Investors Alley

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The Dividend Hunter

Welcome to The Dividend Hunter

Fellow Investor,

Greetings, and welcome to the inaugural issue of The Dividend Hunter.

I, as the editor, am very excited to bring what I believe is a quite different and effective approach to income stock selection to you, the subscribers of The Dividend Hunter.

There are many topics about income investing that we'll go over, but I'm going to first briefly cover my background and influences plus a short discussion of what you should expect to get from your subscription.

I started my working career as an Air Force pilot, right after graduating from the US Air Force Academy. I flew OV-10 Bronco and F-16 Fighting Falcon planes and worked my way up to instructor pilot in both aircraft. As a regular pilot, my flying skills came fairly naturally, but to fly at the highest level, those skills were honed with constant repetition.

When I first became an instructor, I learned to self-analyze everything I did to safely fly so I could find cues and indicators to be able to teach other pilots those same skills. This attention to detail combined with my interest in cycles and patterns formed the basis of my approach to stock analysis.

Since leaving the Air Force quite a number of years ago, I have worked in different levels of business, including a stint as a stockbroker and Certified Financial Planner. I have also spent a good portion of my career as a financial analyst much of it focused on building a deep understanding of finding profitable higher yield stocks and what criteria are necessary to analyze to separate out the cream of the bunch.

Our recommendations and ongoing portfolio tracking system in The Dividend Hunter focuses on stock market investments that will provide you with a high, current cash yield with a secondary objective of dividend or distribution growth over time. To avoid losses, the portfolio will be populated with companies that our system has determined are at very little or no risk of a dividend reduction.

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That's me learning the kind of discipline and focus I now use for investing.

For the true income investor, a dividend cut results in double-barreled damage to your portfolio. First, the income you expected from the holding will be less and at the same time the market will drive down the share price, which means if you sell the shares you will have less money to reinvest to try to recover the lost principal and income. I can name numerous historical results where investors went with high yield stocks and then were devastated when that high payout was cut. We will work here to avoid that outcome at all costs.

The highlight stocks in every issue of The Dividend Hunter will show the criteria used to select the stock and what we will

be looking for as danger signals.

On the communications you receive from us, you will often see the information closed with a quote of "Land, Fly or Die". I picked this up during my first operational assignment flying Broncos in South Korea. The squadron was filled with young pilots, most of us at the start of our flying career. One day another pilot called in to the squadron on the radio with questions of concern about the weather and completing his mission. It was a somewhat whiney radio call, and one of the grizzled Captains – he was probably close to 30 years old – picked up the mike and replied simply with "land, fly or die". To me those words meant that if we choose to do a task, do it to the max, or go park the jet and let someone else take the mission.

Land, fly or die,

Tim Plaehn
Editor
The Dividend Hunter

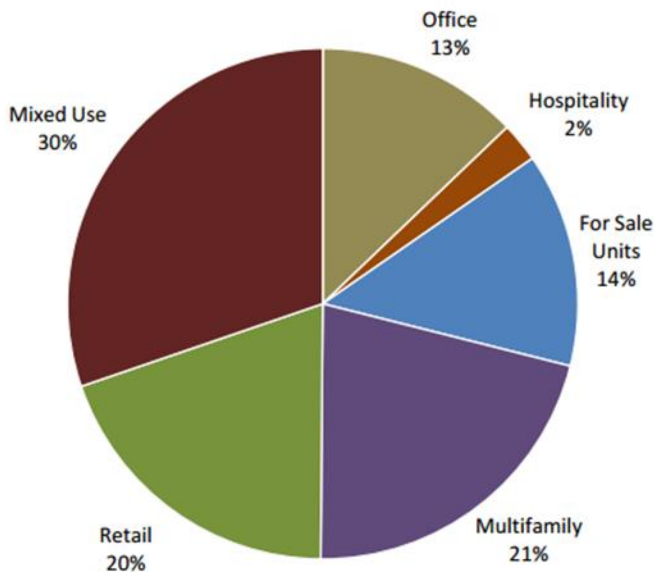
P.S. In the following pages you'll find detailed research on two of the investments in our portfolio as well as a great education piece and finally our current portfolio holdings. If you ever have a question about anything I've written here please feel free to drop me a line at tim.plaehn@investorsalley.com.

