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Armada Hoffler Properties, Inc. (AHH)

Q2 2017 Earnings Call

CORPORATE PARTICIPANTS

Louis S. Haddad
President, Chief Executive Officer& Director

Michael P. O'Hara
Treasurer, Chief Financial Officer

Eric L. Smith
Secretary, Chief Investment Officer

MANAGEMENT DISCUSSION SECTION

Operator: Welcome to Armada Hoffler's second quarter 2017 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, Tuesday, August 1, 2017.

I will now turn the conference call over to Michael O'Hara, Chief Financial Officer at Armada Hoffler.

Please go ahead.

Michael P. O'Hara
Treasurer, Chief Financial Officer

Good morning and thank you for joining Armada Hoffler's second quarter 2017 earnings conference call and webcast.

On the call this morning, in addition to myself, are:

Lou Haddad, CEO

And Eric Smith, our Chief Investment Officer, who will be available for questions.

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

A replay of this call will be available shortly after the conclusion of the call through September 1, 2017.

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, August 1, 2017, and 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 development pipeline, impact of acquisitions and dispositions, 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 will also discuss certain non-GAAP financial measures, including but not limited to FFO and Normalized FFO. 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 am now turning the call over to our Chief Executive Officer, Lou Haddad… Lou…

Louis S. Haddad

President, Chief Executive Officer & Director

Thanks Mike.

Good morning everyone and thank you for joining us today.

This morning we reported second quarter results of 25 cents of Normalized FFO per share, which was in line with our expectations. After successfully raising over 85 million dollars in an overnight public offering in May, we have updated our per share guidance for the remainder of 2017.

Before Mike takes us through the quarterly results, capital markets activity, and updated 2017 guidance in detail, I'll comment on our retail portfolio and the many exciting office, multifamily, and student housing projects in our development pipeline.

As a diversified REIT, we invest in, develop, and build several different product types: office, multifamily, student housing, mixed-use, and retail, and we also generate additional revenue through our operating divisions. Due to our opportunistic rather than formulaic approach to development, over the course of our Company's history the segment mix in our portfolio has fluctuated and will continue to do so. For example, just three years ago, office assets generated nearly half of our portfolio NOI and retail assets made up less than 40 percent. Through constant, proactive and strategic portfolio management, the retail portion of our portfolio today stands at over 60 percent of NOI yet significantly less when combined with other income from our operating divisions.

But it is important to point out, against the current backdrop of excessively broad concern regarding the retail segment, that our current mix is merely a snapshot in time. In fact, this is the highest volume of retail we've had as a publicly-traded company.

Upon stabilization of the multifamily, student housing, and office projects in our development pipeline, we expect that retail will represent less than half of our portfolio NOI and even less as a percentage of our NOI and operating division income.

Irrespective of these metrics, we remain confident and bullish about the retail assets in our portfolio. These properties continue to perform with year-to-date same store NOI up over last year.

As you know, we don't own malls, we don't own department stores and we shy away from big box centers. We own three types of retail properties:

- (1) Mixed-use, destination assets,
- (2) Grocery-anchored centers, and
- (3) Power centers anchored by best-in-class retailers.

The best example of our mixed-use, destination retail is at our signature Town Center project in Virginia Beach. Town Center is home to 800 thousand square feet of office space, 800 residential units, two hotels, and a performing arts center. Within the district we own 460,000 square feet of mixed-use retail comprised of 25 restaurants and cafes, professional services, higher education facilities, and boutiques that support and drive the live, work, play atmosphere. Mixed-use, destination retail currently makes up about a quarter of our retail NOI.

When it comes to grocery-anchored centers, we invest in superior locations in our geographical footprint with high-quality anchors, which we believe will continue to perform well in an increasingly competitive landscape. Roughly half of our retail NOI comes from grocery-anchored assets.

The remaining 25 percent is in our power centers which are led by best-in-class retailers that are discount clothiers, pet supply stores, home goods, and service providers, along with typical outparcel users.

