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Armada Hoffler Properties, Inc. (AHH)

Q3 2014 Earnings Call

CORPORATE PARTICIPANTS

Louis S. Haddad
President, Chief Executive Officer& Director

Michael P. O'Hara
Chief Financial Officer

Julie Loftus Trudell
Vice President of Investor Relations

Eric L. Smith
Secretary & Vice President-Operations

MANAGEMENT DISCUSSION SECTION

Operator: Welcome to Armada Hoffler's third quarter 2014 earnings conference call. At this time, all participants are in a listen-only mode. After management's prepared remarks, you'll be invited to participate in a question and answer session. At that time if you have a question, please press "star 1" on your telephone.

As a reminder, this conference call is being recorded today, Friday, October 31, 2014.

I will now turn the conference call over to Julie Loftus Trudell, Vice President of Investor Relations, at Armada Hoffler.

Please go ahead.

Julie Loftus Trudell
Vice President of Investor Relations

Good morning and thank you for joining Armada Hoffler's third quarter 2014 earnings conference call and webcast.

With me this morning are:

- Lou Haddad, CEO, and
- Mike O'Hara, CFO

In addition, Eric Smith, our Vice President of Operations, will be available for questions.

The press release announcing our third quarter earnings along with our quarterly supplemental package was distributed this morning.

A replay of this call will be available shortly after the conclusion of the call through November 28, 2014. The numbers to access the replay are provided in the earnings press release.

For those who listen to the rebroadcast of this presentation, we remind you that the remarks made herein are as of today, October 31, 2014, will not be updated subsequent to this initial earnings call.

During this call, we will make forward-looking statements, including statements related to the future performance of our portfolio, our identified development pipeline and future pipeline, impact of acquisitions, our construction business, our portfolio performance and financing activities as well as comments on our outlook.

Listeners are cautioned that these statements are subject to certain risks and uncertainties, many of which are difficult to predict and generally beyond our control.
These risks and uncertainties can cause actual results to differ materially from our current expectations and we advise listeners to review the risk factors discussed in our press release this morning and in documents we have filed with or furnished to the SEC.

We also will discuss certain non-GAAP financial measures, including but not limited to FFO, Core FFO and Core EBITDA. Definitions of these non-GAAP measures, as well as reconciliations to the most comparable GAAP measures, are included in the quarterly supplemental package, which is available on our website at www.armadahoffler.com.

I would now like to turn the call over to our Chief Executive Officer, Lou Haddad…Lou . . .

Louis S. Haddad
President, Chief Executive Officer & Director

Thanks Julie.

Good morning and thank you for joining our call today.

This morning, we reported another solid quarter with both FFO and Core FFO per share coming in better than expectations driven primarily by stronger than expected leasing.

In addition to our leasing efforts, we delivered the remaining three development projects slated for this year, closed on the Dimmock Square acquisition, and are in the process of selling two assets. We raised our 2014 outlook and are enthusiastic about a strong finish to this year as well as our ability to execute in the coming year.

The team has a lot to be proud of, as all three of our divisions continue to perform admirably.

Before I turn the call over to Mike O'Hara to discuss the quarter in more detail, let me make a few observations on our performance.

With regard to our stable portfolio, occupancy is over 95% as of the end of the third quarter. We've leased an additional 26,000 square feet that once delivered in the fourth quarter will continue the positive trend in occupancy.

In Town Center, we have signed several additional leases and are delighted that the retail space is essentially 100% occupied.

A number of new tenants opened recently at Town Center including Anthropologie, lululemon and FreePeople. These retailers are creating additional excitement as well as meaningful long-term value for our shareholders. This is evidenced by a quarter over quarter increase in Same Store NOI on both a GAAP and Cash basis.

This quarter marked an inflection point in the execution of our development pipeline, as we delivered Greentree Shopping Center and Encore Apartments, both in Virginia, and the Whetstone Apartments in North Carolina.
We turned over approximately 83,000 square feet of office space to Clark Nexsen – the anchor tenant in the new 4525 Main Street tower.

Office occupancy at 4525 Main Street is over 50%. Let me remind you that this building is positioned as the most expensive address in the region. It's completely state-of the-art. It's the best address in this market. It is designed to give us a couple years' worth of absorption. For the last several years - with essentially no office space to lease here at Town Center - we've had to turn prospects away. We now have the capacity to absorb this tenant demand over the next few years.