Starwood Property Trust NYSE: STWD

Starwood Property Trust (NYSE: STWD) presents some outstanding income investment traits, but a general lack of understanding of how this finance company functions allows investors in the know to earn a very attractive yield from this high-quality real estate investment trust (REIT).

Background

Starwood Property Trust was created by the private equity firm Starwood Capital Group and launched with an initial public offering in April 2009. At the time the new REIT was the largest blind pool company ever listed on the NYSE. A blind pool company is one with no assets or business. It takes the cash from the IPO to fund start up business operations. On its IPO date, STWD had a market cap of $950 million. Now, five years later, the company is approaching a market value of $5 billion, an increase of greater than 500 percent.



The primary business of Starwood Capital Group is real estate investing and SCG acts as the external manager for Starwood Property Trust. The REIT focuses on originating and investing in commercial mortgage loans and other commercial real estate-related debt investments. There exists a tremendous opportunity for synergies between the Starwood Capital Group's global real estate operations and the Starwood Property Trust business of originating commercial real estate loans. STWD management has stated several times in the past that the company often gets first look at any financing opportunities the other parts of SCG run into.

Competitors in the Market

There are a few other REITs focused on commercial mortgages. In May of last year, Blackstone refocused the separate, publicly-traded Blackstone Mortgage Trust Inc. (NYSE: BXMT) to operate in the commercial real estate lending space. Also in 2013, residential mortgage REIT Annaly Capital Management (NYSE: NLY) purchased the commercial mortgage REIT, CreXus Investment, for which Annaly had been acting as the investment advisor. Both the former CreXus and Blackstone Mortgage Trust are $1 billion market cap companies. Other competing REITs include Colony Financial Inc. (NYSE: CLNY) with a $1.6 billion market cap and Apollo Commercial Real Est. Finance Inc. (NYSE:ARI), currently worth about $600 million. Commercial banks ranging from local to regional to the large money center banks also offer commercial real estate loans.

As the largest commercial lending REIT and with financial size and strength to compete against the largest banks, Starwood Property Trust looks to make larger sized loans, targeting finance amounts greater than $50 million, up to $300 million. In a May 2014 presentation, 90% of the loans in the company's pipeline were for loan amounts greater than $150 million. Few of the lenders, REIT or bank, that want to compete with Starwood are even able to handle the size of loan this company targets.

There is also plenty of opportunity in the market. Unlike residential mortgages, commercial real estate loans have terms of five to 10 years with a balloon payment at maturity. This means that there is always a pipeline

of prospects that need to fund a commercial property purchase or refinance and existing mortgage. In a recent 12 month period Starwood Property Trust reviewed over 600 possible finance transactions for $46 billion. The company issued term sheets on 79 for $6 billion and closed 28 deals for $2.1 billion worth of loans.

The bottom line is that Starwood Property Trust is a major force in the commercial mortgage sector and the company often has first and final shot at the best and most profitable lending opportunities.

A Different Approach to Generating Yield

As a REIT, Starwood Property Trust has few if any restrictions on how it manages its business model in regards to the types of loans it makes, alternative investments that can be purchased and sold, and how new loans are structured. However, three items of how Starwood manages its business show the methods used to generate double digit returns on the company's capital base.

