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Colony Capital, Inc.

The Big Pivot on Hold

Primary Report **July 25, 2020**

In response to activist pressure precipitated by a deterioration in its financial performance and a steady decline in its stock price, Colony Capital announced in November 2019 a new strategy to focus on growing its Digital Realty and Investment Management business, divest over time its healthcare, hospitality and other equity and debt assets and sell substantially all of its investment management business to Colony Credit Real Estate (CLNC).

Most of that plan, however, is now on hold due to the economic downturn precipitated by the COVID-19 pandemic. Colony has experienced operating losses from a plunge in occupancy at its hospitality properties, more muted but still consequential declines in occupancy and increasing operating costs at its healthcare properties, payment defaults on its other senior loans, mezzanine loans, preferred equity interests and property leases and sharp declines in prices of its real estate debt securities.

As a result of the squeeze on its own profitability, Colony has announced that it is in payment default or non-compliance with $3.54 billion of its total $8.10 billion non-recourse debt, 90% of which is attached to its hospitality properties. The company is in active negotiations to execute forbearances and/or debt modifications and extend maturities on loans coming due.

Despite these challenges, Colony has taken steps to bolster its liquidity and financial flexibility. In March, it borrowed $600 million under its corporate credit facility. In late June, it amended its credit facility to ease financial covenants and add digital assets to the borrowing base. In exchange, the company paid down the facility by $200 million, leaving $800 million of cash at corporate and $100 million of available credit. In mid-July, Colony issued $300 million of 5.75% Exchangeable Senior Notes due 2025, the proceeds of which will be used to repay the maturing $400 million of 3.875% Convertible Senior Notes on January 15, 2021. Also in mid-July, the company paid the quarterly dividends on its four outstanding series of preferred stock.

In the midst of all of this, Colony has completed a change in its senior management. On July 1, Marc C. Ganzi, who was brought in to lead the Digital business, became Colony's CEO, replacing Colony founder Thomas J. Barrack, Jr., who remains Executive Chairman. Jacky Wu, another Digital executive, is now Colony's CFO. Longtime Colony veteran Mark M. Hedstrom continues as EVP and COO.

From here, Colony will stay focused on addressing the current challenges in its businesses. As the economy continues to improve, so should its financial performance. The company could get a boost from another round of aid to the hospitality sector from the Federal government. Although there are questions about potential long-term structural changes that could affect recovery values especially in sectors like hospitality, price discovery for real estate properties will improve with the economy.

With the normalization in economic activity, Colony will be able to proceed with its pivot to Digital and its plan to divest most of its real estate assets and the investment management business. Although there are considerable uncertainties that could limit ultimate recoveries, Colony's stock is trading at $1.80, off of its all-time April low of $1.33, but well below its pre-COVID levels of around $6.00. Assuming that its healthcare and hospitality properties can return near to their pre-COVID valuations, my analysis suggests that the stock has upside to around $4.01 ($3.68 with the potential dilution from the conversion of the new Exchangeable Notes into equity). Growth in the Digital business and a recovery in the value of Colony's 36.5% stake in CLNC (which would be driven by a rebound in CMBS and other real estate debt securities prices) could provide further upside.

Colony Capital, Inc. (CLNY) will report 2020 second quarter earnings on August 7. Colony Credit Real Estate, Inc. (CLNC) will report its second quarter earnings on August 6.

Common Stock Performance Rating: 1; Safety Rating: D **S&P 500: 3215.63**

Amt Outst ($m)	CUSIP	Description	Recent Price [f]	Coupon	Maturity	Yield	Spread	Call Date	Call Price	Credit Ratings
402.5	19624RAB2	Conv. Senior Notes [a]	99.75	3.875%	1/15/21	4.32%	421 bp	Now	130% of stock price	NR
200.0	19624RAA4	Conv. Senior Notes [b]	92.00	5.000%	4/15/23	8.35%	820 bp	Now	130% of stock price	NR
300.0	19626LAA5	Exch. Senior Notes [c]	109.21	5.750%	7/15/25	3.70%	343 bp	NA	NA	NR
13.6	66705PAC7	Exch. Senior Notes [d]	NA	5.375%	6/15/33	NA	NA	Now	Exch. for cash, stock	NR
280.1	NA	Junior Sub. Notes [e]	NA	3M L+	2035-2037	NA	NA	NA	NA	NR

(a) Currently convertible at the rate of 63.47 shares per $1,000 par value or $15.76 per common share.

(b) Currently convertible at the rate of 60.3431 shares per $1,000 par value or $16.57 per common share.

(c) Issued July 21, 2020 in a private offering under SEC Rule 144A. The Notes are exchangeable at the rate of 434.7826 shares per $1,000 par value or $2.30 per share.

(c) Originally issued by NorthStar Realty Finance Corp. The Notes are exchangeable at the option of the holder into cash, common stock or a combination of cash and stock (at the option of the operating partnership). The current exchange ratio is 83.10 shares per $1,000 or $12.07 per common share). They last traded on January 8, 2020.

(d) The junior subordinated debt was assumed by the company through its merger with NorthStar. Prior to the merger, subsidiaries of NorthStar (NorthStar Realty Finance Trusts I through VIII) issued trust preferred securities in private placement offerings. I have not been able to find any relevant trading data on these securities.

(f) Recent prices as of the close on July 24, 2020.

Amt Outst ($m)	CUSIP	Description	Recent Price [a]	Annual Dividend Rate	Maturity	Current Yield	Call Date	Call Price	Credit Ratings
88.3	19626G405	Series G Cumulative Redeemable	19.87	7.500%	Perpetual	9.44%	Now	25.00	NR
287.5	19626G702	Series H Cumulative Redeemable	19.61	7.125%	Perpetual	9.08%	Now	25.00	NR
345.0	19625W872	Series I Cumulative Redeemable	19.50	7.150%	Perpetual	9.17%	6/5/22	25.00	NR
315.0	19625W864	Series J Cumulative Redeemable	19.40	7.125%	Perpetual	9.18%	9/22/22	25.00	NR

(a) Recent prices as of the close on July 24, 2020

Shares Outst. (mil.)	Common Stock	7/24/20 Price	Div./ Share	Div. Yield	Tangible Book Val.	Proj '20 FFO/Sh [a]	2020 P/FFO	Proj. '21 FFO/Sh [a]	2021 P/FFO
481.9	Colony Capital, Inc. (N:CLNY)	$1.80	$0.00	0.0%	$4.53	NA	NA	NA	NA

Investment Considerations

Positive

1. Significant upside potential at current valuations. My analysis indicates that the stock has a potential value of $4.01 (or $3.68 after considering the potential dilution from the recent issuance of Exchangeable Senior Notes). The valuation assumes a recovery of healthcare and hospitality property values back to pre-COVID levels. There is potential upside to my valuation if losses are avoided on mezzanine loans and lower CMBS tranches held by Colony and its affiliate Colony Credit Real Estate, Inc. (CLNC) and the Digital segment delivers higher returns on capital.

2. Leading real estate investment management platform with a successful track record of capturing opportunities and managing through the cycles. For more than a quarter century, Colony has been a leader in sponsoring and managing private real estate investment funds. Privatefunddata.com lists 30 Colony funds, including the eight original Colony Investors funds and five Colony Distressed Credit Funds. The company built its business on distressed real estate investments. It has often been quick to spot and capitalize on emerging opportunities, for example, in the single-family rental market following the 2008 financial crisis.

3. Long-term growth potential in digital. Colony is "all-in" with the planned redeployment of 90% of its capital to its Digital Real Estate and Investment Management business. Steady growth in digital and telecommunication services has increased the demand for digital real estate assets, even during COVID-19 pandemic. Colony is investing in towers, data centers, fiber infrastructure and small cells. In 2018, it launched the $4.05 billion Digital Colony Partners I fund. At March 31, 2019, it had $21 billion of digital assets under management and has plans to increase that to $40 billion by the end of 2021.

4. Colony's current strategy will simplify and provide greater focus to its business, making it more readily understandable to investors. The pivot to Digital and the likely sale of all of its other real estate assets and businesses, including the eventual transfer of its non-digital investment management platform to CLNC, will make Colony a more focused company and easier for investors to follow. Although Colony has slowed its evolution to Digital as a result of the pandemic, it still expects to complete most of the transition by the end of 2021.

5. Recent steps taken to preserve financial flexibility. Early on in the pandemic, both Colony and CLNC drew upon their available credit facilities to raise cash and ensure that they each would have the ability to fund losses temporarily during the approaching economic downturn. Both have also completed amendments to their bank credit facilities to ease the financial covenants to provide the necessary financial flexibility to respond to the challenges and opportunities presented during the crisis. In July, Colony raised $300 million through a private placement of 5.75% Exchangeable Senior Notes, raising the funds now to repay a maturing $400 million debt issue in January 2021.

6. Economic activity is on the upswing. Although there are still questions about its strength and durability, the global economic recovery is underway. After a projected 32% plunge in 20Q2 GDP, forecasters anticipate an 11% third quarter rebound, followed by two quarters of 6%+ growth, according to the Philly Fed Survey of Professional Forecasters. In real estate, hotel occupancy is up from a low of 20% in April to around 4521% currently, but still below the pre-COVID level of 70%. Other sectors, like senior housing and office, have mostly seen more modest occupancy declines and will likely experience more gradual recoveries, as well.

7. The Trump Administration is pursuing relief for the hospitality sector in this next round of stimulus. Congress is currently considering a second round of financial stimulus to address some of the economic dislocations caused by the pandemic. According to the New York Times, Treasury Secretary Steven Mnuchin told a House committee that the retail and travel sectors require additional relief.

8. Opportunity to create value in a transaction with Colony Credit Real Estate. There is an opportunity for Colony to create value by internalizing CLNC's management through the transfer or sale of Colony's investment management platform to CLNC. In my opinion, Colony should also transfer or sell the related co-investments from its Other Equity and Debt segment to CLNC. (Otherwise, part of Colony's business will become externally managed, which investors frown upon.) There are at least a few ways that Colony could accomplish the transfer: through (1) a direct sale (for cash and/or CLNC stock), (2) by acquiring the rest of CLNC outright in a stock-for-stock transaction and later spinning out the new CLNC to CLNY shareholders or (3) by enlisting the support of third-party investors to acquire CLNC and the related Colony assets.
9. Opportunities to create or salvage value through CMBS workouts on its existing properties. Since the onset of the pandemic, prices of mezzanine loans and junior CMBS tranches have fallen sharply in value. Although Colony is in payment default or non-compliance on a significant portion of its non-recourse debt, it has the opportunity to negotiate with its CMBS lenders (or directly with investors who purchase such loans at a discount) to restructure these loans and recapture some of the lost equity value on properties whose market values may be permanently impaired.
10. Investment opportunities across Colony's capital structure. Although prices for Colony's outstanding securities are well off their lows, they still have upside potential. For example, Colony's 5% Convertible Senior Notes due 2023 have recently traded at a yield of 8.35% and a spread of 820 bp over Treasuries. Its four series of preferred stock currently offer yields of 9.1%-9.4%. Its common stock at its current price of $1.80 has the potential to more than double in price if my valuation estimate proves to be correct.

Negative

1. Colony is in payment default or non-compliance on $3.54 billion of its non-recourse debt, mostly in the hospitality sector. As of May 11, $3.16 billion of the defaulted debt was collateralized by Colony's hospitality properties, including its THL portfolio and the remaining $380 million of defaults was against its healthcare properties. Colony has received notices of acceleration on $780 million of hospitality debt. A press report indicates that two Colony hospitality portfolios, Inland and THL, may be placed into receivership. Colony is negotiating with its lenders to obtain forbearances, maturity extensions and debt modifications.
2. Colony has significant exposure to the healthcare and hospitality sectors, both of which have been hurt by the COVID pandemic. I calculate that 87% of the net book value of Colony's real estate and nearly 13% of the carrying value of its loans receivable is attributable to healthcare and hospitality properties. Colony also has meaningful exposures to those and other vulnerable sectors in its (and in CLNC's) equity and debt investments. Although there is a good chance, in my opinion, that the values of most of these investments will recover over time, the magnitude of the potential losses that the company will eventually suffer is still unknown and could be significant.
3. Across the commercial real estate industry, many tenants are behind on their rent and many borrowers are delinquent on their debt payments. Unless the economy continues to recover quickly and steadily, rent and debt defaults will eventually lead to greater foreclosures and restructurings and could bring more properties on to the market. This in turn could lead to lower lease rates and property values and delay a rebound in the real estate industry.
4. There is considerable uncertainty about the recovery potential of the economy and commercial real estate. Some market watchers predict a new normal in which there is less demand for real estate, especially in the retail, hospitality and office sectors. Whether that vision becomes reality depends upon the timing and strength of the economic recovery. If the "second wave" of COVID proves to be less consequential than feared, activity in many sectors could

quickly return to pre-COVID levels. That would still leave some sectors, like retail, challenged, but overall the industry would face a less consequential adjustment.

5. There is a wide bid-ask spread on property valuations. Few properties are trading. Unless forced to sell, owners are keeping their properties off the market, because buyers are expecting rock bottom prices that reflect reduced levels of profitability and the uncertainty of the recovery. When the Federal government stimulus programs run their course and as the trajectory of the economic recovery becomes more predictable, properties will begin to trade more actively, many through distressed sales and foreclosures. A V-shaped economic recovery would avoid much of the potential decline in property values. Until there is greater clarity in the outlook, it appears that market values of real estate investments will continue to be cloudy.

6. Colony's financial performance continues to be hampered by the fallout from overpaying for NorthStar. Since the NorthStar merger, the company has incurred $1.5 billion of goodwill and intangibles impairments and $765 million of real estate impairments (much of which is attributable to the write-up of assets in the merger). By my calculations, Colony could still incur nearly $800 million of non-digital goodwill and intangibles impairments and a potential $350 million impairment on its 36.5% equity stake in CLNC. It also may write down the carrying values on its real estate properties, equity and debt investments and loans receivable. There is a high probability that Colony will recognize additional impairments over the next two quarters.

7. Colony should improve its financial disclosures. Although Colony provides extensive disclosures in its financial statements, earnings releases and financial supplements, some of that information is reported on different bases, making it difficult to interpret, and some important disclosures are missing. If it presented its disclosures consistently, I believe that company could reduce the volume of disclosure, making it less costly to produce and relieving some of the burden on investors and analysts who monitor its performance. I recognize that Colony's financial reporting will become much simpler when it completes its digital evolution; but if the evolution will be delayed due to the pandemic, it should consider making some changes now.

   There are several areas that I believe require attention: First, although Colony provides sufficient information in its financial supplements to determine the percentage of each OE&D segment asset category that belongs to noncontrolling interests, the defined asset categories do not correspond to the OE&D asset categories that are presented in its financial statements. That makes it difficult to assess, for example, what percentage of loans receivable or equity and debt investments belongs to Colony. The company should base these noncontrolling interest disclosures on the OE&D asset categories provided in its financial statements.

   Second, Colony should improve its presentation and disclosures about the performance of its OIM segment. The segment has recognized significant goodwill and intangible impairment charges and completed several asset sales that have produced extraordinary gains and losses, making it difficult to assess OIM's underlying profitability. Colony's MD&A and segment disclosures are inadequate, in my opinion. While its financial supplement disclosures provide very good detail, they are on a basis that is different from the financial statements.

   Third, in Colony's consolidating segment disclosures given in the financial supplement, it is evident that it assigns significant corporate expenses (i.e. compensation and administrative expenses) to amounts not allocated to segments. Yet, there is no discussion of corporate expenses in the MD&A. Furthermore, the amounts not allocated to segments probably include intercompany adjustments, making it difficult to determine the exact amount of corporate costs.

   Finally, Colony should provide, as it does for its bank group, separate summary financial statements for either its operating partnership or the parent holding company on an annual basis.

