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Armada Hoffler Properties, Inc. (AHH)

Q4 2018 Earnings Call

CORPORATE PARTICIPANTS

Louis S. Haddad
President, Chief Executive Officer & Director

Michael P. O'Hara
Chief Financial Officer

MANAGEMENT DISCUSSION SECTION

Operator:

Welcome to Armada Hoffler's fourth quarter 2018 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, Thursday, February 7, 2019.

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
Chief Financial Officer

Good morning and thank you for joining Armada Hoffler's fourth quarter and full year 2018 earnings conference call and webcast.

On the call this morning, in addition to myself, is Lou Haddad, CEO

The press release announcing our fourth quarter earnings along with our quarterly supplemental package and our 2019 guidance presentation were distributed this morning.

A replay of this call will be available shortly after the conclusion of the call through March 7th, 2019.

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 7th, 2019, 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 mezzanine program, 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.

Lou will start the call today by discussing our 2019 guidance. At this time, I'd like to draw your attention to our 2019 guidance presentation that we published this morning. I'll now turn the call over to Lou.

Louis S. Haddad
President, Chief Executive Officer & Director

Thanks Mike.

Good morning everyone and thank you for joining us today. This month, Armada Hoffler will celebrate its 40th anniversary. We take a good deal of pride in achieving this milestone not often seen in the commercial real estate business. Over the years we've earned a reputation for integrity, consistency, and professionalism, traits that are the foundation of our success. Complementing our seasoned management team, we have a vibrant young staff and like-minded partners that have us positioned for even greater achievements in the future. In addition to analysts and investors, there are many employees and joint venture partners listening in on the call today. On behalf of our founder and chairman, Dan Hoffler, the board of directors, and executive management, we sincerely thank you for being a part of our team. I'm proud to be associated with each one of you.

The focus of my comments today will be on our 2019 guidance as presented in the release this morning.

Before we discuss those projections, I'll offer a few thoughts on the fourth quarter and 2018. As you can see from our earnings release, the fourth quarter was extremely busy at the company. We started a number of new projects, signed several third-party construction contracts, sold a major portfolio asset, and closed on the distribution center sale with over a 15% profit. Perhaps most importantly, leasing in our portfolio continued at a very brisk pace with healthy increases in both Same store NOI and releasing spreads. Lease-up in the newly delivered development projects remains on track as well.

Our fourth quarter results were in line with expectations and Normalized FFO for the full year was 1.03 per share, which was at the high end of our guidance range. As we said at the beginning of last year, 2018 would yield respectable growth in per share earnings over 2017, and it has done so with a year over year increase of over 4 percent. More notably, we anticipated that our activities over the course of 2018 would build a solid foundation for significantly higher earnings in 2019 and beyond.

Turning to our guidance presentation, as you can see by the earnings target on page 4, we intend to deliver on that assertion. The mid-point of our per share guidance range of 1.14 represents an increase of over 10% over last year. Our guidance is even more impressive when you consider the FFO headwinds from both anticipated and completed dispositions. During 2019 we expect to sell a grocery anchored center in the fourth quarter. More significantly, on December 31st Home Depot exercised its below market purchase option upon lease expiration at our Broad Creek Center, resulting in a considerable loss of some 700 thousand dollars of NOI.

Before I walk you through the other highlights of our presentation, I am going to reiterate a fact that many who follow our company have correctly pointed out, that we do not fit neatly into the standard REIT box. With third party construction profits, build-to-suit asset sales and mezzanine interest income, our platform has a unique complexity that can't be wholly measured by traditional REIT metrics. That said, while these ancillary income streams augment earnings and decrease the need for external capital, the end goal of monetizing development spreads in this fashion is to enhance growth in our portfolio income through new development projects and off-market OP unit acquisitions.

Illustrative of this point, as you can see by the information at the top of page 5, we expect our portfolio NOI to climb by over 50% from 2018 levels when the current development projects are fully stabilized. The FFO per share contribution from this additional NOI will be meaningfully higher due to the millions of dollars earned from mezzanine interest and construction income that we reinvest into the company, thereby reducing the need for outside capital.

Also of note on page 5, as we have been projecting, the pie chart showing the NOI contribution of our various product types continues to rebalance with concentration moving from retail into multi-family and office. While the non-retail assets that are being added to the portfolio are of trophy quality and offer significant long-term growth, I'd like to emphasize that we are very bullish on all components of our retail portfolio. Neighborhood grocery centers, regional discount stores, entertainment and mixed-use retail will remain as a high-occupancy and growing sector of our business. That said, we anticipate taking advantage of low cap rates to raise approximately 25 million dollars by selling one of these centers.