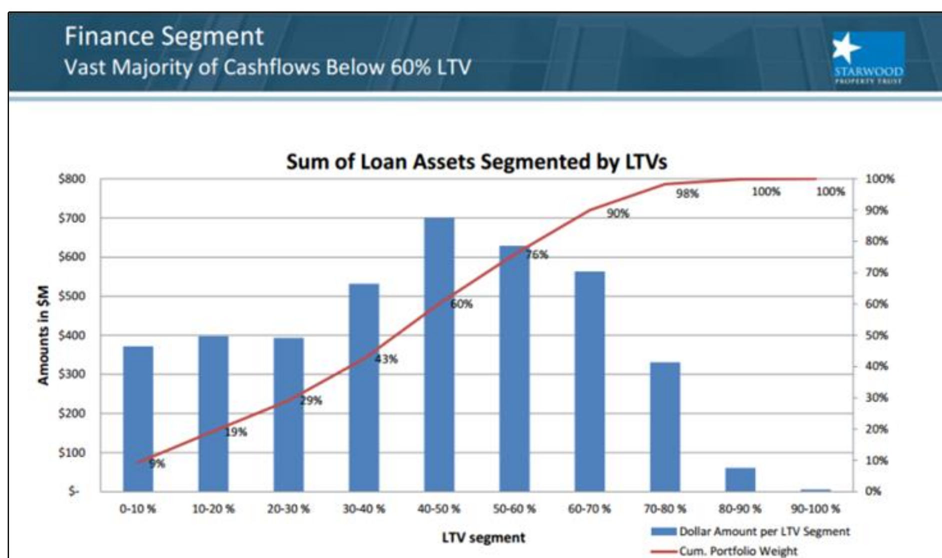


Figure 1 courtesy Starwood Property Group

First, when making real estate loans, Starwood does not put itself at risk from falling property values. The maximum loan amount is 85% of the property's value, and in most cases, Starwood makes loans for 65% to 75% of the commercial property value. Right now, the company's portfolio is at 67% loan to value. Sticking with a low loan-to-value lending criteria protects equity value. If commercial real estate values fall, borrowers could start defaulting on loan payments. That equity cushion protects Starwood and gives the opportunity for additional profits if a borrower defaults.

Second, – and this is the really neat part of Starwood's lending business – a portion of a new mortgage loan will be sold off, leaving Starwood with the "B" note yielding much more than the loan's actual rate. For example, on a $100 million property, Starwood makes a $75 million first mortgage loan at a 5.75% rate. Then the company sells the "A" note of the loan as a $50 million, 50% LTV (loan to value) note with a yield of 3.0%. There are many types of financial institutions such as insurance companies that will readily snap up a very safe 3%, 5-year note when the 5-year Treasury is yielding just half that rate. By earning 5.75% on the entire loan, Starwood Property Trust is left with the $25 million "B" note with an effective yield of 11.25%. Plus it gets the $50 million back from selling the A note to repeat the process.

Finally, over 85% the loans made by Starwood Property Trust are variable rate. If interest rates start to increase, the company will earn even higher yields on the portions of its loans that are retained on the balance sheet.

A Transformative 2013

In 2013, Starwood Property Trust took a couple of steps to further set the company ahead and above the competition.

In April 2013, Starwood Property Trust completed the purchase of privately owned LNR Property LLC. LNR can be viewed as a mini-Starwood and brought some unique additions to Starwood's business including:

- A commercial real estate loan business focused on the $10 to $30 million loan size sector.

- The second largest in the U.S. commercial loan special servicer. This means LNR handles the workouts of defaulted commercial real estate loans for a fee. A workout involves taking over the loan and either foreclosing on the property for resale or setting up conditions for the borrower to get current on the loan.
- A portfolio of controlling class positions of real estate backed securities.
- The largest independent and special commercial mortgage servicer in Europe. The large European banks currently have big portfolios of commercial mortgages that in many cases they do not want to refinance when the terms come due. There is a growing opportunity for independent lenders like Starwood/LNR in the established European economies. For example in November 2013, Starwood Property Trust funded £180 million of a £220 million refinance loan on Centre Point, one of London's most iconic towers.
- Auction.com: the primary listing site for both bank-owned residential and commercial real estate. Site ownership is split 50/50 with Starwood Capital Group.