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Industry Background

Most of the real estate sector has been hit hard by COVID-19. Commercial real estate properties whose owners and tenants have suffered the greatest declines in their businesses have been the biggest casualties. Hospitality has led the sector down as travel for both business and pleasure nearly ground to a halt in April. Retailers, especially those that were already on the ropes before the coronavirus hit, have similarly paid the price. Although there is evidence that the economic upturn has helped lift the real estate sector off the bottom, it is still uncertain as to what the trajectory of the recovery will be.

At this point, there are only tentative signs of change. Property sales activity is still down sharply from pre-COVID levels. Sam Zell says that industry participants are still behaving like a deer in the headlights, uncertain about which way to move. Even though we are now four months past the steepest part of the economic decline, potential buyers are expecting to obtain steep discounts that reflect current levels of business activity, but sellers still want prices that are at or near pre-COVID levels.

One way or another, the wide spread between bid and ask prices will eventually narrow. For now, the potential sellers, even those who are in default on their rent or debt service payments, are waiting and hoping that the recovery in the economy will eventually lift business activity to levels that will allow them to meet their monthly obligations, even as some of their landlords and lenders begin to take action in court to begin the eviction or foreclosure processes.

Some are still anticipating additional help from the Federal government. According to the New York Times, Treasury Secretary Steve Mnuchin, who recently asked Congress to pass more stimulus this month[1], said "We are monitoring economic conditions closely. Certain industries, such as construction, are recovering quickly, while others, such as retail and travel, are facing longer-term impacts and will require additional relief."

Until that question of Federal relief is resolved, those sellers that are able to hold on will refrain from taking any action now. Meanwhile, as the economic recovery continues and as long as there is no significant "second wave," more businesses will likely open their doors, continue to expand their service offerings and see customer traffic move back towards pre-pandemic levels.

On the other hand, tenants and borrowers that were facing difficulties before the pandemic hit will not be able to forestall the inevitable, even if they receive some assistance from the Federal government. Consequently, we should expect to see a rise in foreclosures, bankruptcies and restructurings. Some investors are gearing up to benefit from their pain. For example, KKR has raised a $950 million fund[2] targeting the riskiest "B-pieces" of CMBS securitizations.

While the real estate remains in purgatory, some market watchers are contemplating bigger changes. The Economist, for example, wonders whether the downturn will mark the end of mainstream financial institutions' "love affair" with property. It suggests that big insurers and pension funds, who have been the key drivers of the property bull market, will be replaced by private equity vultures looking to put capital to work in distressed situations for outsized gains. Blackstone, which works both sides of that fence, recently said that it would shutter a small fund that invests primarily in CMBS securities.

The precariousness of the industry's position was not lost on Colony Capital's founder and Executive Chairman Thomas J. Barrack, Jr. Early on in the pandemic-driven downturn, he penned a blog post entitled "Preventing COVID-19 from Infecting the Commercial Mortgage Market[3]." to express his views of steps needed to address the crisis that was on the industry's doorstep. Mr. Barrack called for decisive action by the government to avert a looming crisis in the CMBS market that could have severe long-term consequences for the economy. He advocated a menu of actions, including financial subsidies, regulatory relief, forbearance and liquidity support, a suspension of mark-to-market accounting standards and a delay in implementing the new "current expected credit loss" (CECL) accounting standard to head off substantial defaults and a drying up of market liquidity that could accelerate the downturn.

It is not clear whether Mr. Barrack is happy with all that the Federal government, the Federal Reserve and the financial markets have done; but even though defaults persist and many junior CMBS securities are trading at big discounts to their par value, there is as yet no evidence of the sort of panic that could bring the commercial real estate property and financing markets crashing down. If the economy continues to recover and the Federal government provides a modicum of additional support (or at least does not stand in the way), then many tenants and borrowers will eventually be able to resume their payments and negotiate some combination of partial forgiveness or tacking on of arrearages to the back end of their leases and loans.

Business Overview

History

Colony Capital, LLC was founded in 1991 by Thomas J. Barrack, Jr., a Los Angeles-based lawyer who had been a Principal with the Robert M. Bass Group and also served in the Reagan administration as Deputy Undersecretary of the Dept. of the Interior. Over the years, Mr. Barrack has served on many corporate boards, including First Republic Bank (whose management buyout was co-led by Colony), Carrefour S.A., Accor, S.A., Challenger Financial Services Group Limited (Australia) and Continental Airlines. He was awarded France's Chevalier de la Legion d'honneur (knight of the Legion of Honour) by President Nicolas Sarkozy in 2010.

From the outset, Colony sponsored private equity real estate funds whose investors were typically large institutions, such as pension funds and insurance companies. In its initial year (1991), it launched the $250 million Colony Investors I, L.P. which acquired a distressed real estate portfolio from the Resolution Trust Corporation. As its operations grew, it expanded its offerings to retail investors and its "management platforms" grew to include listed and non-listed REITs and registered investment companies.

There have been eight <u>Colony Investors</u> funds with a total combined equity investment of $8.7 billion and five <u>Colony Distressed Credit & Special Situation Funds</u> with a total combined investment of $5.3 billion. In addition, Colony has sponsored the Colony Asia fund, the Yangtze Special Situations and, in a partnership with Eurazeo[4], two Colazeo Investors funds.

Colony Financial IPO. In September 2009, Colony Capital completed the initial public offering of Colony Financial, Inc. (CLNY), a real estate finance company externally managed by Colony that was organized to acquire, originate and manage a diversified portfolio of commercial real estate-related debt instruments, primarily commercial mortgage loans and other related investments, such as commercial mortgage-backed securities (CMBS). In its IPO, Colony Financial sold 12.5 million shares at $20 each for $250 million. Colony Capital, LLC purchased 250,000 shares of Colony Financial at the IPO price in a private placement.

Merger of Colony Financial and Colony Capital. In April 2015, Colony Financial's operating subsidiary, Colony Capital Operating Company, LLC (OP), completed the acquisition of substantially all of Colony Capital, LLC's (CCLLC) real estate and investment management businesses and operations. At the time of the acquisition, CCLLC had sponsored $24 billion of equity investments in real estate funds and investment vehicles that had collectively invested over $60 billion of capital. Following the acquisition, Colony Financial changed its name to Colony Capital, Inc. and became a self-managed REIT.

Merger with NorthStar. In January 2017, CLNY merged with NorthStar Asset Management Group Inc. (NSAM) and NorthStar Realty Finance Corp. (NRF). The all stock merger of equals had an initial equity market capitalization of approximately $9 billion and AUM of $58 billion. Upon completion of the merger, the company was renamed Colony NorthStar.

Like Colony, NSAM, which was spun out of NRF in 2014, was a global asset management firm focused on managing real estate and other investment platforms. NRF was a REIT that invested primarily in commercial real estate properties and securities. On a pro forma combined basis, the $58 billion of AUM of the three companies would have ranked fifth in size among global real estate investment managers at the time. In announcing the transaction, the management teams highlighted the benefits and strategic advantage that increased scale would bring the combined companies and the prospects to boost profitability through cost synergies.

It should be noted, however, that in the fourth quarter of 2015, nearly a year before agreeing to merge with CLNY, NRF cut its dividend and began pursuing asset sales to reduce debt. It also explored a potential recombination with NSAM. This effort was undertaken to reduce the company's leverage and boost its stock price, which NRF believed was well below the stock's underlying net asset value. NSAM, meanwhile, hired Goldman Sachs in January 2016 to explore strategic alternatives to maximize shareholder value.

The tri-party merger was accounted for as an acquisition of NSAM and NRF by CLNY. The value of the consideration was $6.7 billion: $2.7 billion for NSAM and $4.0 billion for NRF. CLNY recorded $1.4 billion of goodwill in the merger, all of which was assigned to NSAM. The goodwill represented the value expected from economies of scale and synergies from combining the operations of the three companies.

Colony NorthStar's Financial Performance Following the January 2017 Merger. Since completing the merger in 2017, CLNY has recorded increasing losses each year, much of which has been due to goodwill write-offs, including $316 million in 2017 and another $800 million in 2019. In June 2018, CLNY changed its name back to Colony Capital.

Table 1

Colony Capital, Inc.

Summary Financial Data: 2015-2019

(in $000s)

	12 Months 31-Dec-15	12 Months 31-Dec-16	12 Months 31-Dec-17	12 Months 31-Dec-18	12 Months 31-Dec-19
Statement of Operations Data:					
Total revenues	631.8	642.5	2,549.5	2,386.9	2,326.3
Income (loss) from continuing operations	277.2	293.7	(120.1)	(534.8)	(1,650.7)
Income (loss) from discontinued operations	(21.2)	(3.0)	55.4	39.6	1,501.8
Net income (loss)	256.0	290.8	(64.6)	(495.2)	(148.9)
Net income (loss) attrib. to CLNY stockholders	107.4	67.2	(333.1)	(632.7)	(1,152.2)
Funds from operations (FFO) attrib. to CLNY	237.7	158.5	(25.8)	(101.8)	(1,150.1)
Core FFO	NA	NA	NA	333.3	266.3
Per Share Data:					
EPS from continuing operations - diluted	$ 0.71	$ 0.40	$ (0.70)	$ (1.31)	$ (3.38)
EPS attributable to CLNY stockholders - diluted	$ 0.65	$ 0.39	$ (0.64)	$ (1.28)	$ (2.41)
Dividends per common share	$ 1.01	$ 1.08	$ 1.08	$ 0.44	$ 0.44
Balance Sheet Data:					
Total assets	10,039.3	9,761.0	24,785.7	22,215.2	19,832.2
Total debt	4,178.8	3,715.6	11,024.7	10,040.0	9,216.9
Noncontrolling interests	2,569.3	2,843.1	3,975.6	4,149.7	3,716.5
Preferred stock	625.7	625.8	1,636.6	1,436.6	1,033.8
Common equity	2,221.2	2,148.0	6,771.3	5,569.4	4,182.3
Total capitalization	9,595.0	9,332.5	23,408.3	21,195.7	18,149.4
Leverage:					
Total debt-to-total capitalization	43.6%	39.8%	47.1%	47.4%	50.8%
Debt, N/C int. and pref. stock-to-total capital.	76.9%	77.0%	71.1%	73.7%	77.0%

Source: Colony Capital, Inc's 2019 10-K and Lark Research calculations.

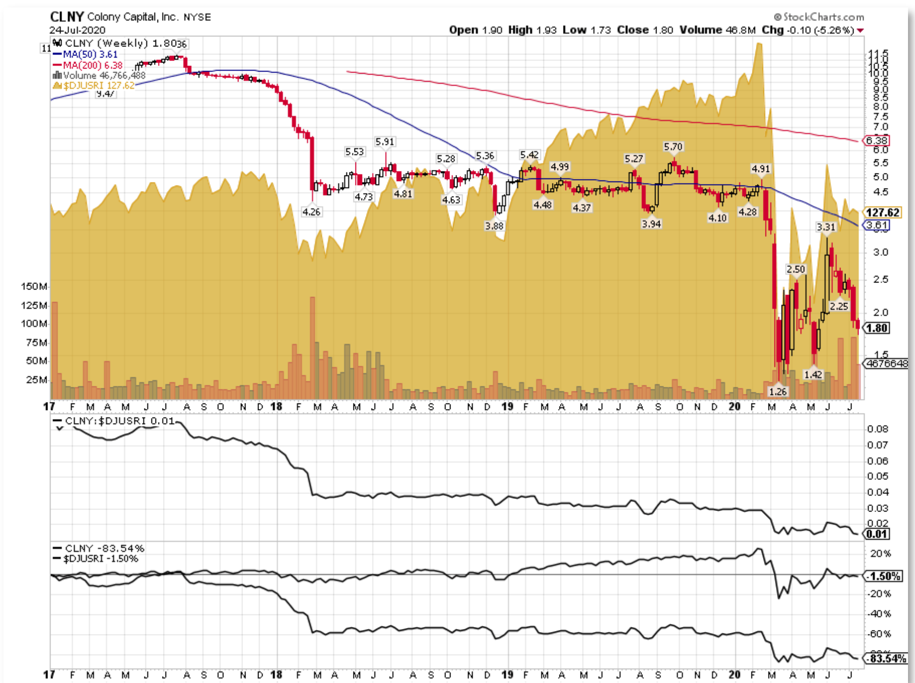
The table above highlights the deterioration in Colony's profitability since its mergers with NSAM and NRF. As noted, much of the deterioration is due to the write-offs of goodwill and intangibles, which are non-cash charges. 2019's results were dominated by the recording of the $1.5 billion gain from the sale of the industrial segment, which was included in discontinued operations. Since most of this gain was attributable to noncontrolling interests, Colony recorded a large $1.15 billion loss for the year.

Similarly, NAREIT's definition of FFO does not permit addbacks for impairments of goodwill or intangibles, which was the key factor in Colony's posting FFO of negative $1.15 billion in 2019.

In 2019, Colony announced that it would redeploy its capital from its traditional real estate businesses. It would over time divest its healthcare, hospitality and industrial real estate properties, most of its debt and equity investments and its investment management business, which was the original and core business of Colony Capital. Capital raised from selling these assets would be redeployed to the digital business. In making the shift, Mr. Barrack highlighted the risk that technology could render much of traditional real estate obsolete.

Still, it is quite surprising that Colony would decide to exit over time the traditional real estate sectors and investment management platform, which has been the core engine of its profitability since its founding. While I believe a good case can be made that Colony will benefit from a less complex business mix, it has over most of its history been able to navigate the business cycle in traditional real estate sectors well, as a result of its experience in distressed real estate investing, which lends support to staying the course.

Stock Price Performance. It has been a rough ride for CLNY shareholders since the NorthStar merger. In the three and one-half years that followed, CLNY stock has lost 83.5% of its value on a total return basis (i.e. including dividends, which have been suspended since the onset of COVID-19). By comparison, the MSCI U.S. REIT Total Return Index (RMS) is up 1.9%.



Courtesy of StockCharts.com

The underperformance of CLNY is consistent across 3-year, 1-year, year-to-date and post-COVID timeframes. Year-to-date, CLNY has lost 60% of its value, compared with a 15% decline for the REIT sector. Since early March, right before the onset of COVID, CLNY is down 48.5%, compared with a 14.0% decline for REITs; but from the bottom in late March, CLNY has snapped back 22.5% vs. the 23.7% gain for the REIT sector. (The rebound in CLNY was meaningfully higher until just recently, before Colony announced the issuance of $300 million of 5.75% Exchangeable Senior Notes which are dilutive to its common shares.)

Current Business Portfolio. Today, Colony is a global investment management firm with approximately $49 billion of assets under management (AUM), $36 billion of which is managed on behalf of third-party institutional and retail investors in private funds, listed and non-listed REITs and registered investment companies. The remaining $13 billion represents investment interests on its own balance sheet, managed on behalf of its stockholders.

Following the sale of the industrial segment in December 2019, Colony now classifies its operations in six segments. These include:

a. its Digital Real Estate and Investment Management segment ("Digital"),
b. a 71% interest in a portfolio of 358 healthcare properties,
c. a 94% interest in a portfolio of 157 hospitality properties,
d. a 36.5% interest in Colony Credit Real Estate, Inc. (CLNC),
e. interests in various other equity and debt investments
f. its other investment management businesses.

Digital Real Estate and Investment Management

Creation of the Digital Business. In 2018, concurrently with the sale of its European data center business, DATA4, Colony launched a U.S. digital infrastructure fund called Digital Colony Partners, L.P.[5] (DCP or Digital Colony) in partnership with Digital Bridge Holdings, LLC[6] (DBH or Digital Bridge). In June 2019, Colony announced that it had obtained $4.05 billion in commitments for DCP.