In summary, our philosophy and approach to retail is simple – we develop and invest in places where people want and need to shop. So despite the current perceptions facing the retail sector, we will continue to apply our methodical approach that has worked for almost 40 years.
While we remain upbeat about our retail assets, as is the case with our other product types, we continue to actively manage our portfolio to divest or expand when and where it makes sense. Along those lines, we may sell or repurpose a couple of our smaller retail centers in the coming quarters.

With regard to active portfolio management, we recently closed on the sale of our two build-to-suit state office buildings at a nearly 40 percent profit margin over our development cost, which once again exceeds our target wholesale to retail spread and demonstrates the value creation from our development platform. We used these proceeds to partially fund the acquisition of the outparcel space at Wendover Village in Greensboro, North Carolina for 14.3 million dollars. This acquisition complements the primary phase of Wendover Village that we acquired a little over a year ago as part of our 11-property portfolio purchase.

Moving on to the rest of the portfolio, as I previously mentioned we anticipated that our three-year streak of positive same store NOI growth would come to an end this quarter and it has. The construction of Phase VI of Town Center has impacted multifamily occupancy at The Cosmopolitan next door – and with a number of office tenant relocations within Town Center – we expect these impacts to continue until the end of the year. At the same time, we are confident about our ability to return Town Center occupancy to its historical levels and contribute to future growth in same store NOI.

I'll now spend a few minutes on our projects currently under development and construction.

By the end of the summer, we expect to begin construction on two student housing projects on the historic Charleston peninsula located within one mile of the College of Charleston and in close proximity to five other schools in the area. We continue to evaluate and explore opportunities to grow our footprint in this market.

Design progress on our new build-to-suit office building for Huntington Ingalls at Brooks Crossing is on track for an early 2018 construction start and 2019 delivery. This state-of-the-art facility is expected to house nearly 600 employees and serve as a catalyst for further development in this public private partnership with the City of Newport News.

Our Harding Place project in downtown Charlotte is well underway and we are very pleased with the rent growth and absorption that this sub-market continues to display.

The construction of Phase VI of the Town Center of Virginia Beach is now in the vertical stage and is tracking for a delivery next summer. This infill block will have a variety of entertainment options as well as exciting new retailers and loft-style apartments.

The initial units at Annapolis Junction will be delivered next month and Point Street is on track to begin deliveries early next year. Given their prime locations and compelling market dynamics, we are excited about these projects and fully expect to exercise our at-cost purchase options.

Last quarter, we entered into an LOI for a significant block of the remaining office space at One City Center in downtown Durham. Lease negotiations continue in earnest and assuming lease execution, the office component will be 90 percent preleased in advance of our expected summer 2018 delivery. We've begun preliminary discussions with our joint venture partner and Duke University about the next phase of this project.

With almost 440 million dollars of development in our current pipeline and our target wholesale-to-retail spreads of around 20 percent, we expect that these projects alone will add well over a dollar per share of NAV.

We continue to explore a number of exciting development opportunities in our target markets. With a growing stable of trusted and like-minded development partners, we have been able to increase our development run rate without compromising our core underwriting criteria – premier locations, high-quality anchor tenants, accretive returns, and healthy wholesale-to-retail spreads. As a result, we continue to be highly selective and decline the vast majority of opportunities presented to us. The standards we use to evaluate whether to deploy our precious capital on a new project will continue to be exceedingly rigorous. All of these decisions are considered in light of management's position as far and away the largest equity holder in the Company.

The sheer volume of opportunities allows us to select only the most attractive projects for evaluation, after which only a small fraction of those opportunities are pursued in earnest.

As an example, this quarter we entered into an agreement with S.J. Collins, a seasoned developer of high-quality, grocery-anchored retail centers, to deliver a Whole Foods center in Decatur, Georgia. We are hopeful that this relationship will lead to more opportunities with both this developer and exclusive retailer.

Lastly, our construction company continues to exceed expectations and is on track for one of its best years ever. This quarter, we substantially completed work on three new Lidl stores in Southeastern Virginia and look to expand this new relationship as their rapid Mid-Atlantic expansion continues.