Turning to page 6, you can see that we've also been very successful in diversifying the portfolio on a geographic basis. Upon stabilization of the current pipeline, nearly half of our property NOI will come from outside of Virginia. This diversification is the result of years of goodwill and strong relationships built with strategic partners in these dynamic markets. Beyond the current pipeline, we are evaluating multiple new opportunities in these and other neighboring areas. While these have not been finalized, our expectation is that at least one of these new engagements will be ready to announce later this year.

The development pipeline is described on page 7. Currently, we have over half a billion dollars in various stages of development. Several of these projects are nearing stabilization while some are still under construction. All of these were previously disclosed and are on track, and we are very pleased with the progress to date on each of our projects. The furthest along is 1405 Point, the apartments at the inner Harbor in Baltimore. This trophy asset is over 90 percent leased and we expect both stabilization and execution of our at-cost purchase option in the second quarter. The fully leased Brooks Crossing office building will also come on line in the same time frame. We can answer any specific questions you may have regarding the pipeline in the q and a portion of this call.

Page 8, shows our mezzanine investment program. This initiative allows us to provide development and construction expertise as well as our strong credit to trusted partners developing high quality projects in return for most of the value creation. We've separated the program into 2 parts: assets that we intend to ultimately acquire through a discounted purchase option, and projects that we feel are better suited as short-term investments. The assets in this latter category are expected to trade at cap rates significantly below our cost of capital thereby making our acquisition less practical. Consequently, our partners will be offering the projects to the general market. The mezzanine lending strategy, combined with the schedule, quality, and cost control provided through our general contracting arm, enables us to participate in top quality developments, such as Whole Foods centers, and monetize a large percentage of the wholesale to retail spread through interest and fee income. Stated another way, this aspect of our investment strategy maximizes flexibility in deciding which projects are best suited for inclusion in the portfolio and which are best to monetize based on a variety of factors, including capital market and commercial real estate conditions.

As you can see, over a multiyear period we expect to generate some 60 million dollars of net proceeds, substantially reducing our need for external capital. Based on the projected payoff dates of the current projects and likely engagements in predevelopment, we expect the program to stay at or near these levels at least through 2020, yielding significant profits over the next few years. Mike will update you on the 2019 guidance on this segment of our business.

Page 9, covers our third-party construction and other real estate services. With a healthy backlog of over 160 million dollars, the division is expected to make over 5 million dollars in gross profit this year. While we don't anticipate a build to suit engagement in this calendar year, this skill set remains a part of our overall strategy in the construction division, and we typically execute on one of these opportunities every 18 to 24 months. Lastly, on this page you'll see the remaining 4.5 million to be recognized from the sale of our purchase option at Annapolis Junction; you'll recall that the accounting treatment for the 5-million-dollar payment we received last fall requires us to book this profit over the remaining term of the mezzanine loan.
Stepping back to a macro look at the business, the top of page 10 shows the year over year anticipated change in the composition of our Normalized FFO. As you can see, property FFO rises the most on an absolute basis, followed by mezzanine interest.

The pie charts show that while a significant portion of our FFO is derived from ancillary real estate related sources, the vast majority is generated from traditional rental income. With the ramp up of the mezzanine program and the profit contribution from the option sale, 2019 shows a corresponding decrease in the percentage earned from rental real estate. However, our expectation is that mezzanine, construction, and build-to-suit contributions will stay more or less static over the next few years, while stabilization of the existing development pipeline will increase property NOI by some 30 million dollars. We expect the resulting FFO generated will return the property segment to well over 80 percent of the total on a consistent basis, thereby solidifying our earnings base and multiple.
Now I'll turn it over to Mike to give some further detail on our guidance as well as some specifics on last quarter.

Michael P. O'Hara
Chief Financial Officer

Thanks Lou.

After a couple of comments on the quarter, I will continue the discussion on our 2019 guidance.

This morning, we reported FFO of 26 cents and Normalized FFO of 30 cents per share for the fourth quarter. For the full year, FFO was 99 cents and Normalized FFO was $1.03 per share. The majority of the difference between FFO and Normalized FFO in the fourth quarter was from the non-cash mark to market adjustments from our interest rate hedging strategy and severance related charges. These unexpected severance related charges caused our G&A to be outside of our previously announced guidance range.