Besides being a nicely profitable business on its own, LNR has opened up numerous new sources for business in Starwood's main lines of lending.

Later in 2013, Starwood announced it would spin off into a new company its holdings of single family rental homes and non-performing residential mortgages. Although these assets did not match with Starwood's core business, management recognized value in the sector and picked up the assets when prices for homes and non-performing loans were at the bottom of the trough. To realize the value in these assets, Starwood chose to spin them off as a new REIT called Starwood Waypoint Residential Trust (SWAY). On the January 31, 2014 effective date, investors in STWD received 1 share of SWAY for each 5 shares of STWD owned.

The interesting part of this transaction is that when SWAY was spun off, the STWD share price dropped by about $6 to reflect the value of SWAY per share. After the spin-off STWD investors held shares of both STWD and SWAY. However, as part of Starwood Property Trust the SWAY assets were not producing any cash income. Starwood Property Trust retained all of the income earning assets. This means that the $30 per share stock turned into a $24 stock with the same dividend rate and cash flow behind that dividend.

A Creative Plus Conservative Market Leader

When making commercial real estate loans, Starwood Property Trust sticks with a very conservative approach to protecting its investment in the loans and the interest those loans will generate. On the flip side, the company's underwriting can be very creative when it comes to the structure of a loan. Starwood can structure loans to provide a client company the capital and time to do things like redevelop or renovate a property to increase its value, which benefits both the client and Starwood. Starwood also usually makes loan decisions quicker than commercial banks do. Decisions on whether to approve a loan are decided in a matter of weeks rather than months.

Starwood Property Trust also leverages its relationship with Starwood Property Group and now the LNR sales force to make sure it gets a look at every large loan prospect in the U.S. – and growing so in Europe. While on paper, there is a significant amount of competition in the commercial real estate lending market, Starwood Property Trust has put together all of the tools to make it the premier lending source in the space.

Investment Expectations

In spite of the company's strength, stability, and leading market position, Starwood Property Trust remains a high-yield REIT. The current $0.48 quarterly dividend puts the yield just below 8% with the share price at $24. Management has forecast 2014 core earnings of $2.00 to $2.20 per share, which handily covers the current dividend rate. Over the last couple of years, the

dividend has been increased by about 4% with the March distribution.

The major risk faced by Starwood Property Trust would be a widespread decline in commercial property values. The company mitigates this risk by making loans across all sectors of commercial real estate.

With the share price drop due to the SWAY spin-off, STWD is now quite undervalued, and our current BUY recommendation is good up to $25 per share. As the market and investors start to realize the high dividend rate is still in effect, expect the share price to move back up towards $30, when the stock will yield 6.5%, which is more typical for this stock.

Recommendation: Buy up to $25 to lock in an 8%+/- yield.

Is the Market Due for a Drop/Correction/Bear Market?

With this inaugural issue of The Dividend Hunter, we have launched the newsletter with the stock market sitting at or near record high values. While we all like the values of our stocks to continue to climb, any long term watcher of the market knows that bull markets always end at some point and are followed what is typically a short, but painful bear market.

As I continually watch the market and the dividend stocks I track and research, the threat of a serious bear market is always a consideration. While I do not expect a bear market in the foreseeable future, I thought I would jot down some notes to share with you what I am thinking concerning the intersection of the current stock bull market and choosing stocks for long-term income generation.

In general, even with stock index values at record highs, I do not think the overall stock market is over-valued. With a current P/E ratio of about 18 and a projected forward P/E of less than 16, the S&P 500 value is firmly camped in the 15 to 20 P/E range that has defined most of the 21st century outside of the 2008-2009 bear market period when actual corporate earnings dropped significantly. For comparison, in 1999 and 2000, right before the tech bubble burst, the S&P 500 P/E reached the high 20's. You know what happened afterward.

