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Armada Hoffler Properties, Inc. (AHH)

Q4 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 fourth 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, February 6, 2018.

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 fourth quarter 2017 earnings conference call and webcast.

On the call this morning, in addition to myself, are Lou Haddad, CEO and Eric Smith, Chief Investment Officer, who will be available for questions.

The press release announcing our fourth quarter earnings along with our quarterly supplemental package and our 2018 guidance presentation were distributed this morning.

A replay of this call will be available shortly after the conclusion of the call through March 6, 2018.

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, February 6, 2018, 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 guidance and 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 forward-looking statement disclosure in our press release this morning and the risk factors disclosed 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.

Now, I will turn over 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 fourth quarter results of 23 cents of Normalized FFO per share, which was in line with our expectations. We finished the full year at 99 cents per share which was the mid-point of our previous guidance. We also issued our guidance for 2018, which will be the focus for most of my commentary.

To briefly summarize 2017, I'd like to refer back to what we said on this call one year ago. At that time, we informed investors that we anticipated a year of strengthening our balance sheet and executing on our large development pipeline. Without any development deliveries slated for 2017, we stated that earnings would be more or less flat compared to the previous year, with significant NAV and earnings growth expected to occur beginning in the latter half of 2018 with the delivery and eventual stabilization of several development projects. I am pleased to report that we have met all of our goals for last year and the pipeline is on track to deliver the value that we anticipated.

As you can see on page 3 of our guidance presentation, we anticipate 2018 Normalized FFO per share between a dollar and a dollar five. The mid-point of this range is a measurable increase over last year's results, even though development deliveries are not expected to provide any appreciable impact to 2018 earnings.

We expect another strong year for our company in all aspects of our business. Portfolio leasing and accretive acquisitions combined with another stellar year from our construction company will continue to deliver value to our shareholders. Let's look at these factors in that same order.

Starting with our existing portfolio and referring to page 4 of the guidance presentation, our portfolio NOI is projected to rise incrementally exclusive of 2018 acquisitions. This growth is expected to come predominately from additional Town Center leasing across all product types. Our expectation is that with construction disruption ending by mid-year, multi-family occupancy will increase. Office vacancies caused by relocation and expansion of existing tenants are well on the way to being backfilled. We also anticipate filling the few pockets of retail vacancy within the project. The other two-thirds of the portfolio remains leased, on average, in the high-nineties.

On the acquisitions front we have adhered to the basic tenets of real estate for nearly forty years: prime locations, proven operators, and diligent monitoring of sales traffic and demographics. As I mentioned on our last call, the current retail environment has yielded a host of opportunities to acquire such properties, particularly in the grocery sector. Over the last few months we evaluated numerous assets and identified a number of these centers that not only meet our investment standards, but, as importantly, help us solidify relationships with quality operators and development partners to fuel our primary growth vehicle, our development operation. What you see on page 5 of the guidance presentation are the completed and pending acquisitions resulting from this effort. As you know, we invest in superior locations in our geographical footprint, including high quality addresses in secondary and tertiary markets that most public REITs dismiss. These are predominantly off-market opportunities and some involve the issuance of OP units, a trademark of our acquisition strategy.

For example, last week, we closed on the acquisition of Parkway Centre, a newly constructed retail center in Moultrie, Georgia anchored by Publix. We acquired Parkway Centre in an off-market transaction in which this developer, Teramore Development, took back half of their equity in the form of OP Units. We look forward to potential future opportunities to work with this new partner.

We have also agreed to terms on the acquisition of two newly constructed Lowes Foods anchored centers in South Carolina. For those of you not familiar with Lowes Foods, they are a North Carolina based, family owned and operated enterprise, who have been in business for over sixty years. Lowes foods is part of a two-billion-dollar organization. With a new store concept comparable to Publix and Harris Teeter, Lowes Foods operates nearly one hundred full-service supermarkets primarily located in the Carolinas. Both were off-market transactions and one involves our strategic development partner, SJ Collins, who will be taking back a meaningful portion of their equity in the form of OP units. We anticipate closing on both acquisitions in the late first quarter or early second quarter of this year.

Last month, we closed on the acquisition of Indian Lakes, a retail center in Virginia Beach anchored by Harris Teeter and Wawa. Indian Lakes is a property we know quite well. We originally developed and built the center in 2008. And when the opportunity to acquire the asset at an attractive cap rate presented itself, we acted on it. The four acquisitions total 66 million dollars at a blended 6.8 percent cap rate. But as I mentioned previously, these transactions include additional leasing upside as well as positioning us for further engagements with these strategic developers and operators.

Again, as seen on page 5 of our guidance presentation, these properties will temporarily increase the retail percentage of our NOI. As the far-right chart shows, traditional retail is projected to be well under 40 percent of NOI with the delivery and stabilization of the current pipeline. Please note that in all of these charts, a separate portion of our portfolio is labeled as entertainment and mixed-use retail, this category primarily consists of restaurants, entertainment venues, professional office, higher education facilities, and some boutique shops. We believe the tenants represented here are of a materially different nature than traditional retail.