Although 2018 was not a good year for REIT stocks, our total return was slightly better than the RMS. Our 5-year total shareholder return through February 1st was 122 percent versus 55 percent for the RMS. We are obviously pleased with these returns and are grateful for the trust our shareholders have placed in our company.
Our core operating portfolio occupancy for the fourth quarter remains strong at 96 percent, with office at 93, retail at 96, and multifamily at 97.

Same store NOI was positive for the third consecutive quarter and slightly positive for the year.

Additionally, our releasing spreads were positive again this quarter, 5.7% on a GAAP basis and 3.4% on cash. They were also positive 5.4% on a GAAP basis and 1.1% on cash for the year. We believe these positive metrics are a reflection of the quality of our portfolio.

Now back to the guidance deck. Starting on page 11, there are a couple of slides relating to the balance sheet. As you can see, we have maintained leverage within our corporate targets of: Total debt to EBITDA with an upper limit of eight times and core debt to Core EBITDA in the six times range. There were exceptions to this in 2018 with regards to Core debt to Core EBIDTA. As we previously discussed, we elevated leverage in 2018, for the build to suit distribution center. With the short-term nature of this project and associated debt, we did not raise any equity capital for this project, which sold in December as planned. As you can see, leverage was back in our target range at year end. We anticipate the following sources will meet our capital needs for 2019 and expect that we will maintain leverage within our target range for the year:

- First, the disposition of a grocery anchored shopping center for expected proceeds of approximately 25 million dollars. The proceeds from this sale will be used to pay down debt.
- Second, we expect the Decatur Whole Foods Center and Annapolis Junction loans to be paid off this year. The expected payments are approximately 60 million dollars.
- And, third, raising 50 million dollars thru the ATM program, which is less than 2018, assuming favorable market conditions.

As Lou said, we are evaluating a number of new development opportunities. We do not expect any of these to break ground until later this year, and, therefore, require little capital investment in 2019.
Now turning to page 12 to review debt maturities. There was only one maturity in 2019, which was paid off in January. In 2020, there are two loan maturities, both of which are construction loans, totaling 45 million dollars. The loans are for the Greenside Apartments in Charlotte and Town Center Phase six. With the leasing activity on both projects, we have no concerns on either exercising our extension options or refinancing these projects. I will have further comments on the balance sheet later in my remarks.
Next, I will discuss a couple of segments of our business. Page 13 of the deck illustrates our core operating portfolio occupancy, since 2013, which has been the mid 90's. This reflects the strength of our properties and we expect this to continue at these levels in 2019.

Page 14 of the deck illustrates the details of our 2019 mezzanine investment program guidance. The size of this program has increased substantially during the fourth quarter with the closing of the three new mezz loans. With the growth of the program, we are considering making this a separate segment for financial reporting in 2019. We do not anticipate the program growing beyond current year levels but will remain substantial over the next few years. If we make this change, under GAAP, the interest income will be reported net of interest expense. For the year, we expect net interest income of approximately 16 million dollars, which includes 4.5 million from the amortization of the Annapolis Junction purchase option sale. As discussed earlier, under GAAP, this profit is considered interest income and recognized through maturity. The 2019 interest income guidance is based on anticipated loan payoffs of the Decatur and Annapolis Junction loans in 2019 as listed on this slide.

On Page 15, is our 2019 full-year Normalized FFO guidance of a dollar eleven to a dollar seventeen per share, which is a substantial increase in Normalized FFO per share from 2018, which was a dollar three.

The assumptions of the 2019 guidance are:

- The sale of a grocery-anchored shopping center for anticipated proceeds of approximately 25 million dollars in the fourth quarter.
- Acquisition of a 79% interest of the partnership in 1405 Point St apartments during the second quarter.
- Acquisition of commercial component of One City Center from the Joint Venture in the first quarter.
- We have not included any other acquisitions in this guidance but as in the past we continue to pursue accretive OP unit transactions.
- The Decatur Whole Foods Center loan being paid off during the second quarter and the Annapolis Junction loan being paid off in the fourth quarter.
- Raising 50 million dollars through the ATM program, assuming favorable market conditions
- Interest expense is calculated based on the Forward LIBOR Curve which forecasts LIBOR at 2.57 percent at year end.

This 2019 guidance of a dollar eleven to a dollar seventeen per share is predicated on the following updated components:

- Total NOI in the 93.7 to 96.6 million-dollar range,
- Third party Construction Company gross profit in the 4.9 to 5.7 million-dollar range.
- Net Interest income from our mezzanine financing program in the 16 to 16.5 million-dollar range, which includes the remaining 4.5 million dollars recognized from the amortization of the Annapolis Junction purchase option.
- General and administrative expenses in the 10.8 to 11.5 million-dollar range.
- Interest expense in the 25.5 to 26.5 million-dollar range, which does not include the interest expense related to the mezz program, as discussed earlier.
- And, 69.3 million weighted average shares outstanding.

