best case is money owed to the landlord / lender is paid in full, while all other outcomes represent downside. In the case of SAFE, the base case is that money owed is paid in full, while all other outcomes lead to the acquisition of property improvements (~1.5x the value of the ground) at zero additional consideration.

Tenant credit scenario	Tenant remains solvent	Tenant becomes insolvent
SAFE impact	Underwritten rent is received.	Building ownership reverts to SAFE i.e. purchase of an institutional grade CRE asset for ~40c on the dollar.

Source: Company Disclosure, Quay Global Investors

This exceptional 'win' or 'win more' outcome array should lead SAFE to outperform when economic uncertainty is highest. Below is the performance of SAFE's share price relative to other REIT sectors on the market's greatest risk-off days.

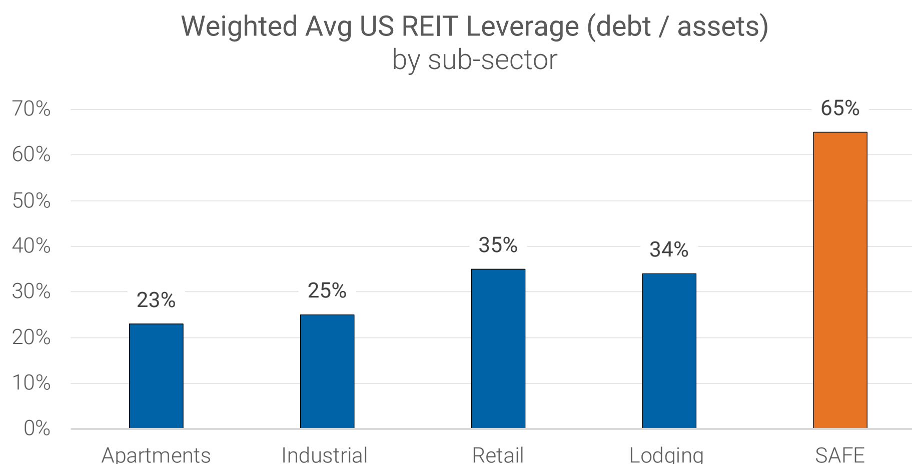


Source: Green Street Advisors, Quay Global Investors
**Top risk-off days in the months of August and September 2024*

This price action is inconsistent with the economic reality of SAFE's cash flows in the event of a deteriorating business environment. We see this as further evidence of investor ignorance towards the SAFE structure and a clear indication of market inefficiency.

Look-through overcollateralisation

We have reason to believe that investors baulk at SAFE's balance sheet. While the view that SAFE is over-levered could be justified by a quick scan of the debt to assets ratio, this does not tell the full story.



Source: Green Street Advisors, Quay Global Investors

A scenario where SAFE defaults on its loans almost certainly requires its tenants (building operators) to have stopped paying rent. Under such a scenario, the value of the building improvements reverts to SAFE, meaningfully altering the composition of the balance sheet. A simplified example is set out below.

Line Item	Current Balance Sheet	Upon Tenant Default
Land	40	40
Improvements	-	60
Total Assets	**40**	**100**
Debt	**26**	**26**
Debt / Assets	**65%**	**26%**

Source: Company Disclosure, Quay Global Investors

It is for this reason that SAFE's true underlying asset base (lender security) is understated by the balance sheet alone.

This look-through overcollateralisation, while potentially lost on investors, is recognised by the leading credit agencies. SAFE now has a dual 'A style' credit rating, Moody's (A3) and Fitch (A-), which places them in the upper echelon of REITs globally. This credit rating drives material benefits to SAFE over the long term, including;