Now, turning to construction. Our previous expectation was that after two years of record profits for the sector, construction would return to its historical norm of 4-5 million dollars of gross profit. This was based on the expected decrease in contract volume anticipated in 2018. I'm pleased to report, that due to our unique cross-selling platform, we expect to be able to maintain the high end of our historical range despite this projected decrease in third party contract revenue.

As I mentioned last quarter, our construction group has a long history of third-party work in the industrial and distribution sector. This experience began back in the early 1990s and continues today as we will be building a 23 million dollar, 220 thousand square foot distribution center for a fortune fifty company. This new building is the result of a consolidation of three older facilities. In the negotiations with the client, we offered a menu of fee construction and development, build-to-suit purchase, or long-term lease, giving this client optionality that is only afforded with our integrated business model. The client selected the long-term lease arrangement. As we are not long-term holders of industrial real estate, we expect this project will be designed, built, occupied, and sold within 2018, all at the taxable REIT subsidiary level. Due to the favorable rates contained in the new tax law, it is practical for us to monetize this value creation in this manner. Therefore, profit recognition is expected to be significantly higher than just the typical fees we would have earned under a third-party construction contract.

As you know, our construction group receives this type of build to suit opportunity on a fairly regular basis. Since our IPO, we have executed on four facilities of this nature, 2 state office buildings, the Newport News Police Precinct and the Oceaneering building. The disposition of these buildings, other than the police precinct, resulted in our acquiring other properties under a 1031 exchange. While tax free exchanges will still be a part of our strategy, lower tax rates will enable us to alternatively handle these engagements at the TRS level as well, where taxes will be paid and the net proceeds can be used for balance sheet purposes.

Turning now to the development business and page 8 of the guidance presentation, you'll see here that the pipeline is now at approximately 484 million dollars' worth of investment. Given our typical wholesale to retail spread of 20%, we estimate that once these assets are stabilized, NAV will increase over a dollar per share.

You'll notice that we have added to the already robust pipeline previously reported. The Market at Mill Creek in Mt. Pleasant, South Carolina is our first development with Lowes foods in a grocery anchored shopping center. This center, along with our expected acquisition of the Lowes foods centers previously discussed are the first steps in what we hope to be a long-term relationship with both this first-rate regional grocer as well as our newest development partner, The Adams Property Group.

Construction on all of the other projects in our development pipeline remain on track. Furthermore, we'll be breaking ground on the build-to-suit office building for Huntington Ingalls Industries at Brooks Crossing later this month.

On the leasing front, I'm excited to announce that WeWork has agreed to lease over 60,000 square feet at One City Center. WeWork, combined with Duke University, brings pre-leasing on the office component of the project to approximately 90 percent. As a result, we expect to deliver One City Center at or near stabilization later this year. We previously announced that Pottery Barn and Williams Sonoma will be anchoring the retail portion of phase 6 of town center.

We delivered the Annapolis Junction project and as of today, there are over 130 signed leases at pro forma rents. We are very pleased with the initial leasing demand.

Assembly of our next development pipeline is well under way, and we look forward to discussing those projects with you later this year.

At this time, I'll turn the call over to Mike to discuss our fourth quarter results and 2018 guidance in detail. Mike…

Michael P. O'Hara
Treasurer, Chief Financial Officer

Thanks Lou.

Today I want to cover the highlights of the quarter, the full year, thoughts on our balance sheet, and our 2018 guidance.

This morning, we reported FFO of 24 cents per share and Normalized FFO of 23 cents per share for the fourth quarter.

For the full year, both FFO and Normalized FFO were 99 cents per share. This compares to FFO of 96 cents and Normalized FFO of a dollar one in 2016. As we discussed, 2017 was a year of execution on the development pipeline and positioning the balance sheet for future growth. We were successful on both accounts in 2017.

2017 was another good year of total shareholder return for AHH. Our 2017 total return was 13 percent versus 5 percent for the RMS. And since our IPO in May 2013, total shareholder return through December 31st was 78 percent versus 34 percent for the RMS. We are obviously pleased with these returns and are grateful for the trust our shareholders have placed in the management team.

During the year, our equity market cap increased by 164 million dollars, reaching a peak equity market cap of one billion dollars and a total enterprise value in excess of 1.5 billion dollars in December.

The dividend was well covered with an 83 percent AFFO payout ratio for 2017.

Same store NOI was negative this quarter and for 2017 as expected. As we have discussed the past couple of quarters, this metric was impacted from ongoing construction of Town Center Phase Six as well as by the relocation and expansion of two significant office tenants to 4525 Main Street, which is not in the Same Store NOI calculation. We have made progress in leasing this vacated space, with approximately 50 percent released at this time.

To illustrate what is truly happening with our portfolio, look at our occupancy and releasing spreads. Our core operating portfolio occupancy this quarter is 94 percent, with office at 90 percent, retail at 97 percent and multifamily at 93 percent. Additionally, our releasing spreads were strong for 2017, with GAAP positive 5.2 percent and cash positive 1.8 percent.