We delivered the initial units at both Encore Apartments and Whetstone Apartments in September 2014. Encore is currently about 30% leased which is several months ahead of expectations.
At Whetstone - in Durham, North Carolina – we have approximately 20 units already leased at this early stage in the process as the leasing team has only been onsite since late September.

Finally, as of today, we delivered the remaining space at Greentree Shopping Center in Chesapeake, Virginia.

We are pleased that several of these deliveries were earlier than expected. Controlling costs and positively impacting timelines are the benefit of having our own captive general contractor.

As for the return on cost metrics for our development projects – we have maintained our corporate targets. Because of this discipline, our spreads have continued to widen as we are maintaining our return on cost targets in our pipeline regardless of the continued aggressiveness in cap rates.

Lastly, the Johns Hopkins Project continues to move forward with a signed ground lease and the schematic design phase well under way.

With the delivery of our development pipeline in full swing and the fluid nature of the stabilization process we have made changes to the "Development Pipeline" page in our supplemental package in an effort to make it easy to track our development projects through various stages of delivery and stabilization.

As you'll see, we have categorized our development pipeline into three sections:
1. Not Delivered;
2. Delivered Not Stabilized
3. Re-Development

For those project that are not yet delivered, not much has changed in the reporting. Although we think it is important to mention that it is not unusual for projects to change in scope and timing, particularly in their early stages.

An example of such a change is Brooks Crossing. You will notice that we have removed the data we've previously disclosed on this project.

As a reminder, Brooks Crossing is a multi-building, multi-phase partnership with the city of Newport News. The first phase was originally a development pipeline project that would have been placed into service in our stable portfolio of assets.
However, the city of Newport News has decided that they prefer to own this building – a police precinct and 911 call center – turning this into a development project with a sale-upon-completion.

We hope the buildings in future phases will become part of our stable portfolio, however flexibility in public private partnerships is key to repeat business and is a big reason why we have been engaged by municipalities over 20 times.

Next on our pipeline page are those development projects that are delivered but not yet stabilized. This concept is straight forward but we believe it is important to differentiate these projects as they create near-term noise around our stable, on-going FFO. For the same reason, these assets are not yet in our occupancy and same store NOI calculations.

This noise is more pronounced currently since we have three multifamily properties in lease up, which typically take longer to reach stabilization than office and retail assets.

This is the same reason why we have been reporting Core FFO – which excludes the effects from these non-stabilized developments – as we believe that this has been a more meaningful statistic in analyzing the performance of our business.

We will move these assets off this schedule once they reach 80% occupancy.

These first two categories of development projects – those not delivered and those delivered but not yet stabilized – demonstrate the volume of throughput we expect from our development business - approximately $150-175 million dollars of development projects every 18 to 24 months.

We continue to execute at our targeted pace and expect current development activities – those listed on this page and those in predevelopment – to result in approximately $25 million dollars of incremental annualized NOI by 2017.

The third category is re-development projects.

Listed here is the renovation and expansion of the space adjacent to Dick's Sporting Goods here in Town Center – for the national accounting center of USI Insurance.

We expect USI will occupy the resultant 20,000 square feet of this redeveloped space in the fourth quarter.

One last thing to note on the supplemental package – we have added a summary page of our acquisitions and dispositions.

To date, we have executed on two acquisitions.

As we have stated, we are committed to strategic acquisitions as a way to complement the growth from our development pipeline.

During the quarter, we completed the purchase of Dimmock Square, a 100% occupied, 106,000 square foot retail-power-center located in Colonial Heights, Virginia.

The acquisition was accretive to this past quarter's FFO per share and is expected to be accretive to annual FFO per share.

Earlier in the year we closed on Liberty Apartments.
Currently, we have nearly 70% of the apartment units leased with about half of the retail space either leased, under letter of intent or in negotiation.

Also listed here are two pending dispositions. As we have stated, we are continuing our long-standing strategy of selling non-core and single tenant assets from time to time.

We are on track to wrap up the previously disclosed sale of the Virginia Natural Gas office building in the coming quarter. As you will recall, we intend to sell this building for approximately $8.9 million dollars which represents an implied cap rate of approximately 6.25%.