In July 2019, Colony acquired DBH. Digital Bridge was founded by Marc Ganzi and Ben Jenkins, two entrepreneurs with demonstrated success, knowledge and connections in the telecommunications infrastructure sector. Along with the DBH acquisition, Colony announced that Mr. Ganzi would become CEO of Colony, succeeding Mr. Barrack, who has returned to the position of Executive Chairman. Mr. Jenkins was appointed CIO of the Digital business. With the leadership change, Colony said that growing and expanding its digital real estate and investment management business would be the company's primary focus going forward.

On December 20, 2019, Colony acquired from third party investors a 20.4% interest in Data Bridge Holdings, LLC and its wholly-owned subsidiary, DataBank Holdings, Ltd.[7] (collectively, DataBank), a portfolio company of DBH that provides retail colocation and managed services in nine major markets in the U.S. Despite the minority stake, Colony is deemed to have control over DataBank (presumably because DBH has voting rights over the shares held by noncontrolling interests).

The aim of Digital is to own, invest in and manage assets, such as colocation facilities, cellular towers, fiber optic networks and small cell radio access nodes that offer data center, networking and telecommunication services on both a wholesale and retail basis. With the continuing global growth in technology and telecommunication services due to expanding use and the implementation of newer technologies, such as 5G mobile networks, edge computing and the "internet of things," Colony sees the potential for its Digital business to grow at a high single-digit to low double-digit rate for years to come. Consequently, it plans to redeploy capital from its other businesses to Digital over the next few years.

Digital Colony Partners, the $4.05 billion fund, is targeting investments worldwide in telecommunications network infrastructure. Its portfolio[8] currently consists of minority investments in 12 companies, including Zayo Group Holdings[9], a provider of bandwidth infrastructure services in the U.S. and Europe that was taken private in March 2020 in a $14.3 billion buyout by a consortium led by Digital Colony and EQT Infrastructure IV fund, and

Vantage Data Centers[10], a developer and operator of hyperscale data centers, also in the U.S. and Europe.

As of the end of 2019, Colony reported that pro forma for its planned participation in the Zayo transaction, DCP had already committed to invest 73% of its $4.05 billion of funding. On July 7, it announced that a Colony-led investor group will invest $1.2 billion, with $200 million from Colony's own balance sheet, in Vantage's data center portfolio, including 12 stabilized North American data centers. This could take the form of a loan to Vantage that is collateralized by customer leases. The financing will provide capital for Vantage to continue its planned expansion in Europe. Colony did not disclose the identities of the other members of the investor group; but if the entire investment is coming from DCP, it would represent the balance of its remaining available funding.

This week, Highline do Brasil, a DCP portfolio company, has reportedly[11] met the minimum 15 billion reais ($2.9 billion) bid price for Brazilian telecom provider Oi's mobile assets.

Acquisition Costs and Accounting Impact of the Acquisitions of DBH and DataBank.

Colony acquired DBH for $328.6 million in cash, OP units and deferred compensation. At the time of the acquisition, DBH managed $20 billion of digital infrastructure globally and its portfolio included 342,000 sites and 39 data centers. In conjunction with the acquisition, Colony also recorded a gain of $51.4 million on its 50% share of the manager of Digital Colony Partners.

Colony acquired its 20% stake in DataBank for $185.7 million, mostly all of which was in cash. Since it is deemed to control DataBank, it added all of Databank's assets and liabilities to its balance sheet and also marked up the value of the 80% non-controlling interests to the same price that it paid for its 20% stake. In total, this added $1.7 billion of assets, $539 million of debt and $736.6 million of non-controlling interests to Colony's balance sheet.

A breakdown of the accounting impact of the acquisitions of DBH and DataBank is given in Table 2 below.

As of March 31, I calculate that CLNY's total direct investment in its Digital segment was about $680.7 million. This included the $380 million cost to acquire DBH, $185.7 million to acquire its 20% stake in DataBank and $115 million (out of a total commitment of $250 million) for its investment in DCP. In July, as already noted, CLNY agreed to invest $200 million in Vantage Data Centers. When the remaining DCP investment and the Vantage investment are funded, CLNY will have $1.02 of direct investments in Digital.

As a result of its investment in DBH and the investments made so far by DCP, Digital now has $20.1 billion of assets under management (AUM) and $7.7 billion of fee earning equity under management (FEEUM). Its goal is to bring AUM and FEEUM to a total of about $40 billion by the end of 2021.

Table 2

Colony Capital, Inc.

Accounting Entries and Estimated Valuations for the Acquisitions of DBH and Databank.

(in $000s)

	DBH	Databank
Consideration		
Cash	181,167	182,731
Deferred consideration	35,500	
OP Units issued	111,903	2,962
Total consideration for equity interest acquired	328,570	185,693
Fair value of equity int. in Digital Colony Manager	51,400	
Total consideration	379,970	185,693
Assets acquired		
Cash		10,366
Real estate		847,458
Assets held for sale		29,114
Goodwill	247,248	479,082
Intangible assets	153,300	222,455
Other assets	13,008	106,648
Total assets acquired	413,556	1,695,123
Total consideration and liabilities assumed		
Debt		539,155
Tax liabilities, net	17,392	113,228
Intangible and other liabilities	16,194	132,480
Noncontrolling interests in investment entities		724,567
Total consideration	379,970	185,693
Total consideration paid and assumed	413,556	1,695,123
Purchase price (i.e. enterprise value)		
Debt		539,155
Noncontrolling interest		724,567
Total consideration	379,970	185,693
Total purchase price	379,970	1,449,415
Estimated annualized EBITDA	39,468	61,632
Implied EBITDA multiple	9.6	23.5

Source: CLNY 2020 10-K (Note 4), CLNY 20Q1 Supplemental Financial Report and Lark Research estimates (for annualized EBITDA and the implied EBITDA multiple)

Valuation of the Digital Business. At this point, it is hard to value the Digital segment, given its limited history. For now, I have developed rough estimates of the acquisition multiples for the valuation of the pieces of Digital based upon annualized 20Q1 EBITDA and also for the entire segment based upon annualized core FFO.

Table 3

Colony Capital, Inc.

Estimated Consolidating Statement of Operations for the Digital Real Estate and Investment Management Segment for the quarter ended March 31, 2020

(in $000s)

	DRE	DIM	DEI	Total
Revenues				
Property operating income	45,149			45,149
Interest income		37		37
Fee income		18,944		18,944
Other income	18	198	160	376
Total revenues	45,167	19,179	160	64,506
Expenses				
Property operating expense	16,906			16,906
Interest expense	9,402			9,402
Investment and servicing expense	4			4
Transaction costs	193	228		421
Depreciation and amortization	29,450	7,183		36,633
Compensation expense	8,596	6,000	897	15,583
Administrative expenses	3,700	3,084		6,784
Total expenses	68,611	16,495	897	86,003
Other income				
Other gain (loss), net	(560)		(2,968)	(3,528)
Equity method earnings (losses)			468	468
Total other income	(560)	0	(2,500)	(3,060)
Income (loss) before income taxes	(24,004)	2,684	(3,237)	(24,557)
Income tax benefit (expense)	5,709	(574)	202	5,337
Net income (loss)	(18,295)	2,110	(3,035)	(19,220)
Net inc. (loss) attrib. to noncontrol. interests				
Redeemable noncontrolling interests			(548)	(548)
Investment entities	(14,503)			(14,503)
Operating Company		(411)		(411)
Net inc. (loss) attrib. to CLNY shareholders	(3,792)	2,521	(2,487)	(3,758)
EBITDA				
Total revenues	45,167	19,179	160	64,506
Property operating expense	(16,906)	0	0	(16,906)
Investment, servicing & transaction Costs	(197)	(228)	0	(425)
Compensation expense	(8,596)	(6,000)	(897)	(15,583)
Administrative expense	(3,700)	(3,084)	0	(6,784)
EBITDA	15,408	9,867	(737)	24,538
Less 80% of EBITDA alloc. to n/c interests	(12,326)			(12,326)
EBITDA attrib. to CLNY shareholders	3,082	9,867	(737)	12,212

Notes: (1) DIM = Digital Real Estate; DIM = Digital Investment Management; DEI = Digital Equity Interest

(2) The table above is derived from the disclosures provided in the MD&A section of CLNY's 2020 first quarter 10-Q (p. 74-75) and in Schedule IIIc – Consolidated [sic] Segment Operating Results on page 22 of the 20Q1 Supplemental Financial Report (included in CLNY's 8-K filing dated May 8, 2020).

My EBITDA calculations are given in Table 3 on the previous page. Using the company's disclosures in its 20Q1 MD&A for Digital and the consolidating segment earnings table given in the 20Q1 earnings segment, I estimate that DBH generated 20Q1 EBITDA of $9.9 million or $39.5 million annualized (multiplying by four). DataBank generated 20Q1 EBITDA of $15.4 million ($61.6 million annualized), but only 20% of that or $3.1 million ($12.2 million annualized) was attributable to Colony.

As shown at the bottom of Table 2 above, these EBITDA estimates translate into enterprise value (based upon acquisition costs) to EBITDA multiples of 9.6 for DBH and 23.5 for DataBank.

The 23.5 times EBITDA valuation multiple for DataBank looks high, but it is merely an accounting construct. Although it appears that Colony did indeed pay a very high price to gain that 20% controlling interest, it is not clear to me that the remaining 80% noncontrolling interest should be valued at the same price. Of course, Colony would never admit that the rest of the DataBank equity is worth less than what it paid and under the current accounting rules, it probably would not be allowed to do so; but the write-up of the noncontrolling interest was noncash and the primary cause of the $479 million of goodwill recorded.

Another way to look at valuation is through equity as a multiple of core FFO. Digital reported 20Q1 core FFO of $8.2 million (which is $33.2 million annualized). I believe that core FFO is an appropriate measure because it picks up (non-cash amortization of intangibles as well as non-real estate depreciation).

During the quarter, Colony transferred a legacy consolidated fund to the Digital segment that suffered unrealized losses as a result of the steep decline in the equity markets during March. Those losses reduced the Digital segment's overall profitability, which is another reason why Digital's annualized one quarter valuation seems high. (Colony, I believe, has not disclosed its net equity investment in that legacy fund, so I cannot adjust my estimate for Colony's total investment in Digital to account for it.)

As noted above, Colony's total equity investment in Digital at the end of 20Q1 was $680.7 million. That works out to a core FFO multiple of about 20.5 times, which is high, but reflects what should be temporary losses in the transferred legacy fund and also perhaps the relatively low or perhaps negative contribution from DCP, which is still early in its investment life cycle.

Although Colony has not yet received much of a return from its investment in Digital, it is still early days. With the new investments already committed and others yet to come, the business will hopefully demonstrate earnings growth and a respectable return on investment over time.

Healthcare

As of December 31, 2019, CLNY had a portfolio of 358 healthcare properties, including 154 senior housing properties, 106 medical office properties, 89 skilled nursing facilities and 9 hospitals. The carrying values of each property class and other key measures are summarized in Table 4 below:

Table 4

Colony Capital, Inc.

Healthcare Properties Portfolio at December 31, 2019.

(in $000s, except unit data)

	Number of Properties	Number of Beds/Units or mil. sf.	Initial Cost plus Improvements	Net Book Value	Debt	NBV – Debt	Debt / NBV (LTV)	Approx. NBV/Bed, Unit or sf.
United States								
Assisted Living	108	7,345	1,645,838	1,417,911	1,025,024	392,887	72%	193,000
Hospital	9	456	143,993	133,985	77,778	56,207	58%	293,900
MOB	106	3.8	1,349,161	1,164,346	677,510	486,836	58%	306
Skilled Nursing	83	10,601	1,201,655	1,076,892	753,817	323,075	70%	101,600
Total United States	306		4,340,547	3,793,134	2,534,129	1,259,005	67%	
United Kingdom								
Assisted Living	46	3,082*	682,306	640,691	293,661	347,030	46%	207,900
Total CLNY	352		5,022,853	4,433,825	2,827,790	1,606,035	64%	
Non-Recourse Debt					2,953,706			
Difference					125,916			

Source: CLNY 2019 10-K. * Please note that I have allocated 3,082 beds to the United Kingdom – Assisted Living properties based upon a guess of 67 units per property, which is roughly the average number of units per property for all of CLNY's assisted living communities. CLNY does not separately disclose the number of units for the U.K. properties.

Colony's healthcare properties are owned in investment vehicles in which third-party investors participate. At year-end 2019, Colony reported that its overall equity interest in the healthcare segment was 71%, but its interests in the various portfolios that comprise the segment range between 69.6% and 81.3%.

The $2.83 billion of healthcare property debt, as shown in Table 4 above was calculated by summing all of the loans (or encumbrances) against each of the individual properties. The total does not equate exactly to the $2.95 billion of non-recourse healthcare properties debt that Colony reported in its financial statements. The difference of $125.9 million, probably includes the debt of healthcare properties that are held for sale – six skilled nursing facilities with a total of 909 beds and a carrying value of $57.7 million that were encumbered with $50.9 million of debt. The balance of $75.2 million is unexplained.

Substantially all of the healthcare properties were acquired in the NorthStar merger and recorded at their estimated fair values as of the merger date of January 9, 2017. Consequently, the net book value of the properties, which is net of depreciation and improvements since the merger, should under normal conditions be a reasonable proxy for their current market value. Under this methodology, I estimated that Colony's 71% interest in the healthcare properties is worth $1.14 billion which is equal to the net book value of $4.43 billion minus outstanding debt of $2.89 billion multiplied by 71%. The valuation represents a capitalization rate of 6.8% of the portfolio's 2019 net operating income.

Table 5

Colony Capital, Inc.

Estimated Value of Colony's Equity Interest in Healthcare Properties and the Implied Capitalization Rate of the Healthcare Properties at December 31, 2019.

(in $000s)

Initial cost plus improvements	5,022,918
Accumulated depreciation	(589,036)
Net book value of properties	4,433,883
Less total encumbrances	(2,827,740)
Equity in properties	1,606,143
Colony's interest in the properties	71%
Equity value of Colony's interest	1,140,362
2019 net operating income	301,219
Implied capitalization rate	6.8%

Source: CLNY 2019 10-K and Lark Research calculations. Initial cost plus improvements includes $81 million of subsequent improvements.

Yet, conditions have not been normal since the onset of COVID-19. The pandemic has hit healthcare providers (and by extension, the properties that they operate) quite hard. In its quarterly 10-Q filing, Colony said that its communities as a whole were experiencing a "moderate level" of confirmed COVID cases. Nationwide efforts to contain the virus have forced temporary closures of medical offices, restricted admissions of new residents and patients to senior housing and skilled nursing facilities and raised operating costs. Colony further stated that beginning in April, some tenants have defaulted on their rent payments while others have sought flexibility in terms to help them manage the cash flow strains affecting their operations. Colony anticipates that the restrictions on admissions will lead to a decline in occupancy at its senior housing and skilled nursing facilities in future quarters.

As a result of these pressures, Colony says that it is experience declining revenues and operating margins in its healthcare business. It has begun discussions with its lenders to gain financial flexibility by deferring its payment obligations and seeking waivers for payment defaults and other potential covenant violations. As of May 11, it reported payment defaults and/or covenant violations on $377.1 million of healthcare loans. The company is uncertain about the extent and duration of the pressure on its healthcare business, which depends on the course of the pandemic.

While the near-term effects are significant, Colony is fortunate to have had the foresight to refinance $2.3 billion of its total $2.95 billion of healthcare debt obligations in 2019. It extended its debt maturities on the refinanced loans to 2024, addressing all near-term debt maturities. This should help to allow it to wait for a sector recovery to get underway in order to maximize the value of the portfolio.

Table 6

Colony Capital, Inc.

Healthcare Properties Net Operating Income and Occupancy Rates at December 31, 2019.