Now back to the fourth quarter, which had a lot of activity. In December, unfortunately, Home Depot took advantage of their purchase option of their store in the Broad Creek Shopping Center. While this is a financial negative to the Company, we believe this shows the strength of the center and why it has experienced historically high occupancy. The proceeds from this sale were used to purchase an outparcel adjacent to our Wendover Shopping Center through a 1031 tax free exchange. The net loss of NOI after this acquisition is over 700 thousand dollars which equates to over a penny of earnings per share.

As expected, Kroger did not renew their lease at the Waynesboro Shopping Center. The store is only 38,000 square feet, which is too small for their current model. With its small size and rural location, we decided disposition is the best option. With an executed purchase and sale agreement, the center is now classified as held for sale on the balance sheet, and impairment loss was recognized in the fourth quarter.

One City Center was placed in service with Duke University and WeWork occupying the building. The income from this building, net of depreciation and interest expense,
is recognized in a new line in our Income Statement: Equity in Income of Unconsolidated Real Estate Entities. This project is in a joint venture, of which we own one hundred percent of the commercial space. We expect to distribute the property out of the joint venture and refinance it this quarter.

We also had a lot of activity with our mezzanine loan program. We closed on the Nexton Square project in Summerville, SC and two projects that are part of the Interlock development in Atlanta. The Interlock projects are the Terwilliger Pappas Solis multi-family project and the SJ Collins mixed use building. Please see the press release we issued last month for more information on these projects.

The first project in our mezzanine program was the 1405 Point St Apartments. As part of the structure, we have an at cost purchase option of the project, which we can exercise in two phases. We intend to exercise our first purchase option, which is 79 percent of the partnership during the second quarter.

Now back to the balance sheet.

In the fourth quarter, we raised 5.9 million dollars through our ATM program at an average price of $15.05 per share. In 2018, we raised 66.5 million dollars at an average share price of $14.39.

This month, we paid off the North Point Center Note 1, which was our only debt maturity in 2019. We added this property to the borrowing base of our credit facility and utilized the accordion feature to increase the capacity by 25 million dollars to a total of 355 million.

At the end of the quarter, we had total outstanding debt of 701 million dollars including 126 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 year end, 100 percent of our debt was either fixed or hedged. This quarter, we purchased a 2 year, 50-million-dollar interest rate cap at 2.75 percent and we entered into a 10.0 million dollar swap lock on the Lightfoot Marketplace loan.

As you have just heard, we have a lot of activity 2019 with many moving parts, and we will continue to be transparent and keep you informed.

Now I'll turn the call back to Lou.

Louis S. Haddad
President, Chief Executive Officer & Director

Thanks Mike
We remain extremely bullish on the performance of our company. With an accretive pipeline starting to deliver and a solid balance sheet, we believe we are poised for significant growth over the next few years. When combining these factors with a dividend that has increased annually, and still yields in excess of five percent, we feel that we are delivering exceptional value to our shareholders in the form of above average growth and income. We will be discussing the dividend at our quarterly Board of Directors meeting on February 21st, 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. The floor is now open for questions.

If you would like to ask a question, please press star one on your telephone keypad. If you would like to remove your question from the queue, you may press star two. Participants using speaker equipment maybe necessary to pick up your handset before pressing the star keys. Once again, that is star one to register questions at this time.

Our first question is coming from Dave Rogers of Baird. Please go ahead.

Dave Rodgers:

Yes. Mike, Lou, good morning. Wanted to ask a little bit about the development pipeline, obviously $550 million with a couple of the mezz purchase options in there. But most that completes or stabilizes between 3Q 2018 and kind of 3Q 2019. So, you mentioned adding some more projects potentially by the end of the year, but can you kind of talk about the activity that you're seeing to kind of keep that pipeline full and continue to be able to grow the core NOI of the company?

Lou Haddad

Sure. Thanks, Dave. Yes, I mentioned last quarter that we were looking at further opportunities in Charlotte, in Charleston, in Baltimore and in Nashville. And those still remain the areas of focus. These are pretty complex multi-use projects. At this point we really can't forecast that they are going to start, but they all look promising, which I'll remind you typically means that one gets started, one gets delayed and one gets killed, but we'll see how that develops. But there's an awful lot of activity out there. And it's really good to see our development partners who are very active as well as our own development group.

