3-May-2016

Armada Hoffler Properties, Inc. (AHH)

Q1 2016 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 first quarter 2016 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, May 3rd, 2016.

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 first quarter 2016 earnings conference call and webcast.

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

Lou Haddad, CEO

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

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

A replay of this call will be available shortly after the conclusion of the call through June 3, 2016.

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, May 3, 2016, and will not be updated subsequent to this initial earnings call.

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

Listeners are cautioned that these statements are subject to certain risks and uncertainties, many of which are difficult to predict and generally beyond our control.

These risks and uncertainties can cause actual results to differ materially from our current expectations and we advise listeners to review the risk factors discussed in our press release this morning and in documents we have filed with, or furnished to, the SEC.

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

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

Louis S. Haddad

President, Chief Executive Officer & Director

Thanks Mike.

Good morning and thank you for joining us today.

This morning we reported normalized FFO per share of 25 cents. Based on our revised estimates for the year, we've raised both the top and bottom ends of our 2016 Normalized FFO guidance range.

We continue to successfully execute across all areas of our business, demonstrated by significant year-over-year growth in NOI, Same Store NOI and Normalized FFO. I'll discuss the highlights of the quarter before turning the call over to Mike to discuss our quarterly results and 2016 guidance in detail.

The fundamental and guiding principle of our real estate company for the past 37 years remains unchanged – to invest in and develop the highest quality real estate in our target markets. As you will see – with the number of high-quality transactions that I will discuss this morning – we continue to aggressively manage our portfolio in order to position the Company for sustained long-term value creation.

We started the year with our acquisition of a 170.5 million dollar retail portfolio totaling 1.1 million square feet across 11 assets. The core of the acquired portfolio consists of six retail centers anchored by brand-name credit tenants and well positioned along the I-85 corridor between Raleigh-Durham and Greenville.

Four of the non-core acquired assets are currently under contract or LOI for an aggregate sales price of 32 million dollars. We expect to close on all four dispositions this year, as we had previously anticipated. The fifth non-core asset is still under evaluation.

We partially funded this portfolio acquisition with the net proceeds from our sales of the Oceaneering International and Richmond Tower office buildings. This allowed us to redeploy the equity from predominantly single-tenant office assets in the Richmond and Hampton Roads markets into a portfolio of high-quality retail assets in the Carolinas. With this transaction, we accomplished three major objectives: first, we increased our presence in the major Carolina markets. Second, we decreased our overall risk profile and third, we deferred the taxes on the significant gains realized on the sales of both office buildings.

Continuing the theme of investing in high quality real estate, this quarter we announced our participation in the joint venture to develop One City Center in downtown Durham, North Carolina.

This is a 27-story mixed-use project that is expected to include 130,000 square feet of office space, 22,000 square feet of street-level retail space, a two-level underground parking garage and a residential component. The office space will be anchored by Duke University, which has agreed to lease 55,000 square feet. As a minority partner in the development joint venture, we intend to retain ownership of the 34 million dollar office and retail components of the project upon completion. Our construction company will also serve as general contractor for the overall project with expected completion in mid-2018.

Just over a week ago, we announced our 42 million dollar investment in The Residences at Annapolis Junction Town Center. With estimated completion in the first quarter of 2018, the project will pursue LEED Silver certification and feature 416 apartment units with structured parking.

This residential project represents the multifamily component of a planned 18-acre mixed-use development conveniently located adjacent to a MARC Commuter Rail Station. Upon completion of all phases, the development will include office and retail space, as well as a limited service hotel.

Most notably, the project is located approximately two miles from Fort Meade – Maryland's largest employer, the nation's third largest Army installation and home to both the National Security Agency and the U.S. Cyber Security Command – as well as an additional six million square feet of commercial office park space.

As both a mezzanine lender and the project's general contractor, we realize market rate interest income and fees during the lengthy development and construction process, while at the same time avoiding the stress on our balance sheet during development and initial lease-up. With our option to purchase an 88% interest in the project at cost upon completion, we preserve a healthy wholesale to retail spread.