Our successful execution across all areas of our business – investment, development, construction, and asset management – and our rapid growth in both profits and market cap has led to our addition to the S&P SmallCap 600 index. This will likely expose our Company to an expanded institutional investor base and continue to solidify our identity and brand recognition.

At this time, I'll turn the call over to Mike to discuss our second quarter results and updated 2017 guidance in detail. Mike…

Michael P. O'Hara
Treasurer, Chief Financial Officer

Thanks Lou

Today I want to cover the highlights of the quarter, thoughts on our balance sheet and additional details on our 2017 guidance.

This morning, we reported FFO of 24 cents per share and Normalized FFO of 25 cents per share which met our expectations.

Our same store NOI growth, which has been positive for 11 consecutive quarters, came to an end this quarter as expected. Same store NOI was negative 3.6 percent and negative 2.4 percent on a cash basis as compared to the second quarter of 2016. These results were expected because of the ongoing Town Center tenant changes and construction activity. Multifamily was negative this quarter due to the Cosmopolitan Apartments. Occupancy dropped to a low of 84 percent this quarter as a result of the construction of Town Center Phase Six across the street. Office was negative primarily due to relocating a Town Center tenant to 4525 Main Street, which is not in our Same Store NOI calculation, combined with the lease extension and downsizing of a law firm. Due to these disruptions, we expect this temporary impact to continue for the remainder of the year.

At the end of the quarter, our core operating portfolio occupancy was unchanged at 94 percent, with office at 90 percent, retail at 97 percent and multifamily at 92 percent.

On the construction front, we reported a segment gross profit in the second quarter of 2.7 million dollars on revenue of 57 million dollars. This is another strong quarter for this segment of our business.

At the end of the second quarter, the Company had a third-party construction backlog of 117 million dollars.

Now turning to our balance sheet.

We continued to take actions to enhance flexibility and strengthen our balance sheet including a large equity raise in the second quarter.

Maintaining a strong balance sheet as a private company was instrumental in being successful for 34 years prior to going public in 2013. With the management team being the largest shareholder at 17 percent, this approach has not changed. The company is managed and positioned for the long term and not quarter to quarter. That said, in May, we completed an equity offering to raise 85 million dollars to fund our 440 million dollar development pipeline. With this equity need and the market uncertainty for REITS we thought it was the right time to raise equity and take market risk off the table. Alternatively, we could have raised this equity through our ATM program over the next 12 plus months but that would have left little capacity for additional development projects. With this equity raise, we now have the capacity to complete and bring the current development projects on balance sheet. While this equity raise is dilutive to earnings and NAV in the short term, we believe it will be accretive in the long term. We only move forward with development projects that are accretive to both earnings and NAV inclusive of our cost of equity. The return on cost and the value creation of the projects must be higher than our cost of capital including any equity requirements, which is the case with the current projects. As Lou said, we believe these development projects once stabilized will add in excess of one dollar of NAV per share.

At the end of the quarter, we had total outstanding debt of 470 million dollars including 28 million dollars outstanding under the 150-million-dollar revolving credit facility.

We continue to evaluate our exposure to higher interest rates and look for opportune times to hedge our interest rate exposure. At quarter end, 100 percent of our debt was either fixed or hedged. During the quarter, we purchased a 2-year, 50-million-dollar interest rate cap at 1.5 percent.

Subsequent to the quarter end, we continued with asset recycling. We sold the two Commonwealth of Virginia single tenant office buildings at a 6.8 cap rate with a gain of 38 percent over our development cost. The proceeds from this sale were used in a 1031 tax free exchange to purchase the outparcels at our Wendover Center.

Now for an update on our full-year 2017 guidance that we issued this morning. We expect 2017 Normalized FFO in the range of 97 to 99 cents per share. This guidance is lower than the one we issued initially due to the capital raise in May. As we previously noted, 2017 is a year of execution and positioning the balance sheet for the development pipeline and future growth.