On the construction front, we reported a segment gross profit in the fourth quarter of 600 thousand dollars on revenue of 33 million dollars. For the full year, we reported a segment gross profit of 7.4 million dollars on revenue of 193 million dollars. This is one of the best years in the history of our construction group. These numbers do not include the construction volume on our development projects of 52 million dollars, which is eliminated under GAAP. Construction volume on our developments will also be material in 2018 approaching 100 million dollars.

At the end of the fourth quarter, the Company had a third-party construction backlog of 49 million dollars.

Now turning to our balance sheet.

We continued to take actions to enhance the flexibility of our balance sheet and work on loan maturities.

As we have been discussing, 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. With our current leverage metrics well positioned, we did not issue any equity in the fourth quarter, but we intend on filing a new ATM program this month along with the 10-K. We expect to issue equity under the new ATM program this year if market conditions are favorable. If not, we have other options including selling noncore assets. These proceeds would be used for further deleveraging. Additionally, we are seeing a lot of development opportunities and want the availability of capital for these projects.

We continued to work on loan maturities as well. The credit facility revolver was scheduled to mature in early 2019. During the fourth quarter, we closed on a new credit facility to stay ahead of the maturity. The new facility is 300 million with an accordion to 450 million. This facility includes a 150 million revolver and 150 million term loan. The revolver matures in 4 years and the term loan matures in 5.

In January, the Sandbridge Harris Teeter loan was extended for five years at LIBOR plus 175.

At the end of the year, we had total outstanding debt of 523 million dollars including 66 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. Again last quarter, we purchased a 2-year, 50-million-dollar interest rate cap at 1.5 percent.

Today we introduced 2018 guidance of one dollar to a dollar five per share. As Lou discussed, the guidance includes the expected sale of the distribution center by the TRS as we view this as a construction project that evolved from our cross-selling client platform. We intend to sell this asset before it is placed in service and include it in Normalized FFO. We included the expected profit from this sale in both the Construction Company gross profit and Normalized FFO guidance. This is illustrated on page 6 of the guidance presentation. The guidance for this part of our business has a wider than normal range due to the variability in exit cap rates. This is another example of being an opportunistic real estate company. This transaction will have an impact on Debt to EBITDA in 2018 as our balance sheet will carry the debt with no corresponding EBITDA. Because of the short-term nature of this project and associated debt, we will not issue any equity for this project.

Now I'd like to go through the details of the 2018 guidance. Please turn to page 3 of the presentation.

First, starting with our assumptions:

- The acquisition of the four retail centers, two of which closed in the first quarter. Pending due diligence, we expect to close on the other two late in the first quarter or early in the second quarter.
- Raising 55 million dollars through the ATM program.
- The sale of the distribution center in the fourth quarter. Since the FFO would be recognized at the time of sale, fourth quarter Normalized FFO would be substantially higher than the previous three quarters.
- Interest expense is calculated based on the Forward LIBOR Curve which forecasts rates rising to 2.2 percent by year end.

This 2018 guidance of one dollar to a dollar five per share is predicated on the following:

- Total NOI in the 80.7 to 81.4 million-dollar range,
- Third party Construction Company gross profit in the 4.4 to 7.5 million-dollar range.
- General and administrative expenses in the 10.7 to 11.0 million-dollar range.
- Interest income from our mezzanine financing program in the 9.0 to 9.5 million-dollar range. As of year-end, the aggregate loan balance of these mezzanine loans was 83 million dollars.
- Interest expense in the 19.7 to 20.3 million-dollar range.
- And, 64.5 million weighted average shares outstanding.

Now I'll turn the call back to Lou.

Louis S. Haddad
President, Chief Executive Officer & Director

We remain extremely bullish on the performance of our company. With an accretive pipeline nearing delivery and a solid balance sheet, we believe we are poised for significant growth over the next few years. When combining these factors with a well-covered dividend that has increased annually, and still yields in excess of five percent, we feel that we are delivering exceptional value to our shareholders. We will be discussing the dividend at our quarterly Board of Directors meeting on February 22nd, and we will issue a press release shortly thereafter.

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 "star 2". If you're using a speakerphone today, please pick up your hand set before entering your request.

Once again, that is "star 1" to ask a question. Our first question this morning is coming from David Rodgers of Baird & Company. Your line is now live.

David Rodgers:

Good morning, guys, and thanks for the 2018 Guidance Presentation. I think that was really helpful. I wanted to quickly ask about the office space that's left at, I guess the Town Center overall. Each asset is kind of somewhere hovering around or just above 90%, so it seems like a bunch of small pockets. But it sounds like you guys have some pretty good activity. So Lou, any additional color you could add there?

Louis Haddad:

Sure. So the space that we vacated with those 2 tenants that relocated to 4525 has been filled with, I want to say it's 5 smaller tenants are now going to be occupying about half of that vacancy. We've seen some really good activity here of late, Dave. I guess with the uptick in the economy, we're seeing more people actively looking. I feel really good about filling the rest of that space. As you said, it's all pretty much in small pockets, so it's kind of slow going. But we're looking forward to getting back into the mid-90s where we've traditionally been on office in Town Center.