One City Center and The Residences at Annapolis Junction Town Center, along with Point Street Apartments at Baltimore's Inner Harbor, represent the next building blocks in expanding our portfolio of the highest-quality real estate. Our broad-based capabilities and track record allow us to selectively invest in some of the best projects in our target markets. We remain confident that, over time, the quality of our assets and the lower cap rates they command will translate into a higher NAV for the company as a whole.

Moving from our joint venture platform and mezzanine loan program to acquisitions.

Today we announced our acquisition of Southgate Square, a retail center located in Colonial Heights, Virginia just south of Richmond. Southgate Square adds approximately 220,000 square feet of 100% occupied retail space to our portfolio. The center is anchored by a brand-new Burlington store as well as Michaels, Staples and PetSmart.

The center is strategically situated within the submarket – adjacent to the 900,000 square foot Southpark Mall as well as a Walmart Supercenter – and across the street from Dimmock Square, which we acquired in 2014.

We acquired the asset for a combination of approximately 21 million dollars of debt and nearly 1.6 million Operating Partnership units, increasing our capital base and generating earnings for all shareholders.

The acquisition is expected to be accretive by 1 penny to 2016 Normalized FFO per share and nearly 1 and a half cent per share on an annualized basis.

This opportunity was born out of the same longstanding relationship that led to our acquisition of Dimmock Square nearly two years ago and is an example of a partner taking a second meaningful equity position in our Company.

Shifting to the foundation of our Company – our Core Portfolio – the stabilized assets continue to outperform.

The first quarter of 2016 marked our 7th consecutive quarter of significant same store NOI growth. At the end of the quarter, our core portfolio occupancy stood at just under 95%. Occupancy across all product types at the end of the quarter remained in the mid-90s. While we continue to enjoy organic growth in our stabilized portfolio, it should be understood that the primary growth engine of our Company is our investment and development platform.

Next, I'll briefly touch on the projects in our active development pipeline. Both Johns Hopkins Village and Lightfoot Marketplace are on track for mid-2016 deliveries.

Pre-leasing for Johns Hopkins Village has been robust. As of today, 62 percent of the residential component and over half of the retail space is pre-leased. We expect to open for the fall semester on time and on budget and are confident that the asset will reach full stabilization next year.

Lightfoot Marketplace currently stands at over 70% pre-leased with the anchor Harris Teeter store scheduled to open in July.

Turning to our third party construction business. Our progress on the 170 million dollar Exelon tower within Baltimore's Harbor Point continues on schedule toward completion this spring. Adjacent to the Exelon site, construction on Point Street Apartments is well underway. Additionally, we've mobilized our construction company on both the One City Center and Annapolis Junction projects. With over 176 million dollars in backlog, and several promising opportunities in the pipeline, we expect this segment of our business to continue to generate profits at the high end of our historical average.

With that, I turn the call over to Mike and then we will take your questions. Mike…

Michael P. O'Hara

Treasurer, Chief Financial Officer

Thanks Lou

Today I want to cover the highlights of the quarter, thoughts on our balance sheet, and additional details on our 2016 guidance.

This morning, we reported FFO of 18 cents per share and Normalized FFO of 25 cents per share, which was at the high end of our expectations.

This quarter, we reported gains on sale of real estate of 27 million dollars resulting from two transactions. The first, a gain of 430 thousand dollars from the sale of the police precinct to the City of Newport News. This was basically a construction contract structured as a sale with the gain equating to our construction fee. Unlike previous sales, this gain is included in FFO because the asset was never placed in service and was a sale of inventory.

The second transaction is the sale of the Richmond Tower office building with a gain of over 26 million dollars that is excluded from FFO. Including this sale, we have recognized over 44 million dollars in gains since the beginning of last year. As we have discussed in the past, asset sales and capital recycling will continue to be an element of future shareholder value creation. On a related note, because we structured these transactions as 1031 tax-free exchanges, the gains from these sales are not taxable as tax efficiency remains one of our corporate objectives.