Now, the details of the 2017 guidance.

This updated guidance is predicated on the following assumptions:

- Disposition of the Commonwealth of Virginia office buildings with proceeds being used to acquire the Wendover Outparcels during the third quarter.
- No additional capital market activities including under the ATM program.
- Interest expense calculated on the Forward LIBOR Curve.

The 2017 guidance of 97 to 99 cents per share is also predicated on the following:

- Total NOI in the 72.8 to 73.3 million-dollar range,
- Third-party Construction Company gross profit in the 6.9 to 7.4-million-dollar range.
- General and administrative expenses in the 10.8 to 11.0-million-dollar range.
- Interest income from our mezzanine financing program in the 6.7 to 6.9-million-dollar range. At the end of the quarter, the aggregate balance of these mezzanine loans was 73 million dollars.
- Interest expense in the 16.9 to 17.4 million-dollar range.
- And, 60.3 million weighted average shares outstanding.

Now I'll turn the call back to Lou.

Louis S. Haddad
President, Chief Executive Officer & Director

Thank you Mike.

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 from Robert W. Baird.

David Rodgers:

Hey, good morning guys. Lou, in the spirit of retail, and obviously it remains in focus for your portfolio here in the near term, can you talk about any potential watch list you might have or pressure that you're seeing on lease economics, as tenants might talk up kind of this retail environment, and any additional color around any challenges that you may or may not be having?

Louis Haddad:

Great question, Dave, and good morning. We're really not seeing any pressure in our centers. We're seeing re-leasing, we're seeing options taken, we're seeing sales remain steady or growing. We've got several centers where there are significant leases coming up, in '18, '19 and '20. Right now, we don't foresee anybody doing anything other than renewing their options.

As you've seen, we're sitting somewhere around 97% full in the retail, and we expect that to continue. We really don't have exposure to the types of retail that are—seem to be under pressure. We've got one tenant you see on our top 10 list—Bed, Bath and Beyond, which I think has come under pressure, but we're monitoring the sales in those units that we own—we own four of them. The one here at Town Center is amongst their best stores in the nation, and the other three are in line or a little bit above average. We're really not seeing that pressure there, and that's probably the biggest thing on our watch list.

We do expect, when we bought the 11-property portfolio a year and a half ago, with primarily the Krogers, the last piece of that, the smallest center by far is a center in Western Virginia where there's a 30-some-thousand foot Kroger that we expect to repurpose, probably in the next 18 months or so. I doubt they would stay in a footprint that small.

David Rodgers:

Great. Thanks for that color, Lou. Then maybe, bigger picture—Mike, you had talked about issuing the equity to kind of free up some development capacity as opposed to using the ATM, which I think makes sense. But Lou, maybe you can provide a little additional commentary; you talked about some work down in Durham that maybe you're working on another phase with Duke. But can you handicap, kind of the odds of the development portfolio being substantially larger as you move into 2018, and consistently seeing this high level of activity going forward—talk a little bit more about that if you could, Lou.

Louis Haddad:

Sure. Again, as Mike said, we've got this tremendous pipeline marching its way through the Company, and we're really excited about those properties coming online beginning in—actually beginning next month and working all the way through 2018.

We wanted to make sure that we had the equity set aside to fully absorb those properties. We believe

they're a top quality and going to add substantially, both NAV and earnings. Taking that off the table gives us the opportunity to focus on potential equity needs for the next generation pipeline.

As you know, development is a slow game. When we talk about our shadow pipeline being, in essence, probably about the same size as the current pipeline, that's a very slow build. What we're working on now, be it the next phase in Durham, the next phase in Town Center, the next phase at the Inner Harbor in Baltimore, or Charlotte or Charleston, all of these properties—all of these projects, you're looking at a fairly decent timeframe for entitlement and design before there's any equity needs whatsoever.

I don't think we're going to be in the market anytime soon, either, as Mike said, with the ATM or, obviously, an equity raise. But we do believe that that shadow pipeline is developing very quickly—again, at the rate of development as it proceeds.