(in $000s, occupancy data in %)

	12 Months 31-Dec-17	12 Months 31-Dec-18	12 Months 31-Dec-19		3 Months 31-Mar-19	3 Months 31-Mar-20
Net Operating Income						
Senior Housing - Operating	70,224	66,343	65,077		17,335	16,853
Medical Office Buildings	53,550	56,288	52,681		12,424	12,991
Net Lease - Senior Housing	56,732	60,627	60,859		15,379	14,304
Net Lease - Skilled Nursing Facilities	103,051	103,225	102,527		25,744	22,523
Net Lease - Hospitals	20,855	19,581	20,075		5,363	1,951
NOI - Healthcare	304,412	306,064	301,219		76,245	68,622
Percent change in healthcare NOI		0.5%	-1.6%			-10.0%
Occupancy Rates						
Senior Housing - Operating	87.4%	86.8%	86.5%		86.7%	85.3%
Medical Office Buildings	82.9%	82.3%	82.2%		82.4%	82.2%
Net Lease - Senior Housing	82.9%	82.1%	80.7%		81.4%	79.9%
Net Lease - Skilled Nursing Facilities	82.1%	82.4%	82.7%		82.6%	79.9%
Net Lease - Hospitals	58.4%	58.1%	58.0%		59.5%	64.8%

Source: CLNY's SEC filings, including its 2019 and 2019 10-Ks and 20Q1 10-Q and earnings report.

The COVID-related decline in the profitability of Colony's healthcare business is just starting to appear in its financial statements. In 20Q1, net operating income of the properties, as shown in Table 6 above, declined 10% compared with the prior year, driven by steep declines in profits at hospitals and skilled nursing facilities and smaller declines at its managed and triple net lease senior housing properties.

Second quarter results, which will be reported on August 7, are likely to show further declines as a result of a continuing drop in occupancy combined with higher operating costs. Still, the properties should be on their way back to normal operations. I will be interested in management's outlook for the business: when it expects occupancy rates will improve and what it sees as the likely course of the recovery. Hopefully, the recent surge in COVID infections through most of the South and especially in Texas and Florida will not set back the recovery.

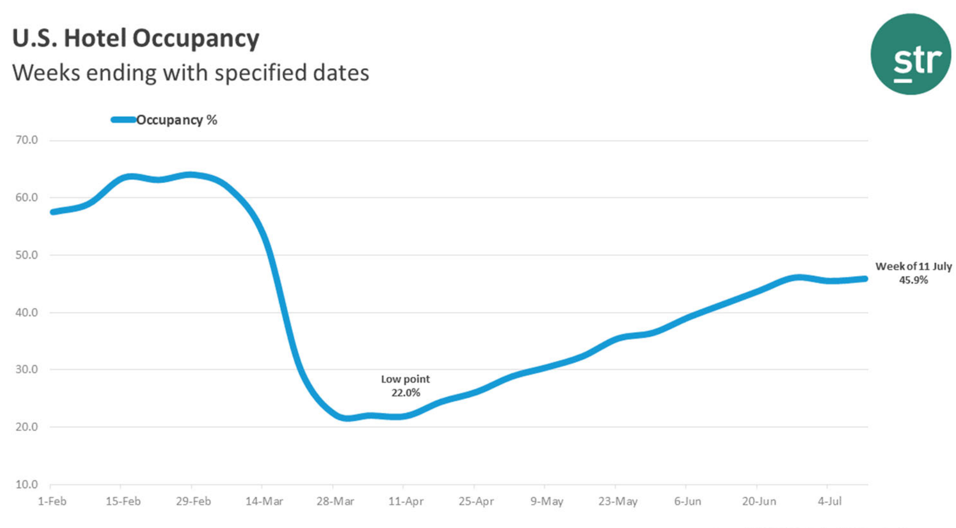
With the sharp decline in profitability and uncertainty about the path of the recovery, healthcare property values are almost certainly lower today than they were six months ago. My check of the data on healthcare property transactions compiled by S&P Global Market Intelligence (SPGMI) shows that few properties have traded this year and those that have appear to have traded at valuations that are meaningfully below the carrying values of healthcare properties at Colony and most other healthcare REITs. Consequently, my estimate of the value of Colony's

71% interest in its healthcare property portfolio, which is based upon the properties' current carrying value (and assessed fair values in 2017), is higher than what the properties would trade for today. Few healthcare property owners would likely sell at today's lower prices. My $1.14 billion estimate may therefore represent a valuation threshold, give or take 10%, at which Colony would consider a sale of all or part of the portfolio. So far, it appears that Colony can wait until prices improve, even if it takes a year or two.

Hospitality

As of March 31, CLNY's hospitality segment consisted mostly of branded extended stay and select service hotels located in major U.S. metropolitan and suburban markets in 26 states across the U.S. The portfolio's largest geographic concentrations (based upon profitability) are in California (28.4%), Texas (17.2%) and Florida (13.9%). Its hotels are affiliated with Marriott (whose various nameplates account for 75.5% of the total portfolios' 29,078 rooms), Hilton (18.6%), Hyatt (2.7%), International Hotels Group, which owns the Holiday Inn brand (1.2%) and other (2.5%). The properties are managed by third parties, including Marriott, Island Hospitality Group and Aimbridge Hospitality.

The economic fallout from COVID-19 has weighed heavily on Colony's hospitality properties and indeed the entire industry. According to STR[12], a hospitality data and analytics provider (and now a division of CoStar Group[13]), industry occupancy bottomed at around 20% in early- to mid-April[14] (down from about 70% in the prior year period) and has been climbing slowly but steadily since.



As of May 11, Colony was in payment default or non-compliance on $3.16 billion (out of a total of $3.51 billion) of its hospitality debt. That debt has recourse only to the hospitality assets and not to Colony or its non-hospitality assets. CLNY has received notices of acceleration on $780 million of the defaulted debt. On July 14, the Real Deal, a Los Angeles-based real estate news service, reported that Colony may lose control of two of the portfolios[15] (Inland and THL) apparently because lenders have granted only short-term forbearance and the properties in the portfolios have been facing significant deficits which Colony is unable or unwilling to finance.

Through its property managers, Colony has taken steps to minimize the operating expenses of its hotel properties. It has also deferred about $95 million of non-essential capital expenditures originally planned for 2020. It is in active negotiations with lenders seeking forbearance, debt modifications, extensions of near-term maturities and other accommodations.

In a May 22 8-K filing, Colony disclosed key operating and financial metrics on seven hospitality real estate portfolios. The company said that it was providing this one-time disclosure in light of the COVID-19 pandemic to enhance visibility and transparency as it evaluates its strategic and financial alternatives for these properties. On May 27, Bloomberg reported[16] that the company had hired Moelis & Company to help it explore its options for its hospitality business.

CLNY says that it cannot predict when its hospitality business will return to normal levels. However, STR says that the industry has reached the 45% occupancy threshold, which it says is breakeven for limited service hotel operators[17]. I am not sure how STR defines breakeven, but it probably does not include debt service costs. Still, the trend suggests that Colony's hospitality properties should be able to resume normal operations soon (if not already) – including hiring back furloughed workers, restoring all services and opening up amenities and other spaces that were previously shut down in April. As occupancy improves, money losing properties that previously could not cover operating costs should begin to generate cash to cover debt service.

Yet, the leveling off of the hotel occupancy rate in July, as shown in the chart above, indicates that the trajectory of recovery in hospitality may not be a smooth straight line up. With 8.3% of its total available rooms in Florida, 14% in Texas and 33.5% in the deep South where COVID has recently been raging, Colony's hospitality properties could experience a delay or even a temporary setback in their recovery.

As a dealmaker and with the help of Moelis & Company, Colony seeks to identify opportunities to take advantage of current dislocations in the market. Although it is not willing at this time to commit significant capital to the business, it is willing to work with other capital providers to exploit these opportunities. At the current implied low valuations for hotel properties, Colony is probably not willing to sell outright; but it might consider a sale that includes contingent consideration that would provide some benefit from the expected recovery in the sector. There may also be opportunities for a third-party investor, perhaps in partnership with Colony, to buy at steep discounts to par value the mezzanine debt and subordinated tranches of the CMBS securities that finance Colony's hotels.

A summary of the 2019 operating and financial statistics for these seven portfolios, as well as debt levels as of March 31, 2020, is provided below.

Table 7

Colony Capital, Inc.

Summary Operating and Financial Statistics for Seven Hospitality Portfolios

Financial performance figures for 2019

	Inland	Innkeepers	New England	K	Courtyard by Marriott	Miami Connection	Hospitality Segment	THL	Total Hospitality Portfolio
Number of properties	48	46	9	20	30	3	156	89	245
Number of keys	6,402	5,948	1,007	1,922	4,379	835	20,493	8,585	29,078
Keys / property	133	129	112	96	146	278	131	96	119
Average age (years)	20	30	17	14	33	28	25	20	23
Improvements since 2018 ($ mil.)	$ 44.0	$ 65.0	$ 2.0	$ 14.0	$ 44.0	$ 15.0		$ 208.0	
Avg. impr./prop. since '18 ($ mil.)	$ 0.9	$ 1.4	$ 0.2	$ 0.7	$ 1.5	$ 5.0	$ 1.2	$ 2.3	$ 1.6
Avg impr. / key since 2018 ($)	$ 6,873	$ 10,928	$ 1,986	$ 7,284	$ 10,048	$ 17,964	$ 5,516	$ 24,228	$ 14,318
2019 Occupancy	76%	76%	80%	77%	69%	83%	75%	71%	74%
2019 Average Daily Rate	$ 125	$ 141	$ 134	$ 107	$ 133	$ 133	$ 130	$ 126	$ 129
2019 RevPAR	$ 96	$ 107	$ 106	$ 82	$ 92	$ 111	$ 98	$ 89	$ 95
Revenue ($ mil.)	$ 241.1	$ 251.3	$ 41.2	$ 61.8	$ 162.6	$ 43.4	$ 801.4	$ 288.4	$ 1,089.8
% growth	0.8%	-1.4%	-7.2%	4.4%	-1.1%	2.1%	-0.7%	-1.4%	-0.7%
NOI before FFE	$ 80.4	$ 85.7	$ 15.8	$ 19.6	$ 54.4	$ 12.4	$ 268.3	$ 88.2	$ 356.5
Margin (%)	33.3%	34.1%	38.3%	31.7%	33.5%	28.6%	33.5%	30.6%	32.7%
FFE	10.5	10.0	1.7	2.5	8.1	2.1	34.9	11.5	46.4
NOI after FFE	$ 69.9	$ 75.7	$ 14.1	$ 17.1	$ 46.3	$ 10.3	$ 233.4	$ 76.7	$ 310.1
Margin (%)	29.0%	30.1%	34.2%	27.7%	28.5%	23.7%	29.1%	26.6%	28.5%
2019 total improvements ($ mil.)	$ 25.6	$ 25.6	$ 1.0	$ 5.6	$ 24.8	$ 6.2	$ 88.8	$ 130.3	$ 219.1
Improv. per property ($ mil.)	$ 0.5	$ 0.6	$ 0.1	$ 0.3	$ 0.8	$ 2.1	$ 0.6	$ 1.5	$ 0.9
Improvements per key ($)	$ 3,998.8	$ 4,304.0	$ 993.0	$ 2,913.6	$ 5,663.4	$ 7,425.1	$ 4,333.2	$15,177.6	$ 7,534.9
Credit Metrics									
Senior Debt ($ mil.)	$ 780.0	$ 755.0	$ 135.3	$ 162.3	$ 415.0	$ 107.0	$ 2,354.6	$ 777.9	$ 3,132.5
Mezzanine Debt ($ mil.)		$ 100.0		$ 57.5	$ 135.0	$ 19.8	$ 312.3	$ 64.8	$ 377.1
Total Debt ($ mil.)	$ 780.0	$ 855.0	$ 135.3	$ 219.8	$ 550.0	$ 126.8	$ 2,666.9	$ 842.7	$ 3,509.6
Total Debt/LTM NOI Before FFE	9.7	10.0	8.6	11.2	10.1	10.2	9.9	9.6	9.8
Tot. Debt Yld. (LTM NOI Aft. FFE)	9.0%	8.9%	10.4%	7.8%	8.4%	8.1%	8.8%	9.1%	8.8%
Total Debt / Key ($)	$121,837	$143,746	$134,359	$114,360	$125,599	$151,856	$130,137	$98,160	$120,696

Source: CLNY 8-K filing dated May 22, 2020.

Six of the portfolios comprise Colony's hospitality segment. The seventh, the THL portfolio, is included in its Other Equity and Debt segment. The THL properties were purchased in a consensual foreclosure in July 2017 by an investor group that included Colony, the Colony Distressed Credit Fund II and Colony THL Co-Investment Partners. Colony itself has a 55% stake in the THL portfolio. Since the acquisition, THL has more spent more than $200 million upgrading the properties.

The identification of the seven portfolios should facilitate inquiries from investors who may be interested in one or more or perhaps even all seven portfolios.

Data from S&P Global Market Intelligence, whose SNL platform tracks public and private property transactions, indicates that the average extended stay hotel traded (acquisitions and dispositions) at about $177,000 per room and the average limited service hotel traded at about $152,000 per room over the one-year period ended July 8, 2020. These two hotel property types account for 25% and 71%, respectively, of Colony's hospitality portfolio.

Applying those valuation averages in roughly the same proportions, I estimate Colony's average room value at $158,000. That translates into an overall estimated value of $4.6 billion for the portfolio. After deducting $3.5 billion of outstanding debt and $193 million that would be due to minority investors, I estimate the equity value attributable to Colony to be $889 million.

This valuation translates into a valuation multiple for the entire portfolio of 4.2 times 2019 full year revenues of $1.09 billion and a capitalization rate of 6.75%, based upon 2019 full year net operating income (NOI), after furnishing, fixtures and equipment (FFE) costs, of $356.5 million. (The capitalization rate on NOI before FFE is 7.75%.)

My valuation estimate should serve as a rough guide at best. Ideally, the valuation should be based upon a consideration of each of 245 properties in the portfolio because valuations vary considerably according to location (which typically correlates highly with profitability). Within the SPGMI database, transaction prices over the past year on extended stay properties range from a low of $82,600 per room to a high of $475,400 per room and limited stay properties range from a low of $54,500 per room to a high of $475,400 per room. It matters whether you are a seller or a buyer – buyers seem to pay more, sellers seem to get less – and there is no disclosure of the sales price for a majority of transactions, especially from sellers.

Furthermore, my valuation is based upon transactions that occurred over the past year (on contracts that were signed months beforehand). There have been no transactions recorded on these property types since April, perhaps in part because 20Q2 results have yet to be reported, but we also know that deal activity has dried up since the onset of the pandemic.

For that reason, if the Colony portfolios were to trade today, they would realize less than my estimated equity value. Indeed, if the press report is correct about the impending receiverships of Inland and THL, those portfolios could be worth zero to Colony. That by itself would reduce my valuation estimate for the portfolios by about $433 million to roughly $446 million.