Please see page 10 of the supplemental for the Normalized FFO calculation. Excluded items this quarter consist of property acquisition costs, development and other pursuit costs, and mark-to-market adjustments for interest rate derivatives. The most notable of these is a non-cash adjustment of 2.4 million dollars related to the 50 million dollar swap lock on our term loan. The other adjustment is 704 thousand dollars in acquisition, development and other pursuit costs, which is largely due to the January portfolio acquisition.

We had our 7th consecutive quarter of same store NOI growth. Same store NOI growth was positive 2.2 percent on a GAAP basis and 3.8 percent on a cash basis.

At the end of the quarter, our core operating portfolio occupancy was 94.7 percent with office at 95.0 percent, retail at 95.1 percent and multifamily at 93.5 percent. The slight decrease in occupancy is due to our recent asset recycling activity.

On the construction front, we reported a segment gross profit, in the first quarter, of 1.8 million dollars on revenue of 37 million dollars. At the end of the first quarter, the Company had a third party construction backlog of 176 million dollars which does not include the 68 million dollar Annapolis Junction construction contract that was signed in April.

Now turning to our balance sheet.

We continued to take actions to enhance flexibility and strengthen our balance sheet including increasing the capacity of the credit facility, hedging our interest rate exposure and continued use of the ATM program.

During the first quarter, we added eight properties to the credit facility borrowing base to increase the capacity by 50 million dollars to 250 million dollars. The facility is now structured with a 100 million dollar term loan and a 150 million dollar revolver.

In addition, we continued to use the ATM program last quarter raising 10.1 million dollars of gross proceeds at an average price of $10.76 per share. This amount was higher than our expectations due to a couple of reverse inquiries. With the announcement of two new development projects, this quarter we decided to take advantage these inquires to raise capital in an efficient manner. We intend to continue to use the ATM program at this level if market conditions are favorable in order to continue strengthening the balance sheet.

During the quarter, we closed on the 11 property portfolio acquisition. This was funded through the 1031 proceeds from the sales of Oceaneering and Richmond Tower as well as cash from the credit facility. The core properties from this acquisition are unencumbered and were added to the borrowing base of the credit facility. Four of the five non-core properties are under contract or LOI for an aggregate sales price of 32 million dollars. The proceeds from these sales will be used to pay down the revolving credit facility.

At the end of the quarter, we had total outstanding debt of 472 million dollars including 101 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 enter into hedges. During the quarter, we purchased a 75 million dollar LIBOR interest rate cap at 1.5 percent for two years that only cost 57 thousand dollars. As we have said before, we believe using interest rate caps is the most efficient way to hedge against increasing interest rates. With this new cap 88 percent of our debt was fixed or hedged.

We are also working on refinancing the 2016 and 2017 debt maturities. We are expecting a commitment any day now to refinance 4525 Main Street and Encore apartments. We are also out to market to refinance the Town Center 2016 maturities with expected financing proceeds greater than the maturity amounts

Now turning to development.

Since the start of the year we have announced two new pipeline projects. The first being One City Center, a mixed-use high rise in Durham. Upon completion, we will own the retail and office components, which represent 37 percent of the joint venture. Since we are the minority owners of this project it will not be consolidated on our balance sheet. Our cost of this project is 34 million dollars which will be funded through the joint venture construction loan and our equity requirement of 9 million dollars funded thru our credit facility. Thus the impact on our balance sheet is minimal until completion in 2 plus years from now.

The other recent announcement is the Annapolis Junction project. This is structured similar to the Point Street Apartments project with our investment funded through a mezzanine loan. The project is non-consolidated, and therefore does not stress our balance sheet during construction and lease up. Projects of this size and duration require debt and equity for over two years with no return on that capital. With the mezzanine debt structure, we are paid a return on our investment, earn a construction fee during development and have the option to purchase a controlling interest in the property upon completion. Our current investment in Annapolis Junction is in the form of a 42 million dollar mezzanine loan which bears interest at 10 percent.

These are the two pending projects included in the guidance issued last quarter that we anticipated being finalized in this time frame.

We now have three large pipeline projects with 24 plus months' construction schedules that are neither consolidated nor stress our balance sheet during development. This structure provides significant flexibility to:

- Manage the balance sheet in preparation for acquisition;
- Sell existing properties and use the proceeds in a 1031 exchange;
- Or sell the asset and monetize the wholesale to retail spread.