David Rodgers:

Then shifting gears to residential and some of the developments coming up, you're within the year now of Annapolis Junction and Point Street completing. How are market rents looking on those projects? You've felt pretty good in the past, I'm just curious on kind of any update on those in terms of how those are starting to play out.

Louis Haddad:

Dave, that's a great question. I want to be cautious with the answer. Both of these properties, the rents, the leases that have been signed are predominantly above our proforma rents. I try not to get overly excited about that, until we get towards the end of the initial lease up rather than the beginning. But certainly, really encouraged about the results thus far.

David Rodgers:

Great. And then maybe last for me, can you talk a little bit more about the retail environment? Obviously some more acquisitions here in the first quarter and in the guidance for the remainder of the quarter. But curious on the yields that you're seeing here, how you're viewing these purchases relative to maybe what you could replace these assets for. Any additional thoughts on the retail landscape?

Louis Haddad:

Sure. I'm going to let Eric answer this question more specifically; but just generally, as I said in my opening comments, we continue to operate as a real estate company, looking for high quality real estate, with high-quality partners and high-quality operators. That hasn't changed for going on 40 years and I don't expect it to change any time soon. What we're seeing in our retail properties is very high demand and very high lease up of the few pockets of space. I think we're at like 97% now on the retail occupancy. The yield on these particular properties, we hope to get into the low 7s, by some lease up and also by some potential dispositions, but I'll let Eric explain that more fully.

Eric Smith:

Sure. Thanks Dave and thanks Lou. I'll be brief in my comments, but I'll touch on each of these very Quickly, because I think anecdotally a couple pithy comments will highlight exactly what we've said; how we focus on the real estate, then the yields, including the upside opportunity. And lastly, the opportunity to expand our relationships. So Indian Lakes is obviously something we were extremely familar with, having developed it. And while at first blush, it appears to be going in cap rate on NOI in the low 7s, there's an opportunity to peel a high value Wawa off, at a very attractive cap rate, and get that into the high 7s approaching 8. And it is real estate we obviously know well here locally. We have a shadow anchored grocery store asset right next door that's perennially been 100% leased, still a very strong submarket. Now, you move down to the Publix acquisition in Moultrie, Georgia, and again, going in cap rate in the mid 6s, but with the small shop space that we have yet to rent; we expect that to get into the 7 range as well. We spent a lot of time diligence this asset. This doesn't arguably have the same 1-3-5 mile demographics, given that you have a county with a 50,000 population. But when you actually go down and put boots on the ground, you find out that the population was turning their backs on the local off brand markets like Harvey's and Oxley's which are not -- they're low-cost providers and not competitors at all -- and driving anywhere from an hour to an hour and a half roundtrip to Tipton, Thomasville, Valdosta, etc., to shop at the Publix in surrounding cities. And so we feel very good, as we're the only site Publix wanted to be in, willing to take in this city. And so we feel really good about the real estate. You touch on the other two, and we're talking about strong demographics in the Lexington, South Carolina area and Greenville, South Carolina just outside the beltloop there in Greer. And we're very pleased with those as well, with some of the similar upside opportunities we discussed. So when you look across those acquisitions, again, through the lenses and the metrics that Lou outlined, you're talking about an opportunity with one of our strategic partners -- we've talked about a lot with SJ Collins and the acquisition of the Lexington asset from them and the taking back of OP units. The development in Mount Pleasant with the Adams Group, the acquisition of the Publix in Georgia with the Teramore Group; so all long-term local partners that we plan on doing more business with. And then you're talking about long-term relationships with Lowes Foods and Publix, that we feel are very strong operators. Those might be a little less well known, part of the $2 billion Alex Lee conglomerate, but we spend a lot of time with their corporate team at their headquarters and touring their new concepts, and it's every bit a true competitor of Publix, Harris Teeter and Whole Foods given their organic and local store concept, given many of their unique in-store concepts, as well as their high service levels. And so we feel very comfortable about those partnership relationships and those operators, and obviously the real estate itself.

David Rodgers:

Appreciate it, thanks guys.

Operator:

Thank you. Our next question is coming from Jim Lykins from D. A. Davidson. Please proceed with your question.

James Lykins:

Morning guys, and thanks for taking my question. First of all, the 2 acquisitions, for the one in Georgia, I didn't see in the press release the square footage for that one. I'm wondering if you can first of all give us that, and then any other color on those 2 transactions. Occupancy, how much you think you might be able to push rents, and if there may be a value add component to either one of those.

Louis Haddad:

Thanks. And then second question on, Williams-Sonoma and Pottery Barn. Can you talk a little bit about two things? One what kind of deal you have to cut in terms of base rent, net and gross, as well as tenant concessions, the TI dollars to get them in this space? And also, are they new to the trade area and are they moving from a different location and if so, from where are they moving?

Louis Haddad:

Absolutely. Again, I'll let Eric take that.