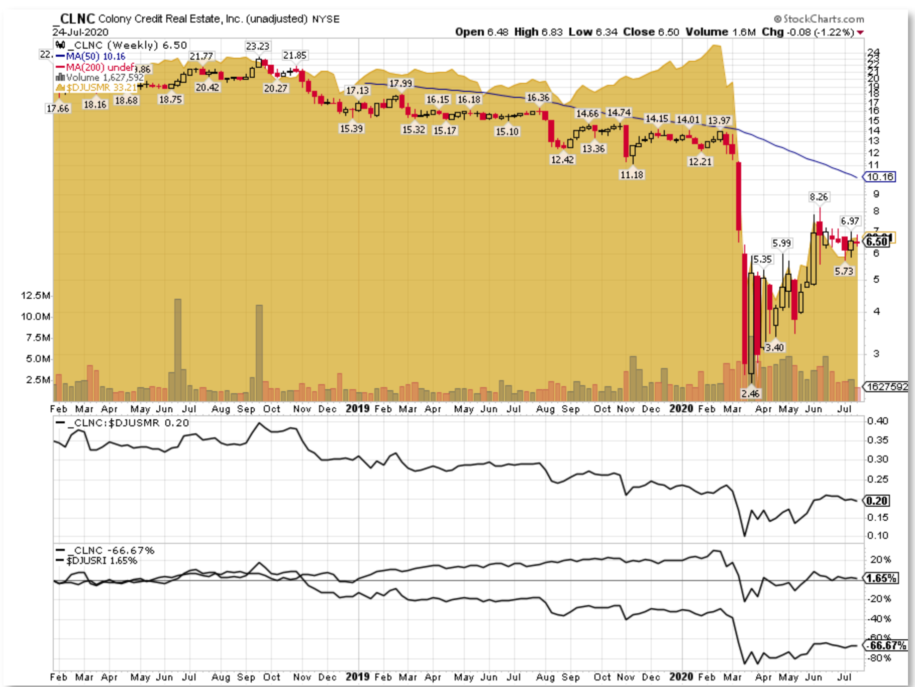
Even so, I will be very surprised if Colony walks away from these two portfolios. If the properties do go into receivership, it could conceivably bid on them during the foreclosure process. Alternatively, it could still negotiate a solution that might involve buying some or all of the mezzanine debt and lower class CMBS tranches at a discount in exchange for agreeing to provide additional support to fund their operations.

Although the current values of the hospitality portfolios are uncertain, I think that it is still possible that occupancy rates could improve sufficiently in reasonable time to support a return to pre-COVID valuation levels. Conceivably, given the modest cap rates that I have assumed, there could conceivably be some upside to my valuation estimate.

Colony Credit Real Estate, Inc. (CLNC)

Colony Credit Real Estate is a publicly-traded, externally managed commercial mortgage REIT that invests in commercial mortgage debt securities and real estate, including senior and mezzanine loans, commercial mortgage-backed securities (CMBS), preferred stock and owned and leased properties. It was created in January 2018 about a year after the Colony NorthStar merger with assets contributed by CLNY and two NorthStar private REITs, which were merged into CLNC. CLNY received a 36.5% equity stake for the assets that it contributed. It also became the external manager of CNLC, which has no employees.

The stock opened at $20.40 in its debut in February 2018 and rose to a peak of $23.23 nine months later. Then, CLNC's quarterly results began to fall short of analysts' estimates due to loan loss provisions recorded mostly on loans made to one borrower in the hospitality sector in the New York metro area. Its stock drifted steadily lower for the next year.



Courtesy of StockCharts.com

In its 2019 third quarter earnings release and conference call, management addressed the weak performance of the stock by announcing that CNLC would alter its strategy. Following a comprehensive strategic reassessment of its business that was conducted with the help of outside experts, CLNC would jettison over time certain assets that it believed did not fit well with its core strategy and expertise. This Legacy, Non-Strategic (LNS) portfolio includes operationally intensive real estate, loans to the retail sector and other underperforming legacy loans that were originated prior to the company's formation.

In conjunction with the announcement of the strategic repositioning, CLNC recorded another $110.3 million of loan loss provisions on retail loans, $248.8 million of impairments on real estate and $22.0 million for its share of losses on joint venture investments. These losses were taken against assets in the LNS segment that were being readied for sale.

With these asset write-downs, CLNC's undepreciated book value per share was $17.77 as of September 30, 2019. On its third quarter earnings conference call, held on November 8, management said that it believed that this figure was a good proxy for the fair market value or net asset value of the company. Some investors apparently disagreed, as CNLC's share price, which had traded at $14.25 the day before, fell nearly 17.5% that day to close at $11.75. It subsequently recovered to a high of around $14.00 before COVID hit in early March.

With the bifurcation of CLNC's portfolio, the company has provided greater disclosure about the composition of its assets with detailed breakdowns of assets included in both the core and LNS portfolios. It also began disclosing information on all loans in its core portfolio, including senior loans, mezzanine loans and preferred equity investments, with each loan rated according to its risk on a scale of 1 to 5, with 1 being "very low risk", 4 being "high risk/delinquent (30+ days)/potential for loss" and 5 being "impaired/defaulted/loss likely". When first put in place at the end of 19Q3, the core loan portfolio was assigned an average rating of 3.1. At the end of 20Q1, the average risk rating had increased to 3.8. CLNC believes that such disclosures will help investors see the inherent value in its assets. For now, though, it shows that the average loan has a higher risk of delinquency and greater potential for default.

Besides the strategic shift, CLNY agreed to amend its management contract so that unrealized loan loss provisions and real estate impairments would be included in the definition of core earnings in the determination of its management fee. (Going forward, these charges can only be excluded upon approval by a majority of CLNC's independent directors.) The change will reduce the annual management and incentive fees paid to Colony. In 20Q1, for example, CLNC's management fee expense declined 30% to $7.9 million from the prior year period.

Immediately before the strategy shift announcement in November, CLNY's Chairman Thomas Barrack, Jr. proposed a transfer of Colony Capital's global credit management business to CLNC. Under this proposal, substantially all of CLNY's credit management team – which has been responsible for managing the credit businesses of both CLNY and CLNC - would transfer to CLNC. The management of CLNC would thereby be internalized.

In his letter, while the specific value to be paid by CLNC for CLNY's credit management business was yet to be determined, Mr. Barrack said that CLNY expected to be paid entirely in cash, perhaps over time, but asserted that it would be accretive to CLNC's earnings from the outset. His proposal assumed that the real estate credit investments currently owned by CLNY would remain with CLNY and it would enter into a new contract with CLNC to manage those assets.

Mr. Barrack's proposal envisioned that CLNC would be led by Darren Tangen, who was CLNY's CFO until November 2018 and President until April 2020, and Kevin P. Traenkle, who had served as CLNC's CEO from its formation in 2017. Yet, Mr. Tangen and Mr. Traenkle have both since left CLNY and CLNC.

On April 1, 2020, CLNC appointed as CEO Michael J. Mazzei, who was the President of Ladder Capital (NYSE:LADR) from 2012 to 2017 and before that headed CMBS operations at Bank of America, Barclays and Lehman Brothers. Andrew E. Witt, a Colony veteran, served as interim CEO after Mr. Traenkle's exit at the end of January until Mr. Mazzei came aboard. He continues to serve as CLNC's COO and also as Chief Credit Offer at CLNY.

CLNY has also installed three new directors at CLNC: Mr. Mazzei, Mr. Witt, and Mark N. Hedstrom, Colony's COO and formerly its CFO, who will serve as Chairman of CLNC. They replace Mr. Traenkle, Mr. Tangen and Richard B. Saltzmann, who was CLNC's Chairman and, up until November 2018, CLNY's President and CEO.

With the collapse in economic activity brought on by COVID-19, CLNC's financial performance has come under significant pressure, leading to the suspension of its $0.10 quarterly dividend. Its 20Q1 results, which include only two weeks of the COVID-related lockdown, provide a hint of what is to come.

Table 8

Colony Credit Real Estate, Inc.

Summary Financial Performance 2018 to 20Q1

(in $000s)

	12 Months 31-Dec-18	12 Months 31-Dec-19		3 Months 31-Mar-19	3 Months 31-Mar-20
Statement of Operations Data:					
Net interest income	115,539	97,678		21,958	27,856
Property net operating income	104,723	253,955		34,954	29,982
Interest expense on real estate	43,437	55,415		13,607	13,078
Depreciation and amortization	90,986	103,220		27,662	17,976
Provision for loan losses	113,911	220,572		0	69,932
Impairments of operating real estate	31,813	282,749		0	4,126
Administrative expense	26,634	31,936		6,653	7,038
Management fee	43,190	42,390		11,358	7,946
Other income (loss)	(1,210)	5,890		(6,722)	(39,614)
Equity in earnings of unconsolidated ventures	23,774	36,942		21,310	17,167
Net income (loss)	(177,353)	(462,648)		14,957	(95,597)
Net income (loss) attrib. to CLNC shareholders	(168,498)	(414,512)		14,908	(78,772)
Per Share Data:					
Net income (loss) attrib. to CLNC shareholders	$(1.41)	$(3.25)		$0.11	$(0.62)
Dividends declared per share	$1.60	$1.65		$0.44	$0.30
Balance Sheet Data - at Period End					
Total assets	8,660,730	7,414,306		8,704,788	7,193,588
Total debt	5,594,245	4,951,412		5,631,183	4.979,329
Total liabilities	5,815,528	5,212,956		5,887,876	5,220,087
Noncontrolling interests in investment entities	72,683	31,631		72,015	21,141
Noncontrolling interests in operating partnership	65,614	50,697		64,968	45,680
Total equity attrib. to CLNC shareholders	2,706,905	2,119,022		2,679,929	1,906,680

Source: CLNC SEC filings, including its 2019 10-K, 20Q1 10-Q and 19Q1 10-Q

CLNC's losses resumed in 20Q1, driven by another boost in the loan loss provision and mark-to-market losses on other parts of the portfolio. The company recorded $69.9 million of loan losses, due to a $29.2 million charge related to the adoption of the new current expected credit loss (CECL) accounting standard and a final $36.8 million charge against the four NY hospitality loans, which was attributed to the COVID-related lockdown in New York. In April, CLNC accepted a discounted payoff of the remaining portion of those loans.

Besides the loan loss provision, CLNC booked $19.5 million of unrealized fair value losses on its securitized mortgage loan assets and a $16.7 million loss on interest rate swaps and foreign exchange. It also recorded (in accumulated other comprehensive income) an unrealized loss of $75 million on real estate securities available-for-sale.

These losses reflected a commercial real estate securities market that was practically in free fall during the early weeks of the COVID crisis. On its 20Q1 conference call, held on May 8, newly installed CEO Michael Mazzei reported that 99% of interest payments on Core portfolio loans were made in April, but some utilized a portion of current reserves to meet their obligations. CLNC remains in very close communication with its borrowers and tenants. It has also been working with its lenders to ensure adequate liquidity, which is a top priority.

Prior to the end of the quarter, CLNC drew $226.5 million on its bank credit facility, leaving it with $340 million outstanding and $29 million in availability (determined from its borrowing base). At the end of the quarter, the company had $393.8 million in cash and cash equivalents and $150.5 million in restricted cash on its balance sheet. As of May 7, CLNC reported that it had $255 million of cash on hand (not including the restricted cash).

On May 6, CLNC amended its bank credit facility, reducing its size from $560 million to $450 million. Borrowings under that facility on that date were $299 million, down from $340 million at the end of 20Q1. It also amended the covenants – most notably by reducing its minimum tangible net worth requirement from $2.1 billion to $1.5 billion - to gain additional flexibility and avoid potential future violations. CLNC also agreed to invest only in senior (and not mezzanine or preferred) loans and securities going forward.

The company has also been working with bank counterparties under its master repurchase facilities (under which it had $723 million of outstanding borrowings as of March 31 and potential borrowing capacity of $2.25 billion). These facilities provide short-term borrowings typically against highly-rated first mortgage loans and similar instruments up to a specified percentage of collateral value. They are subject to margin calls in the event that the value of the collateral falls below specified minimums.

At March 31, CLNC had $83.4 million of restricted cash pledged as margin against collateral, up from $19.5 million at the end of 2019. This cash margin almost certainly increased in April. In order to sustain and preserve its master repurchase financing and stave off future margin calls, CLNC has been agreeing to reduce the advance rates (to provide lenders with a greater collateral cushion against their outstanding loans).

While these proactive measures are necessary (and demonstrate that CLNC management is on top of the situation), they mostly just buy the company time. If the value of its assets keeps falling, but its liabilities hold constant (or decline at a slower rate), CLNC's equity capital will steadily be eroded. The company can buy time and absorb losses by not reinvesting loan repayments, but this permanently reduces its capital base, making it harder to grow its profits on the market upturn to meet its debt obligations and provide income and a return to its shareholders. CLNC's hope is that the commercial real estate market which bottomed in April, will continue to recover quickly, so that its profitability will be restored, losses on its investments avoided and debt obligations kept current.

One of the greatest problems for CLNC, however, is its holdings of preferred equity, mezzanine debt and the non-investment grade "B-pieces" of CMBS securitization pools. These are nearer to the bottom of the totem pole in terms of priority, so they are second and third in line, after the equity interests, to absorb losses suffered on the assets (e.g. real estate and CMBS) that back them.

At March 31, CLNC had investments of $318.2 million of mezzanine loans, $267.8 million of preferred equity and other loans. $20.9 million of non-investment grade CRE debt securities and $90.6 million of CMBS B-pieces. Its LNS portfolio had $63.5 million net book value of (almost entirely) mezzanine loans and preferred equity outstanding on that date. The total net book value of these investments is $761.0 million.

At March 31, CNLC had a signed a "5" rating (highest risk) to a $130.8 million mezzanine loan and $31.7 million of preferred equity on a troubled mixed-use development project in downtown Los Angeles and also to a $27.5 million mezzanine loan on a hotel in Bloomington MN. The average risk ratings on the Core mezzanine loan and preferred equity loan portfolio were 4.4 and 4.1, respectively, up from 3.3 and 3.4 at the end of December.

The average risk of senior loans, on the other hand, was assessed at 3.7, up from 3.1 at the end of 2019. No senior loan carried a risk rank of "5" and the average loan-to-value ratio for this asset category was 70%. In total, 18.5% of the carrying value of senior loans utilized reserves to meet their interest obligations and 1.2% were delinquent. All of the loans upon which reserves were utilized or interest not paid were extended to the hotel sector.

CLNC did not disclose reserve utilizations or delinquencies on its CMBS portfolio, but did say that it expects continued challenges to their values, with potential defaults on the underlying loans, especially those secured by hotel and retail properties. Of the $270.2 million book value of this portfolio, 59.8% or $158.7 million consisted of investment grade-rated (BBB) loans, $20.9 million were rated non-investment grade (BB or B) and the remaining $90.6 million consisted of the "B-pieces" of commercial mortgage loan securitizations which are fully consolidated on CLNC's balance sheet (assets of $1.82 billion and liabilities of $1.73 billion).

CLNC's $1.0 billion net leased real estate portfolio consists mostly of U.S. industrial and office properties (with just under 10% of the square footage represented by a large office property in Norway). The portfolio was 97% leased at the end of 20Q1 and 94.8% of rents due in April were paid.

In Table 9 below, I offer an estimate of the potential value of CLNC's common stock under certain assumptions of losses against its loans and investments. This analysis is based upon disclosures that the company makes in the MD&A section of its quarterly SEC filings about its Core and LNS portfolios.

For simplicity, the model assumes that the $761 million of mezzanine, preferred and other junk-rated investments are worth $0. All of the remaining senior, investment grade-rated loans and securities and all of its net leased and other real estate are assumed to be worth 95%. Against those recoveries, I deduct the amount of related debt outstanding and in the case of the core leased real estate, a small amount that would be due to noncontrolling interests.

Table 9

Colony Credit Real Estate, Inc.

Risk Exposures and Hypothetical Losses/Recoveries on its Core and LNS Portfolios.