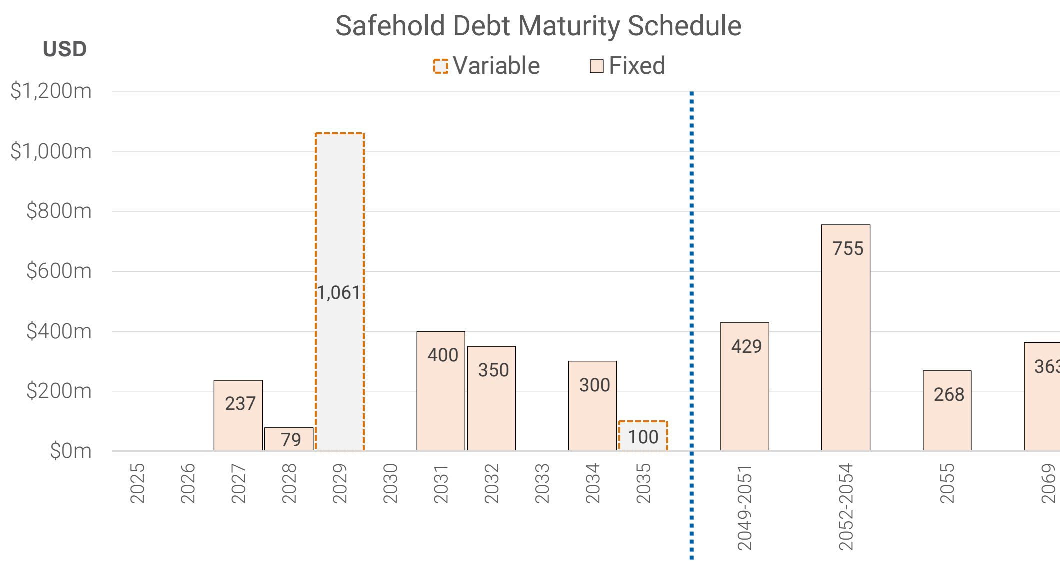
- Lowered cost of funding. A key driver for long term equity returns.
- Reduced refinancing risk via widened access to capital markets.
- Improved flexibility of debt structuring e.g. reverse amortisation.

While difficult to quantify today, there is significant value in SAFE's go-forward optionality when it comes to fixing, hedging, and structuring their debt.

Therein lies the secret sauce - SAFE shareholders receive the economic benefits of high leverage, without the commensurate drawbacks associated with such leverage.

Fixed debt value

As interest rates rise, the refinancing risk for a company with fixed cashflows is substantial. SAFE have been proactive in managing this risk by securing long dated funding, the majority of which was done on fixed terms, as illustrated below.



Source: Company Disclosure, Quay Global Investors

The benefit of this largely fixed debt profile in the face of heightened rates is twofold.

1. The fixed debt, in combination with various derivative contracts and stepped interest rate structures, has been effective in mitigating the increase in SAFE's debt servicing burden.
2. The in place, below market, fixed debt has become more valuable i.e. the economic value of the liability has fallen below the book value. At the time of writing, we conservatively estimate the fixed debt to be worth ~$7.50 per share. At today's price of $17 this forms a significant component of SAFE's trading value and is subject to further growth (absolute and proportional) if rates are to increase further.

Concluding thoughts

Safehold is a truly unique investment opportunity that is impossible to replicate in the domestic market. Moreover, it's relative size (market cap US$1.2bn) means gaining meaningful exposure to SAFE via an index aware strategy is difficult.

Being unique for the sake of it is no justification for investment. However, we are confident that the new-age ground lease niche, to which SAFE is the pioneer, is not yet widely known or properly understood by the market.

Importantly, we believe SAFE is mispriced when assessed from a cursory vantage point. The specific components of the SAFE structure that we think the market is missing include the:

- Asymmetric downside protection in the event of economic collapse: 'win' or 'win more' cash flows.
- Look-through overcollateralisation enabling access to high leverage without the commensurate risks.
- Mark-to-market value of the in place, below market, fixed debt liability at ~$7.50 per share.

At its core, SAFE is a pure land play across the most important cities in the United States. This business has minimal maintenance CapEx obligations and receives an attractive recurring cash yield of 3.7%. In addition, the building improvements (currently worth US$9.1bn) revert to SAFE's shareholders at the end of the lease term – the value of which will continue to compound over time.

SAFE is the type of investment that rewards the patient. It's the type of investment that will shine brightest when economic times are darkest. It's the type of investment that excites us at Quay.

For more insights from Quay Global Investors, visit quaygi.com

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