During the quarter, we entered into a preliminary agreement to sell the Sentara Williamsburg office building for approximately $15.4 million dollars, representing an implied cap rate of approximately 6.3%. So, as you can see, we have already executed on our 2014 objectives and the year is not yet over.

To reiterate, our long-term strategy remains as it has for the last three decades and it is simple – continue to grow NOI.

- Through organic growth in our stable portfolio;
- Through our development pipeline projects;
- Through our third party construction gross profits; and
- Through strategic acquisitions.

When combined with measured decisions about our corporate metrics and balance sheet – we are focused on ensuring that our future NOI growth will translate into increased FFO and free cash flow on a per share basis.

With that, I turn the call over to Mike O'Hara to walk you through some of the key financial and portfolio metrics for the third quarter and then we will take questions.

Mike…

Michael P. O'Hara
Chief Financial Officer

Thank you Lou.

Good morning.

Today I want to cover the highlights of the quarter including a discussion of our recent equity raise, our balance sheet and I'll wrap up with our 2014 outlook.

This was a good quarter for us in all aspects. We reported better than expected earnings, strong leasing activity and reported positive same store NOI results.

FFO for the third quarter was $.21 per share and core FFO was $.22 per share.

Our adjustments from FFO to Core FFO are illustrated on page 11 of the supplemental package. This quarter non-stabilized development projects had positive FFO of $178,000 dollars which was excluded from third quarter Core FFO.

During the third quarter we executed approximately 72,000 sq. ft. of new and renewal office and retail leases.

Office re-leasing spreads for the quarter were lower by $1.13 per square foot on a GAAP basis and lower by $1.36 per square foot on a cash basis. This was primarily driven by the low TI cost associated with these leases. The retail re-leasing spreads were higher by $1.45 per square foot on a GAAP basis and higher by $.78 per square foot on a cash basis.

Same store NOI was positive for each segment during the quarter. In total, same store NOI for the quarter was positive 361 thousand dollars, or 3.7% on a GAAP basis, and positive 216 thousand dollars, or 2.2% on a cash basis.

During the third quarter our portfolio occupancy increased from 94.6% at June 30th to 95.1 %. We expect this trend to continue in the fourth quarter with the signed but not yet occupied leases.

On the construction front, we reported a segment gross profit, in the third quarter, of 1.1 million dollars on revenue of 32 million dollars. At the end of the third quarter the Company had total construction backlog of 154 million dollars.

Now turning to our balance sheet.

In early September, we issued 5.8 million shares of common stock which - net of issuance costs - raised 49 million dollars.

The proceeds were used to repay a portion of the credit facility which had been used to fund our development pipeline.

Between this capital raise and the other balance sheet activity we've discussed – including planned dispositions – we have accomplished four things:

First, we ensured that a majority of the value creation from the current pipeline will be enjoyed by our longer-term stockholders.

Second, we have reduced debt borrowed to fund our current development pipeline activities.

Third, this de-levering has brought our debt metrics and leverage ratios into ranges in which we are comfortable operating.

And fourth, we are well positioned over the coming year to take advantage of new investment opportunities when they present themselves.

Prior to the equity raise, our debt metrics were getting elevated in order to fund our robust development pipeline.
As we've discussed on many prior calls, we incur substantial debt to fund development projects with a lag until the project delivers and the NOI materializes.

Multi-family projects, of which we had three in lease up as part of this pipeline, magnify this issue as the ramp up period to stabilization is typically longer than office and retail assets.

As we manage this time gap, our goal is to maintain core debt to core EBITDA in the 6 times range, where it now resides, and total debt to EBITDA in the 8 times range as we borrow to fund development projects.

At the end of the third quarter, we had total outstanding debt of $336 million dollars, including $54 million dollars outstanding on our credit facility.

Our weighted average interest rate is 3.5% and average loan term to maturity is 9 years.

Approximately 44% of our debt was fixed at September 30th and taking into account interest rate caps approximately 78% of our debt was fixed or hedged. Please see page 14 of the supplemental package for the details of our interest rate caps.

We believe that using interest rate caps limits our exposure to rising rates while giving us flexibility at a reasonable cost.