David Rodgers:

Great, thank you.

Operator:

Thank you. Our next question comes from the line of Rob Stevenson with Janney Montgomery Scott. Please proceed with your question.

Robert Stevenson:

Good morning guys. Lou, just sticking with the retail side of things, when you take a look at the strip center portfolio, I mean, where do you think value is, because obviously—I mean, one of the overhangs on the stock is that you bought this thing 20 months or so ago at roughly a 7% cap rate and there are people out there that believe that today, if you had to sell it, it's worth closer to an 8% cap rate, in that there's been significant diminishing here.

When you take a look at that portfolio today and where things have been trading in the market, in those various submarkets, etc., where do you think value is today?

Louis Haddad:

I appreciate the question, Rob. We try not to pay a whole lot of attention to fluctuations in cap rates and what's in and out of vogue. In the not too distant past, people were talking about the types of centers that we had being able to fetch a low 6% cap rate. Today, people are talking about high 7%, low 8%. Lord knows what's going to happen in the fall.

What we do pay attention to is increasing sales, increasing rents and increasing occupancy. As long as we stay focused on that, then it really doesn't matter a whole lot. That's what's happening in our portfolio, as you can see by the results.

As I said, as you guys know, we're not afraid to recycle this portfolio and we do it fairly regularly, and we do have a couple of smaller centers, I mentioned one that might be repurposed. We've got a couple of small grocery-anchored centers that we believe are at or near peak value, so you might see in the next 18 months that we trim the portfolio in that direction.

But, remember, we've been doing this—I've been in this chair for 33 years, our Chairman before, nearly 40. We've seen a lot of these fluctuations in the past, and it's really easy to get distracted over what matters, and what matters in real estate is location, credit, sales and escalating rents. As long as you stay focused on those real estate principles, you really can't get yourself in trouble.

Robert Stevenson:

Okay. Then, in terms of the Wendover outparcel, what's the plans there, and then can you also talk a little bit about what drove the increase in guidance on the construction segment gross profit guidance? Is that more projects, is that more profitability on certain projects, etc.?

Louis Haddad:

I'm going to take those out of order, Rob. I'll mention—I'll talk about construction, then I'm going to let Eric Smith talk a little bit about the Wendover outparcel.

On construction, as you can see, this is a banner year for us and it's a confluence of several events. We had a very large project that ended earlier in the year and delivered significant savings beyond our fee, nearly seven figures of savings. We also picked up a couple of clients along the way, intra-year, one being this Lidl relationship that added substantially to our backlog. Those projects are starting and finishing, essentially in the same year. It may well be, based on our guidance, that the construction company has a $7 million year.

I do want to say that, as you guys have heard us say before, we're not looking to expand the construction company. It does high-quality work for people who want to negotiate projects with us, and as such, that stays fairly stable at the $200 million, $250 million range, and that typically yields profits where we start in guidance, in that $4.5 million to $6 million range. I expect that construction will return to its norm next year and the years that follow.

Eric, can you take the question about the Wendover outparcel?

Eric Smith:

Sure, happy to. Thanks, Lou, and good morning. As you'll recall, the primary portion of the Wendover Village asset was purchased when we did purchase that 11-property portfolio, and we purchased the entire portfolio in the 7.25% cap rate range on a cash basis, and that has only increased over time as our asset management team has applied increased attention to that asset, both on a quality of leasing perspective, maybe than it had prior to our ownership. So, we've enjoyed some nice bumps there.

Within those 11 assets, the Wendover Village asset was one of the premier assets. As you may know, it's located on the Southwest side of Greensboro, right off of 85 and 40, shadow-anchored by a Costco right at exit 214, and really good demographics around that retail center. We felt very good about the primary center.

The outparcels that we just purchased at that 7% cap rate, a little bit of color commentary of why we were interested in buying retail in the backdrop of the—that Lou mentioned about the retail segment that we currently face. We had the opportunity to buy these outparcels immediately after we acquired the 11-asset portfolio and we turned them down based on the cap rate that the seller was asking for.