Dave Rodgers

Alright great, thanks. And then maybe moving on to the mezz program, it obviously sounds like it's kind of getting to a peak level for you guys over the next couple of years and it's been a good contributor. But I guess what happens if something kind of goes wrong, or if a developer defaults on some of these projects, or can't fulfill the obligations? How do you guys foresee handling that if that were to happen?

Lou Haddad

That's a great question Dave. Let me start by saying that in almost all of these engagements our construction company is the general contractor on the project from inception. Also, our development group is involved in support of the prime developer on the deal. So, in the event of a developer faltering, we have a built-in smooth transition process for us to fulfill the lead role. As you're aware we have decades of experience in construction and development which really is the key reason that we're comfortable with this whole mezzanine structure.

Our security in case of default is the developer's partnership interest in the projects. And that's where our underwriting comes in. We are just as meticulous in the evaluation process as we are in our own projects. We underwrite the market demand, the location, the tenants, the design, the cost estimates, all of this thoroughly before we agree to fund the loan. So, while we certainly wouldn't wish our partners to default, we would be fine with assuming their ownership and their obligations at what would then be a significant discount to the value of the asset.

Nothing in real estate is completely bulletproof. But we believe we have a tremendous amount of protection around these transactions.

Dave Rodgers

Thank you for that. And last one for me - on the retail leasing you had a really active quarter in retail leasing. Can you kind of talk about where that activity was in terms of maybe kind of the entertainment and restaurant versus kind of inline centers and talk about the activity that you saw there?

Lou Haddad

Yes, we're seeing the most activity – you kind of hit the nail on the head, it's more in restaurant and entertainment than it is in traditional retail. As you can see our occupancy is very high at this point. And we're not seeing any cracks in the armor to speak of. But the fast-casual restaurants are really on a tear, we've signed a few here at Town Center in the last few months. We have had a number of renewals in our neighborhood centers as well as the couple of power centers that we own.

And as we said somewhat unfortunately Home Depot took advantage of the option at the end of their 20-year lease at our Broad Creek Center to buy the project from us. I think it's important to note there that that project is all on a ground lease. So effectively Home Depot is signed up for another 30 or 40 years of operations. That center has been extremely strong from day one and continues to be so.

Dave Rodgers

Great. Thank you, guys.

Lou Haddad

Thank you, Dave.

Operator

Thank you. Our next question is coming from John Guinee of Stifel. Please go ahead.

John Guinee

Great, a bunch of questions here. First just out of curiosity, Interlock, do you have any equity there, one? Two, is it close enough to be MARTA accessible? And three, I think WeWork is your major tenant, which is your second development with WeWork as your primary lead tenant the first one being Wills Wharf in Baltimore.

Michael O'Hara

Yes, I guess John a couple of things more and we do not have equity in that project outside the mezz loan. And obviously we've got the collateral around that. It is not next to a MARTA, it's in the mid-west part of Atlanta, which is a new thriving, booming area which has what we like in those kinds of centers is walkability, great location from that standpoint. And yes, WeWork as another major tenant at that location. And they are, I think, 100,000 square feet of development – it's over 300,000 square feet.

John Guinee

Okay.

Lou Haddad

Mike just as a reminder in both of those projects the anchors that you're referring to, the anchors in one case were Duke University and the other case it's Georgia Tech. So, we're happy to have WeWork as well, but the foundation was with the credit of those two tenants.

John Guinee

Got you, okay. And then looking at Page 14, probably Mike projected mezz interest expense of $5.5 million. What's your average balance on that mezz program and what's the interest rate you're assuming to get to the $5.5 million as your cost of capital?

Michael O'Hara

Yes, on a total balance we expect it to peak out, like we – I think we talked about last call in the $145 million range or so. And that's all going to be dependent on when the payoffs come like does it cater Whole Foods, et cetera. On the cost of capital, we use in our credit facility, which is in that 4.5% to 5% range at this point in time. And the amount of interest for us that we used here for 2019 is $5.5 million which obviously doesn't include any interest expense against the Annapolis Junction piece of them.

John Guinee

Yes, so essentially, if I'm looking at this page, essentially the $16.2 million equates to roughly $0.23 in FFO.

Lou Haddad

Correct.

John Guinee

Yes. Okay. Then on Page 9 – where is your sources of use. Okay, this is Page 11. You have a source you have basically your target which you hit in 2018 and then you have your sources of capital in 2019, which is sort of weighted towards the end of the year. You don't have uses here, but I'm assuming the primary uses are the net funding on One City Center and the net funding on 1405 Point. What's the net funding? If I look at Page 7, I've got $99 million and $46 million. Are those – I'm assuming those are gross numbers or are they net numbers?