Eric Smith:

Sure. In similar order that I just mentioned, let's start with Indian Lakes. We're going in at 95% occupied on a 71,000-square foot center; so you have a little over 3,000 square feet vacant. So, there's an upside on leasing there. Like we said, we also feel good about that retail corridor over time for there to be some upward releasing rates. And then finally, the Wawa I mentioned that we could spinoff to get that from the low 7s to approaching an 8-cap rate, so that upside is across those 3 metrics. And then on the Parkway Centre in Moultrie, Georgia, a little over 61,000 square feet. We're going in there with just under 5,000 square feet vacant across four bays, and we feel really good about filling those, which is why we were happy to go in at a mid-6 cap rate, with a goal of getting it over 7. Like I said, that market -- in addition to folks doing the hour to hour and a half roundtrip to other Publix and the 3 neighboring towns I mentioned -- what you have here is a new retail corridor to the northeast of town, as you come in on route 319. And this is where you have all the players of note on the retail side in the market. And this is at Main and Main in that market. So to the extent that there is small shop demand in that market, it will be at this intersection in this Publix center. So we feel really good not only about filling that space, but over time having the premier asset in that market, being able to push rates as those leases roll over in the future.

James Lykins:

Ok, that's very helpful. Also, could you just talk about who, if anyone, may be on your watch list right now at all? So what you're seeing with leasing trends so far into Q1 on the retail side?

Louis Haddad:

Again, on the retail side, Jim, it's been very robust. There's just a very small amount of vacancy. We're seeing good tenant rollover and leasing spreads, as Mike had mentioned, have been healthy. In terms of our watch list, I've mentioned before, we still own 4 centers that have Bed, Bath & Beyond in them. We're somewhat concerned about them as a company, however, the volumes that they're doing in our stores are skewing to the high end of their average store, so we'll see. We feel really good about, if in the eventuality that those actually might go out, being able to release those. As we've mentioned before, we're continually looking at this portfolio for where we think peak value has been reached. I've mentioned that we still have 3 Food Lions in the portfolio as well as a Bi-Lo. We feel really good about the locations and the sales, but as I've mentioned before, I could see us divesting ourselves of those over the next couple of years. Certainly, no reason to dump them if you will, particularly in the current environment, but I think long-term you'll see that rotation out of those few stores.

James Lykins:

Okay, thanks Lou, and I will pop back in the queue.

Operator:

Thank you. Our next question is coming from Rob Stevenson from Janney Montgomery Scott. Your line is now live.

Robert Stevenson:

Good morning, guys. The Lowes Foods-anchored stores that you're going to build or buy, those are actually Lowes stores and not their "just save" concept, right?

Eric Smith:

That is correct. And I would add to that, they're not only the Lowes Foods, but they are all the Lowes Foods new concept; which for those on the phone who might be familiar with Lowes to start with, there is a notable difference between the older store concept and their new store concept. They spent a lot of time demoing the market and working with their customers. And like we said, I don't know that we would be buyers of their older concept stores, but we're very big fans of the new concept stores.

Robert Stevenson:

For the ones that are operating currently, what are they doing sales wise and how does that compare to a Publix or a Kroger or Harris Teeter in a similar market?

Eric Smith:

Sure. The information that we have on -- let's see, let's start with the Greer/Greenville, South Carolina location -- They've been open about a year and their sales per square foot are approaching $400 a square foot. The Lexington store has not been open but for a few months, but we expect that, based on early trends, to be even better. And based on our research and diligence, we believe that they are at par with, if not in excess of, the competitive set I mentioned when they are located right across the street, down the street, etc., in the same submarket.

Robert Stevenson:

That's great, thanks. And then Lou, with the Duke project now 90% leased or preleased, at what point do you guys start talking to the school and start kicking off whatever the next one is --Two City Center, or I don't know how the numbers work down there -- but the next project down there if this one is already 90% preleased at this point?

Louis Haddad:

Great question, Rob. And the answer to that question is, we've been in talks with Duke for the last several months about anchoring the next high-rise. My expectation is that you're going to see some really exciting announcements over the next several months of large, mixed-use, public/private type developments, that are going to stock a new pipeline for us that's going to add the same kind of value that we believe the current one is zeroing in on.

Robert Stevenson:

Mike talked about alternatives to the $55 million of ATM issuance that you guys have in your guidance at this point, if the stock price stayed low or went lower. You talked about having some OP units, not only in deals that you've already closed, but deals that are going to close. At 13 and change, how do you feel about including OP units at a price like that, versus just selling an asset or something like that or using cash at this point in the cycle?

Louis Haddad:

That's a great question and it's something we have to continually evaluate. We've got a number of properties coming online that, like I said, we've developed these properties in order to own them long-term. However, again, as the largest shareholder, that's not at any cost. We think we're adding a tremendous amount of NAV with this pipeline, and if it looks like the stock isn't trading the way we would like it, then we're not afraid to reap some of that value and book the cash. As you know, this is not a static game and I didn't get overly excited when the stock hit $16, I'm not going to get overly excited when it hits $13. But we need to operate our business with an eye towards what's going on in the market simply for the availability of capital and use the best sources that we can.

Eric Smith:

I'll add to Lou's comment very quickly -- which is both the OP units that were issued for the transaction that closed, as well as the pending transaction in both cases-- those OP units were transacted at a price higher than the current stock price, after this material selloff the last few days.