As our development projects ramp up and start to come on line we are evaluating our ratio of fixed rate debt to overall debt. We are evaluating a couple of fixed rate loans at this time.

We continue to execute on our balance sheet strategy to provide the flexibility to fund our growth objectives in the most efficient and cost-effective manner, while managing upcoming loan maturities.

We have little exposure through 2015 with only one loan maturing in 2014 with a balance of one million dollars and two loans maturing in 2015 with combined balances of less than 9 million dollars.

Now let me walk you through our updated full-year 2014 outlook:

We raised our full-year 2014 total Core FFO outlook to approximately 29 million dollars from the previous expectation of approximately 27.5 million dollars.

The increase was driven by better than expected leasing activity across the portfolio most notably at the Cosmopolitan, better than expected construction activity and lower interest expense.

Full-year construction company annual segment gross profit is now expected to be to approximately $4.6 million dollars from the previous expectations of $4.3 million dollars. The increase reflects the impact of $178 million dollars of new contracts, signed in 2014, which are expected to begin in earnest later this year.

We set out to deliver five development projects in 2014, all of which have been delivered as of today and the leasing activity, for these projects, has been strong.

Based on this strong leasing activity, we now expect the negative impact on 2014 FFO - from these 5 non-stabilized projects - to be approximately $400,000 dollars, which is better than the previous expectations of approximately $1.0 million dollars.
Before I move on to some thoughts on 2015, let me update you on our share count.

The outstanding share count has changed with the equity raise and the Dimmock Square acquisition, which - as Lou mentioned earlier in the call – we acquired with a combination of cash and OP units. The weighted average shares outstanding for the third quarter was 34.6 million and is currently 39.8 million for the fourth quarter.

While we are not ready to provide our 2015 outlook parameters today, I want to reiterate what we said in our last earnings call regarding our NOI expectations from the development pipeline. We expect at least eight million dollars of NOI from the development pipeline projects in 2015.

I'll now turn the call back to Lou.

Louis S. Haddad
President, Chief Executive Officer & Director

Thank you Mike.

As I hope we communicated on this call – we are doing what we said we were going to do - are ahead of schedule AND feel great about where we are going.

Thank you for your time this morning, and your interest in Armada Hoffler. Operator, we would like to begin the question and answer session.

QUESTION AND ANSWER SECTION

Operator: Thank you. Ladies and gentlemen, if you have a question at this time, please press "star 1" on your telephone. If your question has been answered and you wish to withdraw it, you may do so by pressing "#". If you're using a speakerphone today please pick up your hand set before entering your request.

Thank you. Our first question this morning is coming from the line of Dave Rodgers with Robert W. Baird. Please proceed with your question.

Dave B. Rodgers
Analyst, Robert W. Baird & Co. Equity Capital Markets

Q

Yes, good morning. Lou, wanted to start with the broader development pipeline. Obviously a good quarter and finally seeing some maturation in the developments, but as you look forward—and I don't know if you provided in your comments—what are you seeing in that kind of equity-owned or AHH invested development pipeline and the opportunities beyond what's listed in the supplement?

Louis S. Haddad
President, Chief Executive Officer & Director

A

Dave, we've got several projects now in predevelopment that are in various stages of negotiations. I'll tell you, the activity we're seeing is probably more robust since—the most robust since the 2006 range. I think it's a combination of the markets that we're in and our ability to execute on a long-term basis with repeat clients.

Dave B. Rodgers
Analyst, Robert W. Baird & Co. Equity Capital Markets

Q

On the flipside of that, dispositions are starting to ramp up a little bit more; it's good to see that. It looks like you've got about $24 million in the queue for the fourth quarter, Brooks Crossing on top of that. As you think about what's in the portfolio what seems like it will be accelerating spending in the next couple of years, over the next 12 or 15 months, getting through the end of '15, what's in the bucket of potential sales that you think of that you can kind of move forward and monetize assets with, both in the development pipeline and kind of within the existing portfolio? What's that number range look like?

Louis S. Haddad
President, Chief Executive Officer & Director

A

Dave, you'll recall in our last conference call, we said that we had identified six such assets, both in existing portfolio and the development pipeline. Taken as a whole, that's probably in the $100 million range, but I don't want to give the impression that we'll execute on all six of those. But as everybody on the phone knows where cap rates have gone, we want to take advantage of that, obviously, so on a measured basis we're going to be looking at it very carefully.