Michael O'Hara

Yes, so the main capital needs are going to be funding the development pipeline, which is Wills Wharf office finishing up the student housing projects in Charleston. On 1405 Point and One City Center we've already funded 100% of the equity requirements on those. So, then it's just a matter of bringing those on balance sheet.

John Guinee

So essentially what you're saying, I think, is that your mezz is essentially the equity and you're going to just bring the debt on the balance sheet?

Michael O'Hara

Correct, yes. Except for One City Center was not a mezz project that's a joint venture of which we had to contribute our capital for our piece of that joint venture, which was the commercial space.

John Guinee

Okay. So, is it safe to assume that you're going to spike up in your debt metrics in the first half of this year and then come down in the second?

Michael O'Hara

No, based upon our models we're going to stay within the ranges that we have here, will it be a little higher than fourth quarter, yes, but it will be within our ranges, we believe so.

John Guinee

Okay. And then the last question is if you look at your - you have on Page 10, $5.3 million of construction build-to-suit net profit. How much of that is your net profit on your construction business, your fee business, and how much of that is a build-to-suit?

Michael O'Hara

So, in 2018 of the $6.1 million, $3.4 million of that was the build-to-suit on the sale of the distribution center. And 2019, we do not have any build-to-suit profit in there, that's all third-party construction.

John Guinee

Okay. Okay, great. Alright. Thank you very much.

Lou Haddad

Thanks, John.

Operator

Thank you. Our next question is coming from Rob Stevenson of Janney Montgomery Scott. Please go ahead.

Rob Stevenson

Good morning guys. Back to Dave's question on development pipeline, Lou it sounded like that when you were answering those questions, it sounded like that the stuff that you anticipate starting in the remainder of this year are multi-use, more complex projects. Is that fair to say?

Lou Haddad

That's correct. These are really exciting projects. I don't want to get too far out there because they still are in that pre-development phase where they still could potentially not come together. But these are large infill CBD type projects that have a multi-use which as you guys know is really in our wheelhouse.

Rob Stevenson

Okay. Because I mean, I guess the question there in terms of looking out on the development pipeline, I mean basically everything except for Wills Wharf winds up completing this year. And so if you're starting in the middle or end of 2019 with complex projects that are likely to have at least 18 months probably, maybe closer to 24-month construction timetables, it seems like the development pipeline is going to ebb in 2020 just in terms of deliveries, that you're going to have a bunch of deliveries this year and then it's going to fall off, you're just going to have the one next year and then maybe some pick back up in 2021. But just wanted to make sure that I was being – thinking about that correctly.

Lou Haddad

Yes, I think Rob, I think that's a fair assertion. We're looking at a number of smaller projects as well that I really haven't called out. We said that our retail portfolio is going to continue to grow, particularly our grocery anchors are very active. So, I think there'll be some infill with that. But I think in 2020, as we tried to illustrate the majority of the growth is going come from that extra $30 million worth of NOI that comes from the development pipeline stabilizing.

Rob Stevenson

Okay. And then what type of IRRs are you getting on the Cosmo redevelopment currently?

Lou Haddad

I'm sorry, could you repeat that?

Rob Stevenson

What type of IRRs or are returns are you getting on the Cosmo redevelopment now that's stabilizing back up?

Lou Haddad

That's a great question. And I hesitate to answer because the returns are better than expected, but it's early. At the end of the day we will have invested over $10 million in Cosmo over a couple year period. The revitalized units have come back online and we're seeing a significant increase in rental income. We also expect that any kind of concessions will go away as well. So, at the front end it looks like a doubledigit return. I'm just not ready to take that to the bank because we have to cycle through 350 units. But it certainly looks really good at this point.

Rob Stevenson

Okay. And then in Mike's guidance it includes ATM issuance. When you're thinking about it today, given the still decent market for asset dispositions, how do you think about raising capital in the ATM versus selling a few more retail centers to fund your capital needs?

Michael O'Hara

We're going to continue doing like we have, Rob. And that's looking at both. If the capital markets are good, we'll get on the ATM. And I thought, especially in the second half of last year really pleased that we were able to sell stock and raise capital. At this point right now, the plan is to sell that one center. But certainly, if the dynamics change, we will switch course.

Rob Stevenson

Okay. Thanks guys.

Operator

Thank you.

Lou Haddad

Thank you, Rob.

Operator

Our next question is coming from Jim Lykins of D.A. Davidson. Please go ahead.