Now, let me walk you through the full-year 2016 guidance that we updated this morning.

We expect 2016 Normalized FFO in the range of 94 to 98 cents per share.

This updated 2016 guidance is predicated on the following assumptions:

- GAAP NOI in the 64.5 to 65.2 million dollar range.
- Third party Construction Company gross profit in the 4.5 to 5.0 million dollar range.
- General and administrative expenses in the 9.1 to 9.4 million dollar range.
- Interest income from our mezzanine financing program in the 3.2 to 3.5 million dollar range.
- Interest expense in the 16.0 to 16.5 million dollar range.
- The sale of three non-core retail properties by June 30th totaling 28.3 million dollars and the fourth property during the third quarter for 3.8 million dollars.
- And, 48.9 million weighted average shares and OP units outstanding.

This guidance excludes any impact from future acquisitions, asset sales other than the four non-core retail assets and other capital markets activity with the exception of continuing the ATM program.

Now I would like to make a few comments about this updated guidance. The Southgate Square acquisition is accretive and was one of the main drivers in raising the 2016 guidance. With the amount of OP units issued as part of this transaction, it is properly levered and does not stress the balance sheet.

As our company continues to grow, we increased estimated G&A expenses for the year due to additional employee costs. However, our G&A ratios continue to decrease.

The updated average shares outstanding takes into account the OP units issued in the Southgate Square transaction as well as increased use of the ATM program during the year as I mentioned earlier.

Before we turn to Q&A, I would like to make a comment about next quarter. We do not expect the second quarter Normalized FFO to continue at the same run rate due to the natural fluctuations in construction company earnings.

I'll now turn the call back to Lou.

Louis S. Haddad
President, Chief Executive Officer & Director

Thank you Mike.

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

QUESTION AND ANSWER SECTION

Operator: Thank you. Ladies and gentlemen, if you have a question at this time, please press "star 1" on your telephone. If your question has been answered and you wish to withdraw it, you may do so by pressing "star 2". If you're using a speakerphone today please pick up your hand set before entering your request.

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

Dick Schiller
Analyst, Robert W. Baird & Co. Equity Capital Markets

Q

Hey, good morning, guys. You guys talked about the Johns Hopkins Village development and I noticed in the supplement that the stabilization date was pushed from Q3 '17—or from Q3 '16 to Q3 '17. What was the reason for this extension? With all the pre-leasing that you mentioned on the call, that seemed odd to me.

Louis S. Haddad
President, Chief Executive Officer & Director

A

Thanks, Dick. We're trying to be cautious there with what we're reporting. The building is close to delivery. Pre-leasing has been going great, but as you know, with student housing, there's going to be a big crunch right towards the end of August. We're feeling that it may well not stabilize by that time, and when it doesn't stabilize by August, then your next window isn't until January. So we wanted to be a bit conservative with our forecast there.

Dick Schiller
Robert W. Baird & Co. Equity Capital Markets
Q

Okay. Sure. That makes sense. Then with the properties that are under evaluation to be sold at this point, are those mostly from the recent Retail portfolio acquisition or are those some core properties that were previously included in the portfolio?

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

Yes. What we referred to earlier was the one—we had always intended to resale five of those non-core assets out of that acquisition. We now have three of them under contract and one under LOI. The fifth one is an interesting proposition that we're still looking at. It may well be something that we end up keeping, but we're not there yet.

Dick Schiller
Robert W. Baird & Co. Equity Capital Markets

Got it. Okay. Great. Thanks. I think Dave is on. He might have a couple of follow-ups.

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

Yes. Good morning, guys. I did want to touch on something. Mike, you had talked about maybe a cash-out refi on the bulk of the Town Center. You know, can you talk about the types of proceeds, maybe a range that you're expecting out of that, and did you look at that as an opportunity to kind of pay down other debt in the portfolio or is that acquisition capital that you're looking to deploy?