(in $000s)

	Book Value	Recovery %	Recovery Value	Associated Financing	Recovery after Financing	Noncontrol-ling interest share	Net Recovery - CLNC Share
Core Portfolio							
Loans and preferred equity							
Senior loans	2,281,164	95%	2,167,106	(1,617,185)	549,921	0	549,921
Mezzanine loans	318,182	0%	0	0	0	0	0
Preferred equity & other loans	267,783	0%	0	0	0	0	0
Total	2,867,129	76%	2,167,106	(1,617,185)	549,921	0	549,921
CRE debt securities							
Investment grade rated (BBB)	158,711	95%	150,775	0	150,775	0	150,775
Non-inv. grade rated (BB or B)	20,861	0%	0	0	0	0	0
Total	179,572	84%	150,775	0	150,775	0	150,775
CMBS securitization "B" Pieces	90,603	0%	0	0	0	0	0
Net leased real estate	1,059,563	95%	1,006,585	(733,351)	273,234	(9,071)	264,162
Total	4,196,867	79%	3,324,466	(2,350,536)	973,930	(9,071)	964,859
Legacy, Non-Strategic Portfolio							
Senior mortgage loans	28,139	95%	26,732	(15,825)	10,907	0	10,907
Mezzanine loans	62,909	0%	0	0	0	0	0
Preferred equity	687	0%	0	0	0	0	0
Net leased real estate	59,375	95%	56,406	(55,326)	1,080	0	1,080
Other real estate	423,153	95%	401,995	(298,541)	103,454	0	103,454
Private equity interests	8,764	95%	8,326	0	8,326	0	8,326
Total	583,027	85%	493,459	(369,692)	123,767	0	123,767
Total Core and LNS Portfolio	4,779,894	80%	3,817,926	(2,720,228)	1,097,698	(9,071)	1,088,626

Source: CLNC 20Q1 10-Q. The book value and associated financing figures are given in the MD&A section of the 10-Q. The book values do not tie exactly with the amounts recorded on the balance sheet. By my calculations, there is a discrepancy of about $24 million. The book value of CMBS securitization "B" pieces of $90.6 million represents CLNC's net investment in mortgage loan securitization trusts that are fully consolidated on its balance sheet with assets of $1.82 billion and liabilities of $1.73 billion.

My assumptions result in a net recovery of 80% of the $4.78 billion combined book values of the Core and LNS portfolios. Against the gross recovery value of $3.82 billion, I deduct the associated financing of $2.72 billion and a small non-controlling interest of $9.1 million (against Core net leased real estate. CLNC's share of the net recovery is therefore $1.09 billion.

With that $1.09 billion as a starting point, I then consider CLNC's remaining assets and liabilities – essentially its net working capital – which totaled $569.6 million at March 31, 2020, primarily because of the large amount of cash, cash equivalents and restricted cash that CLNC held following its drawdown of most of the available financing under its bank credit facility.

I then deduct the debt that was not assigned to either the Core or LNS portfolios. In this case, that amounts to $340 million for its primary bank credit facility and $197.4 million for the CMBS credit facilities.

Table 10

Colony Credit Real Estate, Inc.

Estimated Net Recovery Per Share on CLNC's Total Net Assets.

(in $000s)

Total recovery on Core and LNS Portfolios	1,088,626
Cash and cash equivalents	393,845
Restricted cash	159,521
Receivables and other assets	104,212
TOTAL ASSETS	1,746,204
Due to related party	(10,766)
Accrued and other liabilities	(145,956)
Escrow deposits payable	(49,499)
Dividends payable	(13,147)
Net assets	1,526,836
Bank credit facility	(340,000)
CMBS credit facilities	(197,392)
Net recovery	978,234
Common share equivalents	
Common shares outstanding	128,366
OP units outstanding	3,076
Total common share equivalents	131,442
Net recovery per common share equivalent	$ 7.44

Source: CLNC financial statements and Lark Research estimates.

Actually, the $197.4 million of CMBS credit facilities were assigned by the company to the CRE debt securities (which included the B-pieces) in the Core portfolio. I took them out of there because my analysis indicates that they would not be covered by asset values. The CMBS credit facilities have full recourse to the company.

Although this is essentially a liquidation analysis, I do not consider the losses that CLNC might sustain before it liquidates or the cost of the liquidations, especially the services of professionals, which could run, as a guess into the hundreds of millions of dollars.

Accordingly, using my admittedly simplifying assumptions, my analysis indicates that CLNC's equity is worth a little under $1.0 billion or $7.44 per share. CLNY's 36.5% equity stake, which equates to 48 million CLNC shares, is worth $357.1 million, according to my analysis.

My per share value estimate of $7.44 is 14.5% above Friday's (7/24) closing price of $6.50 for CLNC.

My assumption that all of the non-senior investments are worth zero seems conservative, but is prudent under the circumstances. It is highly likely in my view that most, if not all, of the mezzanine loans and preferred equity are carried as investments in unconsolidated ventures on CLNC's balance sheet. The $585.96 million total of Core Portfolio mezzanine loans and preferred loans, which is shown in Table 9 above almost exactly equals the $585.99 million of investments in unconsolidated ventures identified on CLNC's March 31, 2020 balance sheet. It is typically the case that unconsolidated joint venture investments are subordinated to the senior debt of those ventures, putting them first in line after common equity to absorb losses.

Some may quibble with my assumption that the senior investments and real estate are worth 95% of their carrying values, but most of the senior debt securities were underwritten with average loan-to-value ratios of 70%; so there is a valuation cushion that supports the small loss assumption.

Every 1% change in the recovery assumption for the senior investments and real estate changes the overall equity valuation by $39.8 million or roughly $0.30 per CLNC share. Every 1% move in the non-senior investment recovery assumption changes the equity valuation by $7.6 million or roughly $0.06 per share.

According to my model, a 20% recovery on the non-senior investments, leaving all other assumptions unchanged, results in an equity value of $1.13 billion or $8.60 per CLNC share. On the other hand, a 90% recovery on the senior investments (from 95%) brings the value down to $780.9 million or $5.94 per share.

Assuming that the commercial real estate sector will recover before too long, aided perhaps by assistance from the Federal government in the hospitality and healthcare sectors, CLNY will again turn its attention to its proposal to internalize the management of CLNC. From my perspective, Mr. Barrack's proposal is milquetoast. It merely switches the management from CLNY to CLNC, eliminating perhaps the conflicts of interest at CLNC that arise from the current external management structure, but still leaving CLNY with stranded assets that are related to the commercial loan and securities business.

In my mind, it makes more sense for the credit assets and operations of both companies to merge. This could be accomplished by CLNY selling its OIM and related OE&D businesses to CLNC or perhaps by CLNY making an offer to buy the 63.5% public stake in CLNC (say, in a stock-for-stock transaction) and then later spinning the whole operation off to its shareholders. Alternatively, CLNY could work with third party investors to accomplish such a merger (and Messrs. Tangen and Traenkle may be available to help out).

Colony's 36.5% equity stake in CLNC is carried on its books at $666.1 million or $13.88 per share, more than double the current CLNC share price of $6.50. At December 31, 2019 and again at March 31, 2020, although CLNC's share price was below Colony's carrying value, the company said that it would not record an other than temporary (OTT) impairment charge on its investment in CLNC because it believed that the decline in the share price was temporary and that its internal analysis of CLNC's net asset value is close to CLNY's carrying value. Even so, in light of the uncertainty of the (long-term) economic impact of COVID-19, it will continue to assess the recoverability of its investment and may recognize an OTT impairment in the future. The recent reduction in the tangible net worth covenant on Colony's corporate credit facility makes it more likely that the Colony will recognize another impairment on its CLNC investment within the next two quarters.

Other Equity and Debt

As the name implies, this is a "catch-all" segment that includes various investments in equity and debt held by CLNY, many of which are associated with its traditional investment platform business. It also includes assets that were acquired through the NorthStar merger and probably some odd or atypical transactions that Colony has made over the years.

Because it is a catch-all and also because Colony's disclosures for this segment are incomplete and sometimes conflicting, it is difficult to get a clear picture of what exactly is included in this segment, how profitable each of these investments are and how much of the profit Colony gets to keep. In recent years, Colony has made some changes to the portfolio – for example, moving the digital investments to a new segment, selling off the related industrial assets as well as purchases and sales of additional investments - that serve to complicate the analysis.

It is also unclear what Colony's plans are for this segment. When the company announced its digital evolution, it said that it planned to monetize the bulk of the segment's portfolio. In its 2019 fourth quarter financial supplement, it classified OE&D's investments as either strategic or non-strategic. The non-strategic investments were obviously slated for sale over time.

However, in its 20Q1 supplemental disclosures, the strategic/non-strategic classification is gone, primarily because of the economic fallout related to COVID-19. If the real estate sector (and especially CLNY's investments) recover to pre-COVID levels of profitability, the company will probably resurrect its divestiture plans and perhaps the strategic/non-strategic classification.

Colony's OE&D assets can be presented in different ways, as shown in the tables below:

Table 11

Colony Capital, Inc.

Assets and Debt of Other Equity and Debt Segment at March 31, 2020.

(in $000s)

Assets	
Real Estate	
Held for investment	1,989,449
Held for sale	286,112
	2,275,561
Equity and debt investments	
LP interests in sponsored and co-sponsored funds	58,449
Other equity investments	1,164,393
CRE securities and RE PE fund investments	56,698
	1,279,540
Loans receivable	1,540,837
Total investments	5,095,938
Debt	1,969,639

Source: CLNY 20Q1 10-Q in the MD&A section.

This presentation of OE&D's assets corresponds most closely to the line items in its balance sheet. OE&D real estate held for investment represents about 22% of Colony's consolidated real estate, net; equity and debt investments are about 59% of the consolidated total; and loans receivable are about 97% of the consolidated total.

Colony's 10-K disclosures show that OE&D real estate held for investment includes the THL portfolio. At December 31, 2019, the net book value of THL's assets was $1.1 billion and it carried $842.7 million of debt. CLNY has a 55% equity interest in this portfolio. Since I included the THL portfolio in my valuation of the Hospitality segment, I exclude it from my valuation of OE&D.

The remainder of OE&D's held-for-investment real estate consists of various industrial, office, mixed use and retail properties, almost all of which are located in Europe. At December 31, 2019, these 230 properties had a net book value of $938.0 million and total encumbrances of $730.2 million.

OE&D's loans receivable consist of $473 million of first mortgages, with $204 million or 43% delinquent on principal and interest. It also includes $682 million of subordinated mortgage and mezzanine debt, $102 million of which was delinquent, $248 million of purchased credit impaired loans (i.e. loans that were delinquent but bought at a substantial discount, in this case at 21% of their total unpaid principal). Finally, OE&D's loans receivable includes $149 million of corporate loans. All of the data on loans receivable are as of Dec. 31, 2019.

In the 2020 first quarter, Colony made the surprising step of declaring the fair value option for all $1.4 billion of its loans receivable. The move allows the company to avoid recognizing defaults, since the carrying value of each loan will be based upon market prices. Under the accounting rules, this decision is irreversible. Assuming that Colony is able to avoid substantial defaults, it could later face profitability headwinds on its loans receivable if interest rates ever begin to rise. This accounting move could conceivably be a prelude to selling the portfolio

Information about the rest of the OE&D portfolio and especially its $1.1 billion of other equity investments, is tough to come by. Colony gives us an alternative look at this portfolio in its quarterly financial supplement, which is given in the table below:

Table 12

Colony Capital, Inc.

Assets and Equity of Other Equity and Debt Segment by Investment Type at March 31, 2020.

(in $000s)

	Consolidated Total		CLNY OP Share of Consolidated Total		
	Assets	Equity	Assets	Equity	Equity %
GP Co-investments in CDCF IV and CDCF V	2,116,379	1,645,373	400,548	278,552	16.9%
Other GP Co-investments	974,008	517,675	788,729	447,546	86.5%
Other real estate equity	2,145,324	953,856	1,132,822	548,139	57.5%
Net lease real estate equity	189,331	85,773	188,187	85,246	99.4%
Real estate debt	286,669	286,669	205,881	205,881	71.8%
CRE securities and RE PE fund investments	59,090	59,090	59,090	59,090	100.0%
Other Equity and Debt Total	5,770,801	3,548,436	2,775,257	1,624,454	45.8%

Source: CLNY financial supplement to earnings press release dated May 8, 2020.

This disclosure offers a somewhat different look at the OE&D investment portfolio. GP co-investments are investment partnerships in which Colony is the general partner and has made an equity investment. The first line item in Table 12 refers to Colony Distressed Credit Funds IV and V. Colony has an average 16.9% equity stake in the funds, which have total assets of $2.12 billion. Other GP co-investments include funds where Colony is the primary investor with an average equity stake of 85%. Other and net lease real estate equity correspond roughly to the real estate totals from Table 11. Real estate debt, commercial real estate securities and real estate private equity fund investments are debt securities, most of which are likely carried at fair value, in which Colony has a high ownership stake.

Although the breakdown in Table 12 above does shed some light on the composition of the OE&D portfolio, the co-investments are not classified as either debt (i.e. loans receivable) or equity investments. While there is good detail on loans receivable in the 10-K, there is virtually no information about the equity instruments, making it tough to assign a value to them. Table 12 is important, however, because it provides the percentage ownership of noncontrolling interests. On many of these OE&D investments, Colony has to consolidate fully the assets and liabilities of the funds in which it serves as the general partner, even though the noncontrolling interests are entitled to substantially more than 50% of their profits.

To complete my valuation analysis for OE&D, I apply the noncontrolling interests information from Table 12 above to the framework from Table 11 above, which more closely corresponds to Colony's balance sheet. In order to make this work, I use some simplifying assumptions.

Table 13

Colony Capital, Inc.

Colony Capital's Share of Estimated Recovery Values on OE&D Net Assets

(in $000s, except recovery percentage)

	Estimated Carrying Value	Recovery Percentage	Estimated Recovery Value	Estimated Debt Outstanding	Recovery Value After Debt	Recovery for Non-Controlling Interest	Estimated CLNY Recovery
Real estate assets held for investment (excluding THL)	938,000	80.0%	750,400	730,000	20,400	11,060	9,340
Real estate held for sale	350,000	80.0%	280,000	200,000	80,000	43,360	36,640
Equity and debt investments	1,280,000	50.0%	640,000	200,000	440,000	238,480	201,520
Loans receivable	1,541,000	70.0%	1,078,700	14,700	1,064,000	576,690	487,310
Total OE&D Portfolio	4,109,000	66.9%	2,749,100	1,144,700	1,604,400	869,590	734,810

Source: CLNY 2019 10-K, 20Q1 earnings 8-K filed May 8, 2020 and Lark Research assumptions and estimates. Asset Categories and Estimated carrying values are from Table 11 above. Analysis excludes THL portfolio.

Table 13 requires an explanation as to how it was put together, so I apologize for going a little deep in the weeds here.

Real estate assets held for investment equal the December 31, 2019 net book value of the (mostly) European properties. Real estate held for sale is based on a similar disclosure for the OE&D segment at December 31, 2019. Equity and debt investments of $1.28 billion and loans receivable of $1.54 billion are from Table 11 above and correspond to amounts outstanding at March 31, 2020.

I apply a recovery percentage of 80% to real estate, 50% to equity and debt investments and 70% to loans receivable. The real estate and equity and debt recovery assumptions are guesses. The recovery percentage for loans receivable is based upon disclosures in the 2019 10-K that classify the loans into four categories – first mortgages, subordinated mortgages and mezzanine loans, purchased credit impaired loans (i.e. distressed loans purchased at a low percentage of their outstanding principal balance) and corporate loans – and also provide delinquency data. I assume high recoveries on non-delinquent first mortgages, purchased credit impaired and corporate loans and low or no recoveries on most subordinated mortgages and mezzanine loans.

After determining the estimated recovery values, I subtract out estimated debt balances based upon estimated allocations for each asset category that tie to the total amount of OE&D non-recourse debt outstanding at March 31, 2020, excluding the $842.7 million of debt in the THL portfolio.

In Table 12, I calculate that Colony has a total 45.8% interest in the equity of the OE&D segment. That leaves 54.2% of the equity for the non-controlling interests. I allocate that 54.2% noncontrolling interest percentage to the recovery value after debt for each of the individual asset types in Table 13.

Thus, in Table 13, after deducting the $869.6 million attributable to noncontrolling interests from the total estimated recovery value after debt of $1.6 billion, I determine that Colony's share of the OE&D segment is worth $734.8 million.