Jim Lykins

Good morning everyone. First of all, is there any color you can provide on the office leases expiring this year? Look like you've got over 9% of the portfolio rents coming due.

Lou Haddad

So, at this point, we're not anticipating any big holes in the ship. We've got some expirations towards the end of this year. It's kind of an interesting phenomena right now Jim we all kind of lived through the downsizing of all the lawyers here several years ago. And then we all kind of lived through the downsizing of the investment houses and financial brokers. Now we're living through the downsizing of the schools. We have four schools here at Town Center and each one of them is in the process of downsizing. So that's really kind of been the focus in terms of a sector.

Fortunately for us, the professional services sector has really picked up strong here with architects, engineers, insurance brokers, and the like. We've also got a good foothold now in technology. So, I don't anticipate any large vacancies, we are going to have some holes to fill like I said through the downsizing of some of these schools but it's nothing that gives us a whole lot of heartburn at this point.

Jim Lykins

Okay. And kind of the same question for retail. Is there just any commentary you can provide on what you're seeing right now with how you see what's trending in retail into the quarter and throughout 2019 right now?

Lou Haddad

Right now, we really don't have anybody under duress. I'd tell you this takes constant monitoring because even the stores that are doing reasonably well can become a problem mainly because of what's going on at a macro level in the retail industry. Our people are all over sales, we've talked about this before on this conference call how we really got to stay on top of the sales in our centers and that's really the key.

In the retail center game, as long as you're tracking your sales even – and your sales are strong, even if a tenant becomes weak you know you can refill that spot. It's interesting the way the market continues to shift. Now we're heavily weighted to fast casual restaurants and to discounters as well as services and 10 years ago we were all after the higher-end boutique shops. It requires constant monitoring, but as you see our retail centers have averaged over 95% for quite a long period of time. So, we anticipate being able to continue with that kind of pace.

And like I mentioned in my opening comments, we feel really good about the retail business, the way we're approaching it. We've got a lot of optimistic grocers in tow. And as long as you keep your small shop construction in a reasonable place, these centers yield great results for many, many years.

Jim Lykins

Okay. And one last one, labor construction costs are up for everyone across the board. I'm just wondering, sitting here right now, as you look across the timeline for your putting a pipeline, are there any projects there that kind of sticking out that could – you feel pretty good about how that timeline looks right now?

Lou Haddad

Yes, I think we're okay now. All these things are challenged as you correctly pointed out, the market is very tight. The market for labor is extremely tight. We're seeing schedules elongate on a regular basis. We are trying to anticipate as that as much as is possible. I'm not anticipating any issues right now. We've got some critical deliveries coming up this year between the HII Building later on this spring, as well as the Charleston projects coming this summer.

We appear to be tracking exactly where we need to be. Our construction group does a great job with staying on top of this, but it is definitely a challenge and we saw the projects that we delivered last year took longer to fully close out. Even though we've made the initial dates just getting these things put to bed a 100% has become quite a challenge, but it's what we get paid to do and feel pretty good about where we sit.

Jim Lykins

Alright, great. Thanks Lou.

Operator

Thank you. Our next question is coming from Bill Crow of Raymond James, please go ahead.

Bill Crow

Thanks. Good morning.

Lou Haddad

Good morning Bill.

Bill Crow

Lou you talked about some of the tenant downsize in the office sector with lawyers and financial institutions. Have you turned any leases renewed any leases with material expansions over the last two or three years in the office?

Lou Haddad

Yes, so that's what I meant about the sectors that are really, really performing. We've increased in the technology sector. We had a significant expansion from Mythics as well as Lumos. We expanded in the architects and engineers, you may recall that when we had to expand and relocate Kimley-Horn out of older high-rise into the newer high-rise, professional services is really, really doing well and that's very fortunate for us. Both here at Town Center as well as One City Center we've got a number of prospects for the last little bit of space there. They expect to be filled pretty quickly.

And Wills Wharf, again, abundant prospects and we'll see who lands first, but it's - outside of 2008 type event, it's been my experience over 30 some years that there is always robust sectors of the market and you've got to be positioned to take advantage of that.

Our asset management group is really good at staying on top of these things. As you guys all know that real estate business is very fluid. You have to wake up every day and anticipate where things are heading. We don't always guess right, but I can tell you we are constantly thinking through how to gain an advantage and keep our properties strong.

Bill Crow

Yes, appreciate that. On the retail front, you talked about staying on top of revenues and maybe you could just tell us in Town Center what happened to revenues per foot 2018 versus 2017?