I do not see the signs of frothiness that indicate a market top. For example, the extreme P/E of the whole tech sector and much of the rest of the market in 1999 or the incredibly high commodity prices we saw in the summer of 2008, before the bear market that started in the fall of that year.

The major negative facing the stock market is a lack of any meaningful correction – defined as a drop of at least 10% – since August of 2011. The occasional correction is often viewed as a necessity for a bull market to maintain its longer term momentum. Over the last few years, the stock market friendly policies of the Federal Reserve Board have muted any general fears that stocks could drop by a meaningful amount. With the Fed starting to wind down its bond buying program, that strut for ever higher stock prices has been pulled. Historically, September is the worst month for stocks, so if some outside event does not trigger the 2014 correction, we will start watching the signs closely as the summer winds down. When the market does get around to correcting, the drop may be much sharper than the 10% needed to be an official topic for the financial news talking heads.

A constant thought when reviewing and selecting income stock investments is what will happen when interest rates start to rise. Every income investor needs to be thinking about when this day will come.

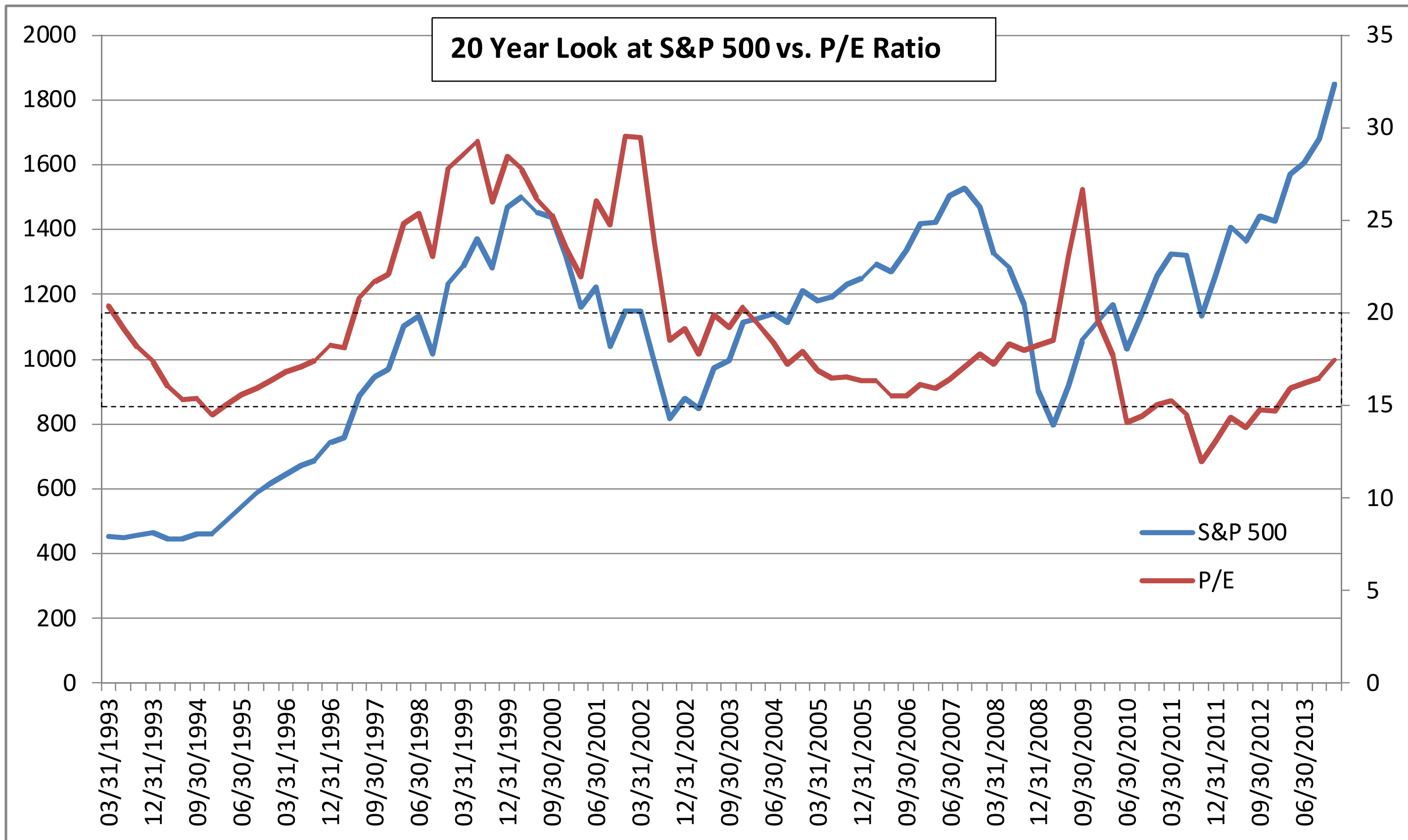


Figure 2: While the S&P 500 may look frothy compared to the past 20 years, the P/E ratio is within the average range as shown by the dashed lines.

That said, short-term rates seem to be locked into their near-zero state for at least another year and longer term interest rate are moving upward in small and fitful steps. After starting the year right at 3%, the yield on the 10-year Treasury is back down to 2.75%. I would not be surprised to see the yield in the mid 3's by year end, but that amount of rate increase will have little effect on our investment outcome projections.

Since we focus on investing in stocks for the yield, higher stock prices are a double-edged sword. We like to see share prices go up on stocks we own, but we want to buy in at lower prices, which result in a higher yield on the dollars invested. With the market at all-time highs, the share prices of some great dividend paying companies are too high to provide the yields desired for the portfolio stocks of this newsletter.

The initial portfolio recommendations for The Dividend Hunter are stocks that have not run up in price, or have experienced recent value pullbacks, so that the current yields are very attractive relative to other income stocks of the same quality. I am proud to launch with the first five stocks for The Dividend Hunter having an average forward yield of 6.85%.