Other Investment Management

While the OE&D segment included Colony's investment stakes in its private real estate credit funds and related co-investment vehicles, its Other Investment Management (OIM) segment includes the revenues, mostly in the form of fees, and costs associated with managing those and other funds, including CLNC. It also includes Colony's other funds and assets under management. In total, its investment management platforms include:

- Institutional Funds – Colony Distressed Credit Fund IV, Colony Distress Credit Fund V and other co-investment vehicles;
- the Colony Credit Real Estate, Inc. (CLNC) management contract;
- NorthStar Healthcare REIT[18];
- CC Real Estate Income Fund[19] (an unlisted, closed-end feeder fund for the CC Real Estate Income Master Fund);
- Colony Latam Partners[20] - Colony's business with the countries of the Pacific Alliance (a trade bloc that includes Mexico, Peru, Columbia and Chile) expanded with its April 2019 acquisition of Abraaj Group's private equity platform;
- Alpine Energy, an upstream energy investment management platform, owned in partnership[21] with Sam Zell's Equity Group Investments[22].

In total, Colony has disclosed that its OIM segment had $17.4 billion of assets under management and $10.8 billion of fee-earning equity under management, as of March 31, 2020.

Prior to 2020, OIM's financial results included its digital investment management platforms. Those platforms were transferred to the new Digital Real Estate and Investment Management segment at the end of 2019.

In July 2019, Colony closed its fifth Colony Distressed Credit Fund (CDCF), raising $428 million, including Colony's commitment of $121 million. When compared with CDCF IV's $1.3 billion of commitments, CDCF V's funding looks disappointing. Colony can reduce its commitment to a minimum of 5% of total funding through additional equity sales. Given the recent surge in distressed investment opportunities, perhaps Colony should consider reopening this fund.

As noted above, Colony had previously proposed to sell its CLNC management contract to CLNC or to a third party. One option, which Colony's CEO Tom Barrack proposed in a letter to CLNC's independent directors in November 2019, would be to sell CLNY's entire investment management business to CLNC. That would internalize the management of CLNC as well as expand its reach to the management of Colony's GP co-investments and other platforms. Due to the ongoing uncertainty regarding the severity and duration of the COVID-19 pandemic, Colony decided in April to postpone its efforts to sell the CLNC management contract.

Recent Historical Performance. Financial results for the OIM segment have been extraordinarily volatile over the past couple of years, making it difficult to assess its core profitability by glancing at the performance figures as presented in the segment reporting footnote. The volatility is due to several factors, including asset sales and impairment charges.

Table 14

Colony Capital, Inc.

Historical Financial Performance of the OIM Segment: 2017 to 20Q1.

(in $000s)

	12 Months 31-Dec-17	12 Months 31-Dec-18	12 Months 31-Dec-19		3 Months 31-Mar-19	3 Months 31-Mar-20
Revenues	240,632	176,568	246,499		40,005	24,299
Operating expenses	112,759	93,434	127,153		19,370	(713)
EBITDA*	127,873	83,134	119,346		20,635	25,012
Depreciation and amortization	56,616	28,653	79,097		8,669	2,591
Impairment loss	375,074	217,850	797,954		0	79,000
Equity method earnings (loss)	18,204	(50,496)	(17,602)		701	107,602
Equity method earnings - carried interest		9,525	11,682		4,896	(18,411)
Income tax expense	111,049	59,179	9,311		94	(14,482)
Income from discontinued operations	4,396	12,935	15,106		0	0
Net income (loss)	(174,564)	(145,161)	(754,314)		17,657	18,130
Net income (loss) attributable to CLNY	(182,038)	(124,024)	(643,631)		15,737	16,359

Source: CLNY 2019 10-K and 20Q1 10-Q and Lark Research calculations. Please note: operating expenses include mostly employee-related costs, including equity-based compensation and carried interests, as well as administrative costs. In 20Q1, the negative operating expenses were caused by a reversal of carried interest expense combined with a sharp decline in employee compensation expense, probably due to a decline in equity-based compensation expense. The figures for the March 2019 quarter are consistent with the company's segment footnote disclosures, but are different from the same figures reported in the OIM MD&A section. I assume that the segment footnote disclosures are correct.

Since the NorthStar merger, Colony has been recording gains and losses on inherited assets and operations that it has sold, including NorthStar Realty Europe, a European equity REIT that was previously listed on the NYSE, the industrial investment management business, the transfer of the digital investment management platform to the new digital segment, and in February 2020 the sale of RXR Realty.

In addition, OIM has suffered significant goodwill impairments that have followed its weaker-than-anticipated performance since the NorthStar merger. OIM recorded goodwill impairments of $375.1 million in 2017, $788.0 million in 2019 and $79 million in the 2020 first quarter. It also recorded impairments and write-downs of intangible and other assets of $273.3 in 2018.

Table 14 above provides my estimate, derived from CLNY's segment disclosures, of OIM's EBITDA, which has averaged $110 million from 2017 to 2019. It has been higher recently due to temporary factors, namely the reversal of the $9.2 million carried interest allocation associated with the sale of RXR Realty. However, it will likely decline by an estimated $11.4 million annually going forward, as a result of the recent reduction in the management fee from CLNC. (Based upon the 20Q1 decline in CLNC's reported management fee expense, I estimate that OIM's annual management fee income will decline from $43 million to $31.6 million.)

My EBITDA estimate for OIM is a consolidated total that needs to take into account the portion allocated to noncontrolling interests. I calculate that 15% of OIM's net losses were allocated to noncontrolling interests in 2018 and 2019. Assuming no noncontrolling interests for CLNC's management contract, I am guessing that 20% of the non-CLNC EBITDA belongs to non-controlling interests. This results in an allocation of $17.7 million, which should increase the percentage allocated to non-controlling interests to 18% going forward.

This OIM EBITDA estimate should really be considered a guess at best. The company's segment disclosures are insufficient to calculate segment EBITDA with any reasonable degree of confidence. Although the segment disclosures in the financial supplement are sufficiently detailed, they are on a different basis than the financial statements. (For example, they include digital OIM for 2019.) Consequently, I do not have a high degree of confidence in my OIM EBITDA estimate and so it could be higher or lower than what I have calculated above.

Valuation. So deducting the $11.4 million reduction in CLNC management fee income and the $17.7 million non-controlling interest allocation from the average 2017-2019 EBITDA of $110 million, I estimate that the new baseline OIM EBITDA attributable to CLNY is $81.0 million. At a multiple of 8, that baseline EBITDA yields a value for the OIM segment of $648 million.

OIM's future profitability and value will almost certainly depend upon the normalized pace of activity in the real estate market. According to a report by Savills[23], real estate investment in the Americas declined by 36%[24] in the 2020 first half. Savills expects that activity will remain below pre-pandemic levels for the balance of 2020, but certain sectors – logistics, residential and life sciences – will likely outperform.

By virtue of its history and experience in distressed real estate investing, Colony's OIM business has the potential to sustain or even grow its profitability over time. Thus, the value of the OIM business should hold steady and could increase if Colony remains flexible and opportunistic in its investment management product offerings.

Capital Structure

Colony's consolidated capital structure is given in Table 15 below. Of the total $14.8 billion in book capitalization, $8.1 billion or 54.8% is non-recourse secured debt lodged within the operating partnership (OP), Colony Capital Operating Company LLC, and designated to each of the segments, through subsidiaries of the OP. The corporate credit facility is a lender to the OP but has full recourse to CLNY. The remaining debt was issued by CLNY and although it has full recourse to CLNY, it is structurally subordinated to the debt, other liabilities and non-controlling interests of the OP.

Table 15

Colony Capital, Inc.

Consolidated Capitalization at March 31, 2020.

(in $000s)

	Outstanding Principal	Wtd. Avg. Interest Rate	Weighted Average Years to Maturity	Conversion or Exchange Ratio
Non-Recourse Secured Debt				
Digital	515,831	6.30%	4.6	
Healthcare	2,926,374	4.56%	4.1	
Hospitality	2,666,910	4.11%	1.0	
Other Real Estate Equity	1,736,435	3.68%	1.7	
Real Estate Debt	250,930	3.37%	1.7	
Total Non-Recourse Secured Debt	8,096,480	4.30%	2.5	
Recourse Debt				
Corporate Credit Facility	600,000	2.86%	1.8	
Other Secured Debt	34,520	5.02%	5.7	
Convertible and Exchangeable Senior Notes				
3.875% Convertible Notes due January 15, 2021	402,500	3.88%	0.8	60.3431
5.000% Convertible Notes due April 15, 2023	200,000	5.00%	3.0	63.4700
5.375% Exchangeable Notes due June 15, 2033	13,605	5.38%	13.2	83.0837
Junior Subordinated Debt (Trust Preferreds)	280,117	4.31%	16.2	
Total Recourse Debt	1,530,742	3.74%	4.5	
Total Debt	9,627,222	4.21%	2.8	
Cumulative Redeemable Preferred Stock	Liquidation Value	Distribution Rate	Maturity	
Series G	86,250	7.50%	Perpetual	
Series H	287,500	7.13%	Perpetual	
Series I	345,000	7.15%	Perpetual	
Series J	315,000	7.13%	Perpetual	
Total Cumulative Redeemable Preferred Stock	1,033,750	7.16%	Perpetual	
Equity and Total Capitalization	Book Value	Shares Outstanding	Book Value Per Share	Tangible Book Value Per Share
Operating Partnership Units (Book Value)	411,380	53,077	$ 7.75	$ 4.58
Common Stock (Book Value)	3,712,676	481,936	$ 7.70	$ 4.53
Total Capitalization	14,785,028			

Source: CLNY 20Q1 10-Q, its quarterly financial supplement contained in its 8-K filed May 8, 2020 and Lark Research calculations.

In June, Colony completed an amendment to its corporate credit facility (for which J.P. Morgan serves as administrative agent) that reduces the revolving commitments available from $750 million to $500 million, increases the interest rate margin by a quarter-point to 2.50% over LIBOR (or 1.50% over the base rate) and modifies certain financial covenants and the borrowing base to give the company additional flexibility. For example, the modifications exclude certain non-recourse debt and the related assets from the leverage and fixed charge ratio calculations and reduce the minimum tangible net worth covenant from $4.55 billion to $1.74 billion. The bank agreement also modifies the borrowing base to increase capacity for the acquisition of digital investments. As part of the agreement, Colony will limit its investments to digital infrastructure assets and pre-existing or protective investments in its existing assets and is prohibited from buying back stock or paying dividends other than dividends on its preferred stock and on its common stock only to maintain its REIT status.

The maximum outstanding amount under the amended credit agreement is $100 million below the $600 million that was outstanding as of March 31, 2020. At the end of the first quarter, Colony made a preemptive drawdown under its then $750 million credit facility to ensure its liquidity during the imminent economic downturn. By the end of June, in exchange for the amendments that would more or less ensure access to this corporate credit facility, the company repaid $200 million of this debt, an apparent sign of confidence in its outlook.

With the recasting of the credit facility, Colony also declared dividends on its four series of preferred stock, payable on July 15, 2020. The company had previously deferred the declaration of dividends on the preferred issues until June 30, pending greater clarity on the outlook for the economy (and presumably the finalization of the credit facility amendment).

At March 31, Colony had three outstanding senior note issues outstanding that are either convertible or exchangeable into common stock. Of particular importance are the $402.5 million 3.875% Convertible Senior Notes which are due on January 15, 2021, less than six months from now.

Earlier this month, Colony's OP issued $300 million of 5.75% Exchangeable Senior Notes due July 15, 2025 in a private placement. Proceeds from this offering will be used to repay the 3.875% Convertible Notes when due or repurchase them in the open market. The new Notes are structurally senior to the existing recourse publicly-traded debt at Colony Capital, Inc., including the 5% Convertible Notes due 2023.

Colony obviously took this step to ensure that it would be able to repay the 3.875% Notes at maturity; but the cost was high. The new notes are exchangeable into common stock at the rate of 434.7826 shares per $1,000 of principal which is equivalent to $2.30 per common share. If fully exchanged, the 5.75% Notes would hold an equity stake equal to 19.6% of CLNY's total outstanding common equivalent shares (including the OP units, but not taking into consideration the potential dilution from the other remaining convertible and exchangeable notes). According to SPGMI, the new 5.75% Notes have recently been quoted at 109.2, which represents a yield of 3.70% and a spread of 343 basis points over Treasurys.

Prior to the issuance of the 5.75% Notes, the 3.875% Notes had been trading around 95 which represented a very high 15% yield for a debt issue maturing in six months. Since the issuance of the new Notes, however, the 3.875% Notes are now trading around par.

The 5% Convertible Notes due 2023 most recently traded at 92 to yield 8.35%, which represents a spread of 820 basis points over the yield on the comparable maturity Treasury.

The 5.375% Exchangeable Notes due 2033, of which there are only $13.6 million face amount outstanding, have not traded since January. In January, the company registered 1.13 million shares of common stock, equivalent exactly to the number of shares that these remaining notes would receive in exchange. As I understand it, the company can initiate the exchange by offering cash, notes or a combination of the two, equal to the face amount outstanding. At March 31, these notes remain outstanding and will likely continue to do so, probably until Colony's share price rebounds which will require a lower cash payout.

The $280.1 million of junior subordinated notes are pledged to eight series of Trust Preferred securities that were issued privately by NorthStar prior to the merger. These notes have final maturities ranging from 2035 to 2037 and carry interests rates ranging from 2.70% to 3.25% above 3-month LIBOR (currently 0.26%). Interest is payable quarterly. The company has the option to defer payment of interest for some period of time, probably for six quarters. As far as I know, the Trust Preferreds have not been listed on any exchange, so I have been unable to obtain a current price on them.

Table 16

Colony Capital, Inc.

Composition of Total Capitalization and Tangible, Recourse Capitalization at March 31, 2020.
(in $000s and percent, as noted)

Total Capitalization	14,785,028
Debt (%)	65.1%
Preferred Stock (%)	7.0%
Operating Partnership Units (%)	2.8%
Common Stock (%)	25.1%
Goodwill	1,373,891
Non-Lease Intangibles	323,031
Total Goodwill and Intangibles	1,696,922
Total Capitalization (Recourse Debt, Tangible Equity)	4,991,626
Recourse Debt (%)	30.7%
Preferred Stock (%)	20.7%
Operating Partnership Units (%)	4.9%
Common Stock (%)	43.8%

Source: CLNY 20Q1 10-Q and Lark Research calculations. Non-lease intangibles include $179.7 million of investment management intangibles, $69.3 million of customer relationships, 438.3 million of trade names and $35.7 million of other.

Colony's capitalization includes four series of cumulative redeemable perpetual preferreds with a total liquidation value of $1.03 billion. These preferred have a weighted average distribution rate of 7.16%. Having bounced back from the early April lows of $7-$8, the preferreds have recently traded at $19.40-$19.87, which equates to a yield of 9.08%-9.44%.

Colony's capitalization also includes 53.1 million shares of OP equity units that are held mostly by Mr. Barrack (for his benefit and for the benefit of other CLNY managers), Mr. Manzi and Mr. Jenkins. The units are convertible into CLNY's Class A shares on a 1-for-1 basis. They represent an equity stake of 9.9% in CLNY currently (or 8.2% after taking into account the exchange into common of the 5.75%.

As of March 19, Mr. Barrack owned or controlled 31.1 million of Colony's common share equivalents, including 734 million of its supervoting Class B shares and 4.82 million OP units that he controlled for the benefit of current and past employees. Thus, I estimate that he had a direct economic interest in 4.9% of the company's common share equivalents and 11% voting control (with the employee OP units).

As of the May 11 filing date of its 2020 first quarter 10-Q, Colony was either in payment default or non-compliance with certain debt and/or lease covenants on outstanding non-recourse mortgage debt of $3.54 billion. Of this amount, $3.16 billion was lodged in its hospitality segment and the THL portfolio (which is included in the OE&D segment). This amounts to approximately 90% of the total hospitality-related debt outstanding.