Robert Stevenson:

That's great. And then Lou, given that comment though, you've got on, I forget, Page 5 of the Guidance, you've got the pie chart showing current portfolio breakdown and then what it is with the stabilized portfolio, development portfolio. If you guys were to sell stuff out of there -- I mean obviously the multifamily stuff is probably the most liquid -- how comfortable would you wind up being having retail go from 49% to 55%, 58%, even 60% if you wind up harvesting gains from other asset classes for some period of time in the portfolio? Is there an upward bound where you start saying, I've got to start selling retail as well as other asset classes when your portfolio mix gets there do you think?

Louis Haddad:

We don't want to let it get too far out of whack. But remember, this is a long-term game. We feel really good about the retail that we own, the mixed-use retail is always going to be there, the grocery-anchored stores are always going to be there. Although we've continued to look at recycling those things. We're comfortable with the real estate that we own. Investors pay us to be real estate professionals, not market reactors. When we've got stores or centers that are 97% or 100% leased and sales are going up, we're going to feel really comfortable about holding that real estate. These are not big boxes, these are not department stores, they're not malls. They are very solid real estate assets that we intend to have for the long-haul. That said, we don't want to turn into a retail company and as such, like we've said before, the majority of this pipeline as well as the pipeline that's forming, takes us away from retail centers and more to mixed use office/residential.

Robert Stevenson:

Okay, and then last one for Mike, so that he doesn't feel too lonely, why were the same store expenses in the apartment segment running so high in 2017 at 5.5%? Was there anything in particular, property taxes or something else really drove that number up? Or was it just a variety of expenses?

Michael O'Hara:

It was in 3 areas. First were utilities and real estate taxes, and then the third is repairs and maintenance. So at the Cosmo especially, as it's aging, putting money into carpet refresh and those kinds of things.

Operator:

Thank you. Our next question is coming from James Feldman from Bank of America, Merrill Lynch. Please proceed with your question.

Kim Hong:

Thanks, and good morning. This is Kim Hong on for Jamie Feldman. It seems like office and multifamily same store for NOI had meaningful drags in 2017. Can you discuss your expectations for same store NOI in these segments and the office leasing spreads included in your 2018 guidance?

Michael O'Hara:

On same store NOI, we're expecting to see a rebound in the middle of the year, especially with the effects on the office. The releasing has started to happen, so that will start hitting the pool when those leases are there; as well as the 4525 Main Street will be in the same store NOI pool come third quarter of next year. So office obviously is going to be rebounding. Multifamily, we are expecting the same. We are expecting to see the occupancy begin to climb back at Cosmo. And on retail, we are expecting a slight growth in same store NOI like we've had the past couple of years on the retail.

Kim Hong:

I know you just spoke about the retail acquisitions, but more broadly speaking, what type of grocery anchor tenants are you looking for? Currently we're seeing a lot of winners and losers in the grocery anchored space. So what are the factors that you look for in these types of tenants and how do you think these grocery anchors will be successful over time?

Louis Haddad:

Sure. We've got longstanding relationships with Kroger, Harris Teeter, and we're forming one with Whole Foods, and now we're working hard on these Lowes opportunities. For us, it's long-term proven operators in the business, as well as looking at competitive set that's out there. I had mentioned Food Lion. We don't think there's anything wrong with Food Lion and with Delhaize Credit behind them, they're not going anywhere. But, we are seeing a lot of pressure at the low end, particularly from the Europeans. And that's why we're not thinking that those stores that we have of theirs would see a lot of growth. For us, it's a combination of several factors. It's familiarity with an operator that's proven over and over and over. It's a location that we feel good about, irrespective of the operator, as evidenced by the sales, both in the grocery as well as in the small shops. It's getting a development partner who can bring us further opportunities. That's the lifeblood of our business. All those factors need to come together and of course we're looking for accretion as well. But I want to make sure that everybody understands on the phone, this company is not set up to grow meaningfully though strict acquisitions. For us, it's creating that value in the wholesale and retail spread that's going to fuel our growth. And also, the same lens is applied to acquisitions. Simply buying something at a 7 cap because our cost of capital is in the low 6s, isn't where we want to go. But that same acquisition, when it contains an opportunity to bring another partner onboard through OP units, as well as further development opportunities, that moves the needle far enough for us to act.

Kim Hong:

Thank you for that color. Regarding the WeWork lease in 4Q, what type of impact do you think WeWork will have on One City Center. And as a landlord, are you open to co-working platforms broadly or specifically attracted to WeWork?

Louis Haddad:

You know, it's something that the market is embracing across a number of different names. I'm not sure that we're ready to embrace it. I believe WeWorks is far and away the leader and the best capitalized and as far as we can see, the most successful model. It's going to bring a tremendous amount of energy to the building, so we're really excited about them picking our building as their base of operations in Durham. I think it validates what we've been thinking all along about downtown Durham. Tremendous activity. They are also looking at a couple of other of our facilities around the portfolio. I suspect that we're going to have further announcements with this particular tenant.

Kim Hong:

The last one for me is, your net debt to EBITDA was 6.6 at year end for 2017. Wondering what your comfort range is and what the leverage will look like here in 2018? And once all the developments are in process to deliver?