It came back across our desk about a year later and we said no again based on the cap rate that was being asked for, just because we didn't need the acquisition; we were interested in it given the health of the Center, but we didn't need it. A little color commentary; the seller came to us when they had another buyer under contract and wanted some RAA changes that we were not willing to do. That deal fell apart and we became, really, the only viable buyer, given that it didn't make sense to another buyer to buy without the RAA changes they were asking for, where they didn't—obviously owning the core Center, not a concern for us.

We put a very aggressive offer on the table that was accepted, so we think we're acquiring it at a nice cap rate relative to its value, especially when you consider that now we have the entire Center without the whole of the outparcels. But we feel really good about that acquisition.

Robert Stevenson:

What do you plan to build on the outparcel?

Eric Smith:

The outparcels are all developed and 100% occupied.

Robert Stevenson:

Oh, okay, so it's not a develop play, it's just an income play. Okay.

Eric Smith:

Right. Almost 36,000 square feet anchored by Panera and a number of other credit-quality tenants.

Robert Stevenson:

Okay, perfect. Appreciate it, guys.

Louis Haddad:

Thanks Rob.

Operator:

Thank you. Our next question comes from the line of John Guinee with Stifel. Please proceed with your question.

John Guinee:

Oh, great, okay. I have just a whole bunch of little questions. First, explain what you're doing in Decatur. How much are you investing, what kind of return are you expecting, how long would you have that investment in place?

Louis Haddad:

Sure. John, once again, that's a Whole Foods center and that was the first step in the relationship that we're working on with S.J. Collins, as well as Whole Foods. For the specifics—I'm staring at Mike. I believe it's a $10 million investment?

Michael O'Hara:

Yes, $10,750,000 mezz loan on that project. Our return on that is 15%, and the loan is the same maturity as the construction loan, I think it's three years.

Louis Haddad:

John, this is the largest developer of Whole Foods in the country and they have a pipeline of these things. When they came to us, this one was ripe. They had been—they're predominantly a merchant builder, and they had been raising this kind of equity with these kinds of returns from third parties, so in order to initiate the relationship, we said we'll step into those shoes, with an eye towards the rest of the pipeline.

John Guinee:

Okay, and they just are paying you the mezz out of the—essentially the borrowing capacity, 15%; will you be able to record that currently, and how long do you expect to be in that loan?

Michael O'Hara:

Yes, we are recording it. Currently, we—the Center is 80% leased and I know they've held off leasing because of demand they think they can push rates. I suspect, I think it's a year and a half construction phase, so I would assume shortly after completion they'll be looking to take us out.

John Guinee:

Okay, so just the two-year $11 million loan. Second, student housing, the math here looks like $537,000 a unit. There's got to be more to it than that. Can you kind of talk about investing $100 million in this kind of product, what the appropriate unit costs are and what kind of yield you expect on this?

Louis Haddad:

Yes, John, I'll give you a statistic. We've got a $100 million invested on two properties, representing 600…

Michael O'Hara:

Six hundred beds.

Louis Haddad:

Six hundred beds. We're looking at $150,000 or so a bed. We're programming this around a 7% return on cost, and properties, as you know, of this ilk, particularly in that location, are selling right around a 5% cap, but our intent is not to sell it but to hold it long term, because it's in the A position.

John Guinee:

Then…

Louis Haddad:

I'm not sure where your math…

John Guinee:

Oh, I'm just looking at your spreadsheet here that says there's 188 units, it doesn't say 600 beds.

Louis Haddad:

I got you, okay.

John Guinee:

Then, Point Street Apartments in Baltimore, Annapolis Junction, purchase option. When would you exercise this purchase option; then, as of today, what sort of yield on cost or yield on purchase option should they generate?