The remaining $380 million of defaulted or non-compliant debt was in its healthcare segment, up from $235.6 million at the end of 2019. There, the problems are more structural in nature on fewer properties; so the company may be seeking to restructure the debt.

The company has attributed most of the defaults to the economic fallout from COVID-19. It is in active negotiations with lenders to execute or extend forbearances, modify the terms of the debt (including extending maturities for debt due in 2020) or pursue other temporary accommodations and/or potential long-term solutions. During this crisis, it is probably seeking to put the defaulted debt on sustainable terms, including extending maturities.

In my view, it is likely that most of the problems with these non-recourse loans relate to non-compliance and not with payment defaults. If they were all payment defaults, I estimate that the skipped payments for one quarter would total approximately $44.5 million. Colony ended the quarter with $1.36 billion of cash on the balance sheet.

We do not know yet how Colony fared overall in the second quarter and specifically whether it sustained any significant cash outflows. Yet, the Board decided to pay the dividend on the preferred in July at a total cost of $18.5 million, according to my calculations. Colony also paid down $200 million of borrowings on its corporate credit facility. If Colony was worried about its cash position, it would probably not have made these payments.

Over the past year or two, Colony has aggressively sought to de-risk its highly-leveraged capital structure by extending maturities and restructuring individual loans as necessary. In 2019, for example, the company refinanced $2.3 billion of non-recourse healthcare debt, eliminating near-term maturities and extending the overall maturity of the debt to 2024 (with extension options). It has also cleaned up a few hundred million of healthcare debt defaults annually over the past few years as they arose.

The issuance of $300 million 5.75% Exchangeable Notes in July shows that Colony prefers not to take chances on meeting its future payment obligations in a tenuous economic environment.

Valuation

Putting it all together, I offer an estimated, mostly sum-of-the-parts valuation, presented in Table 17 below. The determination of the estimated segment equity values is described in greater detail in the analyses of each of the segments in this report. In this section, I will give a brief summary of my conclusions to provide context for the company's overall valuation.

Table 17

Colony Capital, Inc.

Estimated Valuation

(in $000s)

Estimated Equity Value of Segments	
Digital RE and Investment Management	680.7
Healthcare	1,140.3
Hospitality (including the THL portfolio)	889.0
CLNC	357.1
Other Equity and Debt (excluding THL)	734.8
Other Investment Management	648.0
Total Estimated Equity Value of Segments	4,449.9
Corporate	(1,200.0)
Other Assets Held for Sale	275.0
	3,524.9
Cash	1,500.0
Net working capital	(311.6)
Valuation before Recourse Debt	4,713.3
Less: Recourse Debt	
Secured Debt	34.5
Corporate credit facility	600.0
Convertible and Exchangeable Senior Notes	616.1
Junior Subordinated Debt	280.1
Total Recourse Debt	1,530.7
Less: Preferred Stock - Liquidation Value	1,035.8
Estimated Equity Market Value	2,146.7
Common share equivalents outstanding	535.0
Estimated Per Share Value	$ 4.01

Source: CLNY 20Q1 10-Q, earnings report and financial supplement and Lark Research estimates.

Given the uncertainty surrounding the outlook for the real estate sector, I believe the framework of the valuation analysis is more important than a single point estimate of value. As noted above, there have been few transactions to support an accurate assessment of current prices and property valuation multiples or cap rates in many of the sectors in which Colony participates, especially in hospitality, healthcare and CMBS. Consequently, in Colony's Healthcare, Hospitality and Other Equity and Debt segments, I have based my valuations mostly on prices that existed prior to the onset of the pandemic. In most cases, those prices are not indicative of what Colony could obtain today, especially in hospitality. My expectation is that those prices will be attainable over time and hopefully before too long.

In other cases, for CLNC and OIM, for example, I have based my valuations more on where I believe that values are today, either because individual asset prices are more readily attainable or because the valuation is based more upon the segment's recent and expected financial performance, which may be reasonably estimated.

Digital Real Estate and Investment Management. My valuation estimate for the Digital segment is based upon what Colony paid for or the capital that it has committed to each of its digital businesses over the past couple of years. In total, I calculate that Colony has invested $680.7 million in the business, which translates into a multiple of 20.5 times estimated annualized 20Q1 core FFO. That seems like a high valuation, but the business is just getting started – it was classified as a separate segment only beginning this year – so time will tell if the prices that Colony paid for those businesses were reasonable. Valuing the business at less than $680.7 million would suggest that Colony has lost money on its digital investments and I do not have any basis today to make such a claim.

Healthcare. Colony owns 352 healthcare properties, including 108 assisted living communities, 9 hospitals, 106 medical office buildings and 83 skilled nursing facilities all in the U.S., and 46 assisted living communities in the U.K. At December 31, 2019, these properties had a net book value of $4.43 billion and an equity book value of $1.61 billion. My valuation estimate of $1.14 billion is calculated by multiplying the $1.61 billion equity book value by Colony's 71% ownership interest.

The properties were recorded at their estimated fair values in 2017 as a result of the NorthStar merger. The current net book value incorporates three years of accumulated depreciation and property improvements and impairments made and taken since then. Prior to COVID, the healthcare property sector had been struggling to cope with the downward pressure on occupancy brought on by new construction activity. Yet, the reported net operating income on Colony's healthcare properties was pretty stable from 2017 to 2019.

The profitability of Colony's healthcare properties took a moderate turn for the worse in 20Q1. NOI was down 10% in the quarter. Colony says that its communities have experienced a moderate level of confirmed COVID cases. Like other healthcare property operators, occupancy has been declining because of the prohibition on new tenant/patient admissions. Profits will be down in 20Q2 and may be slow to come back

It is fair to say that my valuation estimate is high for the current operating environment. As long as occupancy and profitability returns – and it is difficult to say when that will happen – the healthcare property market should eventually return to pre-COVID levels. My $1.14 billion estimate translates into an average 6.8% NOI cap rate, based upon 2019 results.

Hospitality. Colony owns seven hotel portfolios. Six in the hospitality segment and the THL portfolio, which is included in its Other Equity and Debt segment. For purposes of this analysis, I include all seven portfolios in this valuation of Colony's hospitality assets.

The seven portfolios consist of 245 properties with 29,078 rooms. They had 2019 revenues of $1.09 billion, NOI before FFE of $356.5 million and FFE of $46.4 million. Average occupancy was 74% and average RevPAR was $95.

The portfolios have $3.51 billion of outstanding debt, $3.14 billion of which was in payment default or non-compliance. Colony is currently negotiating to cure these defaults.

Based upon property transactions that have occurred over the past 12 months, which are admittedly at higher prices on average than where the properties would trade today, I assign an average value of $158,000 per room to the combined portfolios. This results in an asset value of $4.59 million and an implied equity value of $889 million, after deducting the $3.51 billion of debt and $193.2 million attributable to minority interests. This values the portfolio at 4.2 times 2019 revenue and a capitalization rate of 6.75% of 2019 NOI after FFE. Although my valuation estimate is above where the portfolios would likely trade today, I expect that with the continuing economic recovery their value will recover to my estimate over time.

CLNC. Colony owns a 36.5% equity stake in Colony Credit Real Estate, Inc. (CLNC), an NYSE-listed commercial real estate mortgage REIT. which is currently carried on its books at $13.88 per CLNC share, below the current share price of $6.50. Colony has previously said that it would not take any further impairments on its CLNC equity stake, because its own NAV assessment supports the current carrying value. Still, with the completed amendment to its bank credit facility which lowers its minimum tangible net worth requirement, Colony could recognize an impairment of $350 million when it announces 20Q2 earnings.

My analysis indicates a value of $7.44 per share or $357.1 million for CLNC. It assumes a 95% recovery rate on net leased real estate and senior CRE loans and securities, but no recovery on mezzanine loans, preferred equity investments and the "B" pieces of CMBS securitizations. My estimated 95% recovery rate on net leased real estate may be a little aggressive.

Other Equity and Debt. The OE&D segment includes real estate property as well as miscellaneous equity and debt investments and loans receivable. Real estate property includes the THL portfolio, which I have shifted to the Hospitality segment for this valuation analysis. The remaining real estate includes certain properties held for sale and a small hodgepodge of office, industrial, mixed-use and retail properties located mostly in Europe.

The equity and debt investments and notes receivable are mostly held by Colony-sponsored private funds created through its investment management platform. In most cases, Colony acts as the general partner and also has a small co-investment in the funds. These funds are fully consolidated on Colony's balance sheet because Colony controls their day-to-day operations, even though its average equity stake is significantly below 50%.

I estimate the recovery percentages on OE&D's real estate, equity and debt investments and notes receivable to be 80%, 50% and 70%, respectively. The average recovery percentage is 66.9% which equates to an estimated recovery of $2.75 billion. After subtracting out $1.15 billion of debt and allocating 54.2% or $869.6 million of the remaining equity to non-controlling interests, I estimate that Colony's share of the OE&D segment is worth $734.8 million.

Other Investment Management. The financial performance of this segment has been volatile in recent years from significant impairments of goodwill and intangibles and gains and losses on the disposition of assets. I estimate the segment's average 2017-2019 EBITDA at $110 million, but given the company's incomplete disclosures, I do not have high confidence in this estimate.

I assume further that OIM's EBITDA will decline by an $11.4 million going forward because of the reduction in the management fee for CLNC. After allocating an estimated $17.7 million to non-controlling interests, OIM's new baseline EBITDA is $81 million. At an 8 times valuation multiple, Colony's share of the equity value of the OIM business is $648 million.

Other Items.

Corporate Expenses. From the financial supplements, I calculate that the company recorded in 2019 $83 million of cash and stock-based compensation costs and $62 million of administration expenses that are included in consolidated expenses but not allocated to any of its segments. These are presumably expenses incurred at the corporate level, but there is no discussion of them in Colony's MD&A. For purposes of this valuation analysis, I "value" this $150 million (or so) of corporate expenses at a multiple of 8 or $1.2 billion. This is treated as a $1.2 billion reduction to the total net equity value of Colony's segments.

This is an unconventional way of incorporating these expenses into the valuation analysis. I might have tried to allocate the $150 million of corporate expenses to each of the segments, thus reducing their profitability and their implicit equity values. However, I do not have any basis for making such an allocation. Such an allocation would therefore be arbitrary.

These estimated corporate expenses are significant and higher than what I typically see for a company of Colony's size. Colony should include a discussion of them in the MD&A section of its quarterly SEC filings.

Yet, as Colony completes the divestitures of its non-digital assets and businesses, these corporate expenses should decline; but by how much and how fast is difficult to determine without a better understanding of the services that are performed at the corporate level.

Remaining Net Assets Held for Sale. At March 31, 2020, Colony had $749.4 million of assets held for sale. I have already included $350 million of those assets in the OE&D segment valuation. The remaining $400 million is listed as a separate line item, after deducting an estimated $125 million of associated debt.

Cash. At March 31, 2020, Colony had $1.36 billion of cash and cash equivalents and $166 million of restricted cash on its balance sheet. I include $1.5 billion of total cash in this valuation analysis.

Net Working Capital. This is equal to non-intangible other assets minus non-intangible other liabilities (including dividends and distributions payable) at March 31, 2020. The net liability recorded in this valuation analysis is $311.6 million.

Enterprise Value. The sum of the estimated valuations for the segments minus corporate plus cash and negative net working capital yields an estimated enterprise value of $4.71 billion.

Equity Value. From this estimated enterprise value, I subtract out $1.53 billion of recourse debt, including the corporate credit facility, outstanding publicly-traded senior notes, junior subordinated debt (i.e. the trust preferreds). I also subtract out the $1.04 billion liquidation value of the four series of preferred stock. That leaves an estimated equity value of $2.15 billion or $4.01 per share, based upon 535 million common share equivalents outstanding (including the common stock and OP units).

I estimate the potential dilutive impact of the $300 million offering of 5.75% Exchangeable Senior Notes due 2025, which are exchangeable at a rate of 434.7826 shares per $1,000 face amount or $2.30 per share. The exchange of these senior notes into common stock would increase the value of equity by $300 million and add 130.4 million shares to Colony's share count. The net effect would reduce Colony's estimated equity value to $3.68 per share.

My equity value estimate of $2.27 billion translates into a core FFO multiple of 11.4 times, based upon core FFO (as defined by Colony) of $188.0 million for the rolling twelve months ended March 31, 2020.

Core FFO is equal to NAREIT-defined FFO excluding gains and losses from the sale of businesses, impairments of goodwill and intangibles, amortizations of intangibles, adjustments for CLNC core earnings, equity-based compensation, straight-line rental revenue and expense, amortization of acquired above-and below-market lease intangibles, unrealized fair value loss on hedges, merger-related costs, restructuring and merger integration costs and remeasurement gains, adjusted for related tax effects.

Activist

In November 2018, Jason Aintabi, the Managing Partner of Blackwells Capital[25], an alternative capital investment firm, sent a letter to the Board of Colony Capital highlighting the deteriorating financial performance of the company and the poor performance of its stock. Mr. Aintabi's firm had acquired 1.12% of CLNY's outstanding common stock and was pushing for changes in order to boost CLNY's share price. Among the problems he identified were (1) poor management, (2) a complex business structure that lacks focus and (3) a private equity investment management platform that does not belong in a REIT. He threatened to mount an investor campaign to replace the entire Board if it did not address his concerns.

During the 2019 proxy season, Mr. Aintabi succeeded in placing two of its candidates on the Board – Craig Hatkoff, a former CMBS banker who has served on the boards of SL Green Realty and Taubman Centers, and Raymond Mikulich, who previously served on the boards of several public and private real estate companies and as head of Lehman Brothers' global real estate banking group.

Colony's Board then created a Strategic Asset Review Committee, whose members included Mr. Hatkoff and Mikulich. The Committee was tasked with reviewing the company's assets and businesses and presenting its findings and recommendations to the Board.

In mid-2019, as discussed above, Colony took its first steps toward its big pivot with the acquisition of Digital Bridge. In the fall of 2019, it also announced its plan to sell its private equity real estate platform to CLNC. When CLNY's stock fell sharply following the platform sale announcement (mostly in responses to impairment charges and other losses that the company reported concurrently with the strategy shift), Blackwells stepped up its call to replace management both at CLNC and CLNY.

In early March 2020, Blackwells called for the removal of Mr. Barack as CEO and other urgent steps to reverse the continuing slide in CLNY's stock. Five days later, Colony reached a settlement agreement with Blackwells, announcing that Mr. Manzi would become CEO on July 1, replacing Mr. Barrack who would remain as Executive Chairman. The company also agreed to accept another Blackwells nominee – Jeannie H Diefenderfer, a former Verizon executive – to its Board.

By the March settlement, Blackwells had increased its position to a 2% equity stake. In his last letter to the Board which was issued around March 25, Mr. Aintabi expressed support for the strategic and management changes that Colony has made.

Since the end of March, Colony has been thrust into the center of a whirlwind as it contends with the economic fallout of the COVID pandemic. Mr. Aintabi has not, to my knowledge, sent any additional letters to Colony's Board of Directors, nor has he made any public comments about developments at Colony. Since his firm purchased its 2% stake in Colony, it is likely that the value of his investment has declined. It is not known whether he has or will purchased more or what his next steps, if any, will be.

Final Note. I have not prepared financial statement projections for Colony or CLNC at this time because I believe that the current situation is fluid with many possible outcomes for Colony's various businesses and assets. If I am able to continue to follow Colony and CLNC, I plan to prepare financial projections as the outlook for the companies becomes clearer.

Lark Research ratings methodology:

The **Performance** rating is scaled from 1 to 5, with a rating of 1 indicating "strong outperformance" vs. the broader market and a rating of 5 indicating "significant underperformance" vs. the broader market.

The **Safety** rating is scaled from A to E, with a rating of A indicating the highest safety profile and a rating of E indicating the lowest safety. E rated investments carry the highest risk and face a high probability of significant loss.

EndNotes.

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