Michael O'Hara:

Debt to EBITDA climbed in the fourth quarter, mainly affecting the fourth quarter of the construction company's gross profit dropped quite a bit from the previous quarters. We have stated we are comfortable with the core debt to core EBITDA in the mid 6x-something range, which is where we certainly focus and try to keep it in that range. For 2018, it will be a little higher during the year than our typical range that it has been in the last 12 months, because of the distribution center that we talked about where we're going to be carrying the debt and the associate EBITDA with that, but it's not going to be until the fourth quarter. Long range, that certainly want to be is in that 6.5x range. Looking out at 2019, that's where we want to have it. What's going to happen between now and then? This is not a static business. As Lou was saying, we're looking at lot of development projects right now, there's a lot of activity, so we're working on the 2019 plan as it comes together.

Operator:

Thank you. Our next question is coming from Craig Kucera from B. Riley-FBR. Your line is now live.

Craig Kucera:

Good morning guys. Mike, I appreciate your commentary on the balance sheet. You've got about $145 million of interest rate caps rolling off here in the next couple of quarters. Do you anticipate just rolling those or extending those again? Or are you thinking about maybe taking a different tact in regard to managing your floating rate debt?

Michael O'Hara:

We're going to look at two things. Certainly, we're going to stick with caps. I mean for us, it's a good way to have a pool of assets that have pre-payable debt, so it gives of flexibility for disposition and keeping the value there; or encumbering the asset for the credit facility or going though, for a credit rating. Obviously we won't be buying caps anymore at 150. LIBOR at 150 would probably be 2% or something, but we'll certainly look at the pricing. And second part is, starting to look at some more fixed rate debt, we've got a couple of properties here that are coming up that will be good to start looking at long-term debt. Obviously one of them being the JHU project, of which now at 100% leased, the leasing for the next school year has been very strong, so now is a good opportunity to take a look at that one.

Craig Kucera:

Got it. Going to the multifamily side of the portfolio, there was some slippage in occupancy I think quarter-over-quarter. Particularly at Liberty. Is that property such that we kind of have to wait until the next school year starts before we'll see a recovery? Or are there other things that you can do there?

Louis Haddad:

That's a great question. I'm going to be brutally frank about Liberty. We're not pleased with where that sits right now. It shouldn't be as cyclical as it's behaving. Not with the rolling admittance that they have at the apprentice school, there with Huntington Ingalls, Inc. We don't see any reason why this property shouldn't be in the 90s and we're giving it a lot of attention as we speak and we're working with Huntington Ingalls to raise the profile. There appears to be some good news in the offing with another ship that's going to come in for a major overhaul and be here for an extended period of time, as multiyear. But, I do want to stress that we are not pleased with where it is and I don't really see the reason why it's there. It's going to get a lot of attention, and we're going to get that performing better, is one of our goals for this year.

Craig Kucera:

One more for me. Just going from a modeling perspective, you mentioned that you have a couple of deals where you priced OP units. Can you give us specifically how many units were issued and what the price was?

Eric Smith:

I don't remember specifically the number of units on the Lexington deal. It was a couple million dollars' worth or will be a couple million dollars' worth on that one. And that was when we cut that deal with our partner, that's in the low 14 handle range, 14, 15 or so. And on the one that closed, down in Georgia, I believe those went off just slightly sub 14.

Operator:

Thank you. Our next question today is coming from John Guinee from Stifel. Your line is now live.

John Guinee:

Two questions. Exactly on a gross and an after-tax basis, is the build to suit you're planning on putting into normalized or core FFO for the industrial build to suit, on a dollar and on a cents basis, FFO basis. And then second, more big picture, the big deal in retail these days is co-tenancy clauses, occupancy clauses, favorite nations clauses. What do you have to give, both in attracting national and regional tenants, and then also, how are you underwriting co-tenancy occupancy and favorite nation clauses when you're buying these food-anchored centers?

Louis Haddad:

All right, John. Good morning by the way. Let me take those one at a time. On the distribution center, the way we're looking at it is this. Had this Fortune 50 client selected us to simply design-build them a distribution center, our fees would have been in the $1.2 million range. We would have charged them about 6% for construction and development, so that's the way it would have headed. In the long-term lease arrangement, we will basically get that obviously as well as another couple of million dollars' worth of profit dependent upon what that ultimate exit cap rate is. So it's a 10-year triple net lease with obviously an extremely strong company. But there is a lot of variability right now out there in the marketplace. Our expectation is for an extra couple of million dollars. That obviously can go up. I don't believe it's going to go down, because of the nature of this credit. But again, that's the reason for the wide range.