This month's feature stocks, Starwood Property Trust and Ship Finance International are currently priced to yield more than 8%, making them extremely attractive as long-term income producers.

I have been locating, researching and following the high-yield stock opportunities for The Dividend Hunter for close to two years. There are some really great dividend paying companies that will become candidates for inclusion in the portfolio if and when there is a market correction and the yields are pushed up to the

point where you will be able to pick up shares at prices that will provide the level of yield this newsletter strives to offer.

Ship Finance International (NYSE: SFL)

I first developed an interest in the shipping industry and related stocks almost 10 years ago. The period of 2005 through 2008 was exciting for both shipping companies and their investors. The record prices for commodities like grains, crude oil and iron ore made it very profitable to buy a new crude tanker or dry bulk carrier vessel and lease them on the spot market at tremendous profit margins.

Of course all of the ship buying happened with borrowed money and when the bottom fell out of shipping rates, many of these high-flying shippers suddenly could not generate enough revenue to cover operating costs and interest payments. As shipping rates fell, so did the market value of vessels owned by these companies.

By 2009, the stocks of some of the biggest names in shipping had lost over 90% of their values and banks were no longer interested in financing any of the ships these companies had ordered during the glory years. While some companies that I covered during this period went bankrupt, others still survive, but with share values 95% below their heyday prices.

Back in 2006 and 2007, Ship Finance International Ltd. (NYSE: SFL) was the boring, moderate yielding choice among the several dozen shipping stocks trading on the U.S. exchanges. Ship Finance came into existence as a 2004 spin-off from Frontline Ltd. (NYSE: FRO), the world's largest crude oil tanker company.

Ship Finance received 47 tankers from Frontline, which were leased back to FRO on long term contracts. Splitting off Ship Finance allowed Frontline to increase its risk/reward profile as tanker spot rates moved up or down. Ship Finance received steady lease payments enhanced with a modest profit sharing agreement with Frontline. As a result, Ship Finance was able to pay steady dividends with moderate distribution growth and use the profit sharing payments to diversify away from a dependence on the crude tanker market.