Lou Haddad

That's a great question. Unfortunately, it's all over the board so I can't really give you a good characterization. The restaurants continue to be extremely strong and we are adding a few. A couple of the specialty retailers struggled, they're still here, but they've struggled I think they are struggling nationwide.

In terms of sales, Bill I wouldn't venture – I wouldn't want to point you in one direction or the other as I could, depending on where we concentrate, we could paint it as positive or negative. One thing that I can say is that, at this point in time here at Town Center, I think we're seeing more retail prospects than we have in quite some time. So, the activity is really encouraging. We've signed a – we are in negotiations for few more leases now. We don't have a lot of vacancy, but it looks really good as far as filling it.

I think this place has established itself as a great place to do business, what's really good - encouraging for me is that not only are we seeing the national groups, but now we're getting more play from local, mom and pops, good regional players that are looking at Town Center as a great place to service the greater Virginia Beach area and that's why I think we have a lot of one-of-a-kind stores.

Bill Crow

Okay. I do have one for Mike but let me follow up with that and I don't want to ask an open-ended question so maybe we'll try and keep it short. But can you characterize the economic trends and vitality of the Virginia Beach market? I mean, what are you seeing there that has you encouraged or discouraged about the area?

Lou Haddad

I'll try not to take up too much of everybody's time, you kind of hit the nail on the head Bill, I'm encouraged and discouraged all at once and I'll tell you why.

The area is doing really well right now. There's been a considerable uptick in defense spending after years of decline. You also may have read that the government just granted double aircraft carrier contracts to HII over on the peninsula, first time in history of our country. And so, the economy here is on the rise, again that underpinning from the port, which is doing incredibly well as well as tourism, which is certainly holding its own and now we had a little uptick in government spending, which is really helpful.

So, I'm really encouraged in what's going on right now. As someone trying to do some things in the community, I'm part of a group that is advocating that the area try and reduce its dependence on government spending. And that's where we've got a lot of wood to chop in order to get where we need to get to.

Bill Crow

Okay. Appreciate it. And then Mike, just finally from me. If I just think about your mezz loan program this year a little over $16 million of income, you lose $4.5 million from Annapolis Junction, you lose $2 million from 1405 Point and Nexton Square, you lose call it half of full year at Decatur Whole Foods, $700. I guess it get us down about $7 million to about $8.5 million or $9 million for next year, gross I don't know what happens to that $5.5 million of expense and is that the right way to think about it as a run rate for next year, if you don't originate anymore mezzanine loans?

Lou Haddad

Bill let me start there and then I'll turn it over to Mike, I want to try and make this clear in what I was saying when I'm looking at the guidance deck. If you look at the page 13 or whatever it was, where we had the pie chart showing the make-up and you see that the other activity is in at 22% - 23% range for this year. We believe that that's going to stay pretty much static.

And we believe that based on all the arrows in our quiver, based on construction activity that we're seeing, further mezzanine engagements that are shaping up as well as more build to suit opportunities. So, in our thinking, we believe that 2020 is going to stay at or near those levels. We just don't have things to announce at this point. Mike?

Michael O'Hara

I don't have a lot to add to that, other than the ones just closed here in December certainly have more outstanding balance during an average balance in 2020 they were in 2019 as those ramp up during the years.

Lou said there's this activity out there on the Whole Foods, that activity seems to be picking up and we hope to be involved in more of those coming up here later this year.

Lou Haddad

I have neglected to mention that we're really excited about the S.J. Collins and their ramp up they're seeing in the Whole Foods/ Amazon portion of their business as well as some other grocers they've become close to. I'll tell you – if I haven't said it before, I can't say enough about our joint venture partners to work with Terwilliger Pappas people, S.J. Collins, Michael Beatty in Baltimore, Maryland. We've got top-quality developers that we're doing business with on a repeat basis in really trophy type assets and that's where big part of our optimism comes from.

Bill Crow

Appreciate it. Thanks for the time guys.

Lou Haddad

Thank you.

Operator

Thank you. At this time, I'd like to turn the floor back over to Mr. Haddad for closing comments.

Lou Haddad

Thanks guys. We appreciate all the time you spent this morning. It seems like it's longer than usual, so we won't keep everybody. We really appreciate the interest. I hope that the presentation that we've made helps to clarify some things in our business. Mike and I are available rest of the day for any comments or questions you might have on a further basis and have a great day and we hope to talk to you soon. Take care.

Operator

Ladies and gentlemen thank you for your participation. This concludes today's conference call. You may disconnect your lines at this time and have a wonderful day.