With regard to what's going on with co-tenancies, there's a couple of different categories. John, you and I have talked about our mixed-use retail before. In terms of these boutique retailers in our mixed use, of which they don't represent a tremendous amount of that mixed use, but what is there is important. And we're talking about the Anthropologies, the LuluLemons and Williams Sonoma and all that. There are very -- let me back up for a second. In order for a secondary market, like Virginia Beach, to attract those types of tenants, where they're basically going to do one store in the entire market, you are not competing with the center down the street. You are competing with other secondary markets. So an Anthropology might have a handful of opportunities for stores in secondary cities and there might be 30 secondary cities after that tenant. So as I've stressed before, these are not money making propositions for us in and of themselves. They demand a tremendous amount of tenant improvement and they don't pay a very high rate. What they do, is enable you to get the other tenants in that mixed-use space at very favorable rates. Be they restaurants or professional office or entertainment or the like. So long answer to a short question, you basically get tied up with a very long co-tenancy list when you are putting these people in. And it's something we have to adhere to and look at constantly in order to keep the mix where these folks are going to stay. In terms of the grocery-anchored centers that we buy, far less stringent, obviously in the small shop space. Basically what we're talking about is stores where you have a grocery anchor and somewhere between 10,000 and 20,000 feet of small shops. The most we will give somebody is a covenant that grocery store will be there or will not go dark. But beyond that, we're not having to give anything. As I've said, leasing in small shops has been very robust for us. We're at 97% occupancy so, releasing spreads are good. You are seeing, again, mom and pops, some of them pressured and particularly people that are somewhat exposed to internet sales. But again, wherever those go out, we're not seeing any slow down in the velocity of getting those spaces refilled.

John Guinee:

Great. Just a quick follow-up. If I wanted to carve out the build-to-suit profit out of 4Q, should I carve our $0.04 which would give us FFO guidance $0.96 to $1.01 for 2018?

Louis Haddad:

I think that's in the right neighborhood. I don't think that basically you -- if you simply said the value is what we spent to build it, you would cut that number in half. So I don't -- but I think your math is correct.

Operator:

Thank you. Our next question today is coming from Laura Engel from Stonegate Capital Partners. Please proceed with your question.

Laura Engel:

Good morning. Thanks for taking my question. I know we're going a little bit here, so I'll be quick. Most have been answered. In general, other than discussing the industrial disposition maybe for later in 2018, I guess broadly, how can we look at that disposition activity for this year versus maybe compare it to prior year or the year before that overall? It sounds like you're pretty fixed with the portfolio, but any other thoughts on things that might get released this year?

Louis Haddad:

Sure. Again, we're -- we've got a very strong pipeline that we talked about ad nauseum. We've got a developing pipeline that's going to give us further requirements for capital, and most likely more in 2019 than in 2018. We're also anticipating using the ATM this year, assuming market conditions are favorable. Again, they may not be favorable, and so we may be in a position where we decide to reap some of that NAV that we're creating in our pipeline, irrespective of our desire to own these things long-term. And that's part of the flexibility that we have to maintain. We try not to pay too much attention to the market, but you can't ignore it in its entirety when you might need to raise capital. So, we're going to be looking at that very strongly. I would say our druthers is that the stock goes back to $16 and we don't sell anything. We'll see if that ends up being realistic.

Laura Engel:

Great. Well, always appreciate all the good information as well as the market insight. So, thank you for taking my question.

Operator:
Thank you. Our next question is coming from Bill Crow from Raymond James. Your line is now live.

William Crow:

Good morning, guys. Mike, maybe for you, what is your assumption as far as the issuance, the ATM, as far as is that pro rated each quarter? Is it backend loaded? What have you built into the guidance?

Michael O'Hara:

What we've built in is $10 million here in the first quarter, and then $15 million per quarter thereafter.

William Crow:

Okay, that's helpful. And then assuming that gets done, or some other way to raise capital, say a similar amount for an asset shift, does that position you for all the activity for next year without having to raise additional equity? Or do you anticipate that that issuance will occur again based on what's delivering next year?

Michael O'Hara:

Bill, I'm going to say that there's too much going on right now to answer that question. Like Lou said, we've got a couple of large build-to-suit projects, I mean large mixed-use public/private partnerships we're looking at right now that are certainly going to take some capital. So when we see what's going on with these development projects at the time, we can give a better answer on that.

Louis Haddad:

I'm sorry, yes, Bill, as you can imagine, just what we've discussed on the phone today. If we succeed in bringing our next project with Duke together, you're looking at another $100 million plus high-rise, mixed use facility. And as that develops and starts taking capital, our decision is going to be do we want to want to own this long-term versus everything else in our portfolio? And that equation has to be done on the fly continually. So, it's really difficult to put anything out there right now.

William Crow:

Yeah, that's fair. I guess I was thinking about just what's been announced, what's being delivered as we can look through 2019. Obviously what gets announced after that would be incremental from a capital perspective. So if the market remains cooperative --

Louis Haddad:

If everything were completely static and we basically just stop moving forward, and deliver the pipeline, and not sell anything in 2019, my guess is we would need a little bit of capital. But that's obviously only a hypothetical that's just not going to happen.

Operator:

Thank you. We have reached the end of our question and answer session. I'd like to turn the floor back over to management for any further or closing comments.

Louis Haddad:

I really appreciate everybody's attention today. Great questions. We look forward to having an announcement after our board meeting in a couple of weeks and subsequent to that, hopefully announcing some new projects coming up this coming year. Thanks again for your attention and have a great day.

Operator:

Thank you. That does conclude today's teleconference and you may disconnect you line at this time. Have a wonderful day. We thank you for your participation today.