The Modern Ship Finance

Over the last decade, Ship Finance has expanded into the ownership of almost all classes of ships including crude oil tankers, car carriers, container vessels, dry bulk carriers, chemical tankers, jack-up drilling rigs, ultra-deepwater drilling units and offshore supply vessels. The company now owns 73 vessels, which includes just 20 tankers remaining from the original fleet obtained from Frontline. As of the end of 2013, just over half of the company' revenue came from the offshore portion of the fleet, about a quarter was from tankers, and the remainder split between dry bulk and container ships.

Long-term lease contracts remain the stabilizing factor in the business model. The average remaining contract time is over 10 years. The Ship Finance ships are now spread among 15 customers, which include some of the largest names in shipping such as Seadrill, Maersk and Hamburg SUD.

The shipping industry contacts and financial strength of Ship Finance make the company a go-to source for the financing of the most expensive vessels on the market. For example, last June the company structured the purchase of a $600 million jack-up drilling rig with a 15-

year lease back to the selling company. The rig is being modified in Norway and is expected to return to operation in May 2014. Over the term of the contract, Ship Finance will earn 15% per year on the invested equity.

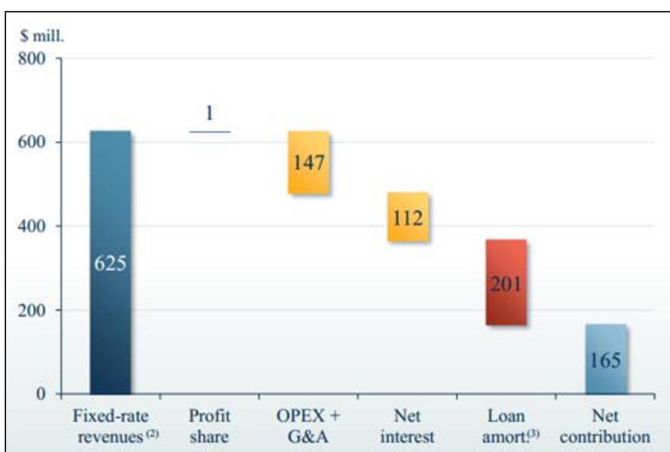
Cash Flow to Ensure Steady Dividend Payments

Ship Finance may be the poster child of cash flow analysis compared to the traditional net income per share to determine the safety and potential dividend payments. Over the last four quarters, SFL has reported net income per share of $0.38, $0.29, $0.14 and $0.20. Over the same period the dividends paid were $0.39, $0.39, 0.39 and $0.40 per share. So you have net income of $1.01 per share and $1.57 per share was paid in dividends.

There are several reasons why Ship Finance can pay this level of dividends:

A large portion of Ship Finance's charter business falls under the capital lease classification and payments on the leases are booked as "repayment of investment to finance leases, results in associates and long-term investments, and the interest income from associates". As a result, the earnings from the leases do not fall directly to the bottom line net income.

Also, as an owner of assets, Ship Finance will book a non-cash depreciation charge every quarter. This expense currently runs at about $60 million per year, which is $0.75 per share that does not show up on the net income line.



To get a firm handle on Ship Finance's true ability to pay dividends, we start with the earnings before interest, tax, depreciation and amortization (EBITDA).

Since quarterly results can vary with the sale or disposition of vessels, it is better to look at a full year's worth of cash flow.

In 2013, Ship Finance generated EBITDA of $479 million. Interest payments totaled $112 million, and since it is domiciled in Bermuda, the company pays no income tax. In addition, for 2013 $201 million was paid to amortize loan balances. Subtract the real cash payments from EBITDA and the remaining free cash flow is $163 million. Ship Finance has about 79 million shares outstanding, so the cash required to pay last year's dividends was $124 million. Even though the reported net income was less than the dividend, the actual cash flow was enough to cover the dividends by a factor of 1.3 times.