Louis Haddad:

Annapolis Junction starts to deliver next month, and effectively, really leasing probably starting in September. We're anticipating—and we always anticipate along these lines, to somewhere around 18-month lease-ups. Our option will be good through 2018, and so depending on how fast lease-up proceeds, we expect to exercise during 2018. It's hard to say right now how early in the year that would be.

John, as you know, we advertise that we work off of at least a 20% spread. We've monetized several of these assets, and I think 20% was probably the least that—of any of those that we've monetized. I would say, were we to monetize either of these assets, it'd be substantially higher than that based on the kind of cap rates people are paying, at the Inner Harbor in Baltimore and at Fort Meade. But that's not our expectation. We're hoping to own these things for a long time.

John Guinee:

But, the question is, on both of them, you're going to shift from earning an 8% and a 10% interest on mezz loans to essentially having those mezz loans repaid, and then you'll exercise a $92 million and $102 million purchase option, and then hold those. Are you going to be buying them at a 4% yield on cost, or a 9% yield on cost?

Louis Haddad:

Our expectation is that those are going to be in the high 6%, low 7%, based on pro forma rent. We expect that the transaction—or transition from mezzanine to wholly owned is going to be an accretive one, both on NAV as well as an earnings basis.

John Guinee:

Okay, great. Thank you.

Operator:

Thank you. Our next question comes from the line of Craig Kucera with FBR Capital Markets. Please proceed with your question.

Craig Kucera:

Hey, good morning guys. You had a meaningful decline in your development occupancy and a rent cut at the Johns Hopkins Village. Can you give us some color on how lease-up is trending going into the school year, and maybe what the supply situation is there?

Louis Haddad:

Sure, I'm going to let Mike talk to you about that decline, but I'm also going to tell you that we are 100% leased starting next month, with I believe, one potential bay left on the retail.

Mike?

Michael O'Hara:

Yes, Craig, what we've had is, come May as students started moving out, we had 10-month leases at that property, so we dropped from 79% occupied to 50% occupied here during the summer. Like Lou said, we'll be at 100% leased on the beds, coming in the next month—coming at the end of this month.

Craig Kucera:

Right. Just another question, this may be difficult to answer but can you estimate what the impact to same store was from some of the movement going on at Town Center related to multifamily and the construction, and your retail client moving to 4525?

Louis Haddad:

We've got a couple of different pieces there. If you think about, as our—as the Cosmopolitan, we had occupancy go from 90% to the mid to low 80%, and that represented in and of itself a couple hundred thousand dollars.

On the office side, basically we took a 14,000 foot tenant and moved him out of the pool. There are backfill leases that are coming in place that are not producing yet. When you take those two factors, as well as the downsizing of essentially the last law firm that cycled through at Town Center, I think it accounts for the entirety of the change.

Craig Kucera:

Okay, thanks.

Operator:

Thank you. Our next question comes from the line of Bill Crow with Raymond James. Please proceed with your question.

Bill Crow:

Hey, good morning, guys. Two questions. The first one on the multifamily at Town Center, is it going to get worse as you look at the upcoming lease rollover trends?

Louis Haddad:

Bill, thanks for the question. I was hoping somebody would ask that because the Cosmopolitan is, as of today, over 90% leased, so it's—we saw the bottom, and as we said last quarter, our expectation would be that it would return to normalcy around the end of the year. We're on track for that.

Bill Crow:

Okay, great. Second question going back to retail, you talked about sizable lease expirations in '18, '19 and '20 and that you were confident you could re-lease some space or renew the tenants, I should say. Are you confident in the outlook for the rental rates as well? Are we going to see positive increases in rents, or how do you feel about that part of it?

Louis Haddad:

We feel really good about that. I don't see anything other than people renewing at their option rate.

Bill Crow:

Okay. That's it for me, thanks.

Operator:

Thank you. There are no further questions at this time. I would like to turn the call back over to Mr. Haddad for closing remarks.

Louis Haddad:

Thanks everybody. We appreciate your interest in our Company and look forward to updating you on our activities and results over the course of the year. Have a good day.

Operator:

Thank you. This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation and have a wonderful day.