Stock Pick of the Week: Starwood Property Trust (STWD)

At times, a particular industry or subset of an industry can get a bad rap, whether deserved or not. However, it is often the case that finding the best companies in a beaten down industry can be very profitable. The real estate investment trust (REIT) segment of the Financials sector is often cited as troublesome, and even more so with the impending rise of interest rates. But not all companies are exposed to this risk.

This week we're highlighting a REIT that steers clear of the more dangerous residential mortgage industry, and operates in commercial real estate lending. This stock also lands on our Most Attractive List for March. Our stock pick of the week is Starwood Property Trust (STWD).

What Is Starwood Property Trust?

Starwood is a real estate investment trust that is focused primarily on originating, acquiring, financing and managing commercial mortgage loans and other commercial real estate debt investments. On top of this, they operate in the commercial mortgage-backed securities market and hold other commercial real estate-related debt investments in both the U.S. and Europe.

Why Invest Now?

Starwood has consistently grown profits since its inception in 2009, with 2014 being a record year. Revenue in 2014 increased by an impressive 28% over 2013, which continues Starwood's history of growing revenues by 49% compounded annually since 2010. On top of this excellent revenue growth, Starwood's 2014 after-tax profit (NOPAT) grew 64% year over year, and 2014 was the third consecutive year of 50% or higher NOPAT growth.

As a result of its growing profits, Starwood increased its return on invested capital (ROIC) to 13% in 2014, up from 4% only five years ago. This excellent ROIC growth can be attributed to management's effective allocation of the capital flowing into the business.

Starwood also pays out an excellent dividend of 8%, as required by REIT legislation to avoid taxation at the trust level.

Won't Rates Affect Profitability?

With respect to the more common residential mortgage REITs, investors are worried and unsure about how much rising interest rates in the United States will impact profits. However, Starwood operates in the commercial mortgage market, where defaults are lower, especially when the economy is expanding, as is the case the United States. At the same time, 77% of Starwood's lending portfolio is tied up in LIBOR-based floating rate loans. Floating rates allow Starwood to act appropriately when rates do move, and the company is not left scrambling to cover hedges or losses.

In an impressive sign of management's capability, Starwood's CEO Barry Sternlicht noted in the company's 2014 10-K that since inception, Starwood has not had a single loan default. This is no small feat, especially when assessing risk across the United States and portions of Europe, where Starwood does business.

These Adjustments Reveal Starwood's Operating Profitability and Valuation

We make several key adjustments to the earnings and balance sheets of companies to uncover the recurring cash flows of each company's core business and the value left for shareholders. We made the following major adjustments to Starwood's earnings in 2014:

- Removed $26 million non-operating expenses included in operating earnings.
- Added back $13 million in taxes due to non-operating expenses lowering operating earnings.

When considering Starwood's valuation, we also add $29 million in off-balance sheet debt (<1% of market cap) to Starwood's reported debt. This adjustment represents all of Starwood's debt, as the company has no other reported short-term or long-term debt.

Unwarranted Fear Has Created Buying Opportunity

Because of the worry surrounding interest rates, Starwood Property is only up 5% on the year, despite its excellent 2014. At current prices, the market is severely undervaluing Starwood Property Trust. At ~$24/share, Starwood has a price to economic book value (PEBV) ratio of just 0.7. This ratio implies that the market expects the company's profits to permanently decline by 30%. This expectation is out of touch with reality considering that Starwood has grown NOPAT at over 50% for the past three years. Such low expectations, coupled with the company's strong fundamentals, allows Starwood to earn our Very Attractive rating.

If Starwood can grow NOPAT by just 9% compounded annually for the next five years, the company is worth $45/share today — an 88% upside from current levels. Even if the market fails to realize the true value of Starwood, which has a $35/share economic book value, the 8% dividend yield makes this stock worth investors' while.

Disclosure: David Trainer and Kyle Guske II receive no compensation to write about any specific stock, style, or theme.

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