Dave B. Rodgers
Analyst, Robert W. Baird & Co. Equity Capital Markets

Q

Great. Next question is with regard to what's still in the leased but not yet occupied pipeline, can you sum that up for us, both in office and retail, and I don't know if apartments is really as relevant, I guess, in that metric, but what do you still see that has yet to move in in the fourth quarter and in the first quarter in aggregate between those two buckets?

Louis S. Haddad
President, Chief Executive Officer & Director

A

Yes, Dave, what we've said—we just said on the call was about 26,000 square feet that's going to get delivered in this fourth quarter that's not in any of our numbers yet. We also have letters of intent for another probably that much again that would be delivered somewhere around the first quarter, but there's not a whole lot there. As you know, of the six projects or so listed in development, three of them are build-to-suits, which are obviously 100% occupied. That comes online first quarter. The three that aren't, being the office building that we just spoke about as well as the two retail centers, we're really down to small shops, so it's not a huge number. As we alluded to at 4525 Main, we anticipate that being a couple of years. The shopping centers, obviously, will be a little bit quicker.

Dave B. Rodgers
Analyst, Robert W. Baird & Co. Equity Capital Markets

Q

Okay, last question for Mike. I think you capitalized about $700,000 of interest in the third quarter. I assume that you stopped capitalizing Whetstone, Encore, Main Street in the third quarter, so what does that capped interest number look like in the fourth quarter, Mike?

Michael P. O'Hara
Chief Financial Officer

A

Good morning, Dave. So the capitalization for Whetstone, Encore, the multi-family, we'll continue to capitalize interest on the portion of the building that is not completed at this point in time, so I think on both those buildings at this point in time we've probably completed, I don't know, somewhere around 30 to 40% of the units, and as those units get completed, turned over, and accepted by property management, that's the time we'll stop capitalizing those.

Louis S. Haddad
President, Chief Executive Officer & Director

A

So just to make it clear for everybody, on our midrise apartment projects, those are delivered on a phased basis and we try and deliver a chunk of 20% or so every couple of months, and that's the way the construction is designed to perform.

Dave B. Rodgers
Analyst, Robert W. Baird & Co. Equity Capital Markets

Q

All right, thanks for the color.

Louis S. Haddad
President, Chief Executive Officer & Director

A

Thank you, Dave.

Operator: Our next question is from the line of Robert Strougo with RIS Investments. Please go ahead with your question.

Robert Strougo
RIS Investments

Q

Congratulations on an excellent quarter. As far as a new point of investing, you're a REIT and you haven't increased your dividend, and it wouldn't be very difficult to increase your dividend at least a few pennies, I would say at least a penny or two a quarter, so that would certainly invigorate the investment. You know, you did an offering at $9.05 which was not a great price, considering the dividend at that price, it was almost 8%, a little less than that. So the question is, can you—you talked about everything but the dividend. What is the outlook for that dividend?

Louis S. Haddad
President, Chief Executive Officer & Director

A

That's a great question, Robert, and as you probably know, Management owns approximately a third of the entire company, so you bring up a subject that's very near and dear to our hearts as well. We're obviously very pleased with the performance of the Company. We've got a tremendous amount of NOI and therefore free cash flow coming online over the next several quarters. Mind you, we've only been public for five quarters, so we're still getting to where we understand the entire scope of metrics that we need to look at before we take on such an increase. However, we're constantly evaluating the best way to deliver value to our existing shareholders, and the topic you bring up, I can tell you is a hot topic around the office here. We're looking forward to completing the year, and as we offer our guidance for 2015, I think you'll see some exciting developments with regard to our ability to deliver value to the shareholders.

Robert Strougo
RIS Investments

Q

Okay, thank you.

Operator: Yes, as a reminder, to ask a question, you may press star, one. Our next question comes from the line of John Guinee with Stifel. Please go ahead with your question.

John W. Guinee
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Great, thank you very much on continued explanations of a lot of moving pieces. Is it possible, and maybe we have to do this offline, to reconcile between essentially Page 18, your development pipeline, and then your balance sheet in terms of construction in process, construction receivables, construction payables, or are there just too many moving pieces, because part of the balance sheet includes third party development, part of the balance sheet includes AHH development.