2014 To Be a Year of Cash Flow Growth

The cash flow analysis above is pretty much how the results have come in for Ship Finance for the last several years. Before the most recent $0.40 dividend paid in March 2014 and just announced $0.41 to be paid in June, the distribution rate had been at $0.39 for 10 of the previous 11 quarters. However, 2014 is shaping up to be the year when Ship Finance returns to a practice of steadier dividend growth.

During 2013, over $1 billion was invested to add to the company's fleet. The cash flows for those investments will start to have a meaningful impact until this year.

A potential additional source of distributable cash is profit sharing payments from Frontline. In late 2011, Ship Finance and Frontline restructured the lease agreements on the tankers owned by SFL. Frontline received some lease rate relief in exchange for an up-front cash payment and new, lower profit sharing thresholds based on the earnings rates per day generated by the tankers. In the first quarter of 2014, tanker rates have finally moved up to levels that will generate profit share payments from Frontline to Ship

Finance. These payments have the potential to add between 20 and 40 cents per share to the free cash flow available to pay to share owners.

Potential dangers for investors would be a delay in the deployment of that very expensive jack-up rig and if any of the Ship Finance customers ran into financial troubles and were not able to make lease payments. The board of directors has shown in the past that it is not afraid to temporarily reduce the dividend rate of current and forecast cash flow are determined to not be high enough to support the dividend rate. For example, when Frontline got into trouble in 2011, the SFL dividend was reduced to $0.30 from $0.39 for one quarter until the situation was worked out with the tanker company.

High Yield Stability with Potential for Growth

At the current $18.46 per share (as of publishing) and the $0.41 quarterly dividend, SFL yields 8.9%.

The SFL share price tends to be quite volatile, swinging by $1 to $3 per share several times a year. You can clearly see this in the following chart.

While we have this stock as a strong BUY for income investors, you may be able to get a lower average cost by spreading out your total investment into three or four parts and investing on the dips. I have no trouble recommending SFL at the current share price, but dips below $17 are definite buy opportunities.

This recommendation is not dependent on future dividend increases, but if the distribution rate does go up during the year, it is unlikely that SFL will see the underside of $18 again. When the market realizes that SFL is starting to grow its dividend, the share price will be bid up to push the yield down to a range of 7.5% to 8%, which means a share price above $21.

Recommendation: Buy up to $19.00 for a minimum yield of 8.9%.

Current Portfolio

Company	Entry Date	Entry Price	Recent Price	Buy Up To	Annual Div	Proj. Yield	Returns
Starwood Property Trust (STWD)	05/30/14	$24.39	$24.39	$25.00	$1.92	7.90%	N/A
Ship Finance International (SFL)	05/30/14	$18.46	$18.46	$19.00	$1.64	8.90%	N/A
Oaktree Capital Group (OAK)	05/30/14	$50.66	$50.66	$56.00	$3.92	7.80%	N/A
Macquarie Infras. Company (MIC)	05/30/14	$61.48	$61.48	$63.50	$3.75	6.10%	N/A
Ventas (VTR)	05/30/14	$64.94	$64.94	$68.00	$2.90	4.30%	N/A

Notes:

Entry price is determined by the last "Ask" price at the closing of the market on the day before publication.

Recent price is determined by the last "Ask" price at the closing of the market on the day before publication.

Div is the dividend payment as declared by the company and made publicly available. It is as of the closing of the market on the day before publication.

Returns include share price appreciation and dividend payments to provide a more accurate assessment of returns in that investment.

We make no guarantee that any company in the portfolio will continue dividend payments.

Announcements

Whitelist our address subs@investorsalley.com with your email provider to ensure you never miss an issue of The Dividend Hunter or any urgent alerts. Several subscribers have reported not receiving their issue and upon investigation found their issues were blocked by their email provider. The best way to prevent this is whitelisting. Your email provider should have instructions on how to do this.

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