Louis S. Haddad
President, Chief Executive Officer & Director

A

That's a great question, John. I appreciate it. The answer is yes, that's a pretty complex explanation. We'll be happy to take you through it, but I think it's best done offline.

John W. Guinee
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Okay. Then just out of curiosity, you have this little building, the gas building, six or seven, I can't remember, $10 million. Why is that taking so long to close, the sale?

Louis S. Haddad
President, Chief Executive Officer & Director

A

John, I don't think—let me look. It's all relative, right? I mean, we signed up for—the highest offer had with it a 45-day due diligence and a 30-day close, so we're tracking exactly that.

John W. Guinee
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Okay, perfect. Talk soon.

Louis S. Haddad
President, Chief Executive Officer & Director

A

Thanks John, appreciate it, and Julie will set something up and we'll continue the discussion offline.

John W. Guinee
Analyst, Stifel, Nicolaus & Co., Inc.

Q

All right, thanks.

Operator: Thank you. As a reminder, you may press star, one to ask a question, and if your question has been answered, you may press star, two to remove your question. The next question today comes from the line of RJ Milligan with Raymond James. Please go ahead with your question.

RJ Milligan
Analyst, Raymond James & Associates, Inc.

Q

Hey, good morning everyone. I just want to follow up on Dave's question about the—Lou, your comments on development demand and that it was pretty robust today. I was just curious in which segments, is it more retail, is it more office, is it both? Where are you seeing the demand coming from?

Louis S. Haddad A
President, Chief Executive Officer & Director

RJ, remember that the—I'll say it's both, but I need to qualify that. Not to pat ourselves on the back, but we've got a quarter of a century of doing public-private partnerships with municipalities and states and institutions and the like. As the economy continues to just bump along, as we've all been experiencing, the pressure on these institutions and municipalities to disproportionately affect the tax base or student base or employee base increases exponentially. Fortunately, through what we've built that Dan Hoffler started 30-some years ago and we continue to build on, we sit pretty much in the catbird seat when such an institution in our footprint has such projects to do. So when I say our pipeline is robust, it's fairly rarefied air that we're operating in. So long answer to a short question, but it ultimately manifests itself as office, retail, or multi-family projects.

RJ Milligan Q
Analyst, Raymond James & Associates, Inc.

Got you, so in other words, Armada Hoffler's demand is through the roof, but it's still not a lot of demand out there in the general market.

Louis S. Haddad A
President, Chief Executive Officer & Director

That's correct. I don't want to give anybody a misimpression. The bread and butter growth out there that you typically would see in higher end tenants and the kinds of tenants that we all want to see in our portfolio, that growth is not there. People are maintaining. We're still reabsorbing space from the big crash, but I think it's going to be a while before you see the situation where the tide is lifting all boats.

RJ Milligan Q
Analyst, Raymond James & Associates, Inc.

Got you. I saw in your guidance, you guys increased the construction company gross profit projections about 300,000. I was just curious what was driving that.

Louis S. Haddad A
President, Chief Executive Officer & Director

Yes RJ, as we've talked before, the construction business is a little bit harder to project, particularly where you have—and I think we alluded to it on our last conference call, we have a particularly large project, the Exelon project at Baltimore's Inner Harbor that's coming out of the ground. It's a $170 million project with a tremendous amount of below-grade work, and so it was very difficult to forecast how fast that work would go with, as you would imagine, unforeseen obstructions and the like. It's just—it's going a bit faster than our conservative projections would have told us.

RJ Milligan Q
Analyst, Raymond James & Associates, Inc.

Okay, great. Thanks guys.

Louis S. Haddad
President, Chief Executive Officer & Director

A

Thank you.

Operator: Thank you. I'd now like to turn the floor back to Mr. Lou Haddad for closing comments.

Louis S. Haddad
President, Chief Executive Officer & Director

Okay, well thanks very much. We appreciate your interest in our company and look forward to updating you on our activities and results in the coming quarters. Take care. Have a great day. Thank you.

Operator: This concludes today's teleconference. You may disconnect your lines at this time.