Michael P. O'Hara
Treasurer, Chief Financial Officer
A

Morning, Dave. Yes, so we have the three blocks of Town Center coming up for renewal in September. I have one term sheet in-hand at $34 million—$35 million, which is around $5 million or $6 million greater than the maturity. Expecting some more quotes in here over the next couple of weeks. Our thoughts are if we can get—you know, to take the extra $5 million or so and take that and have that capital to put towards other things, like we said, towards acquisitions or development.

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

Okay. As you look at your line, I think you said there's about $100 million outstanding out of the $150 million availability. You've got the asset sale proceeds coming in. Are you looking to do some kind of term debt on that or maybe increase the line to kind of pursue more acquisition? Talk a little bit about kind of the financing strategy with respect to putting more capital to work.

Michael P. O'Hara
Treasurer, Chief Financial Officer
A

Yes. So we are going to take the proceeds of the $32 million or so from the sale of those assets and pay down the credit facility. As far as terming it out, we've done that. This past quarter, we increased the term loan by $50 million. It went from $50 million to $100 million on the term loan, and used those proceeds to pay down the line. You know, one reason we did that was because as part of the big acquisition, we use the line to fund the acquisition that was over and above the 1031 exchange money, and part of that we ended up purchasing more assets than we really wanted, so it was—hence, the sales of those—so it's the sale of those five assets, which are under contract to pay down the line.

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

Q

Great. Last one for me. Maybe, Lou, talk about the environment for new development projects. It sounds like you're seeing some good opportunities out there, but really interested in how the overall pipeline fits in with the risk profile, and if you're comfortable kind of expanding that pipeline further at this point.

Louis S. Haddad
President, Chief Executive Officer & Director

A

Thanks, Dave. That's a great question and it'd probably take more time than we have here. We're continuing to see an abundance of opportunity. Again, what everybody should recognize on the phone, this is much more of a rifle approach than a shotgun. As you guys know, we don't—we look at not only markets, but submarkets and specific areas within those submarkets for the opportunities that we're going to invest in. We're seeing those types of opportunities across the board in all of our markets and so we're basically cherry-picking what we believe to be the best. We don't want to expand. We don't want to get out of our (inaudible). We've told people that this run rate is $150 million to $200 million every 18 to 24 months. We're skewing a little bit to the higher end of that range, but it must be said that this isn't a commodity business. The reason we're able to make these spreads that you've seen us monetize again and again is because they take a tremendous amount of effort and a tremendous amount of Executive time in order to bring to fruition. It's not something that scales up easily nor are we that interested in doing it. We've been doing it the same way for over three decades and that's going to continue to be the process.

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

Great. Thanks, guys.

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

Rob Stevenson
Analyst, Janney, Montgomery, & Scott LLC

Q

Good morning, guys. Lou, when you look at your Office portfolio today, I mean, Oyster Point essentially under sale, is it—other than maybe the Chesapeake asset, is there anything else that you're considering non-core going forward in the Office portfolio as a sort of source of funds down the road here?

Louis S. Haddad
President, Chief Executive Officer & Director

A

We still have a couple of single-tenant build-to-suits that are somewhat small. They're the state office buildings that we're not really viewing as Core, but we're also not anxious to sell, but that—so we're fairly limited in what else that we would recycle on that end of the portfolio.

Michael P. O'Hara
Treasurer, Chief Financial Officer

A

Rob, I'll just add on to that. So, those two single-tenant office buildings went into service a little over a year ago at this point in time, and under the REIT rules, once we hit the two-year mark on that, we can sell those and not be a sales inventory under the tax rules and we could take those proceeds at that point in time and keep them in-house and not have to worry about a 1031. So that's another reason that I think we'll be a little bit patient and make sure we get beyond the two-year point.

Rob Stevenson
Analyst, Janney, Montgomery, & Scott LLC

Q

Okay. Then, I mean, as you look at the Retail portfolio, so the Retail has gotten to be bigger percentage of the NOI. I mean, is there stuff in there other than potentially the remaining Texas assets that you guys may look to call over time as you continue to add more retail from an acquisition standpoint? Or is there stuff, you know, whatever you classify in the bottom quartile of that portfolio today, kind of it's for recycling, or given the size of Retail and where you want it to be, is it you're not really interested in selling Retail at this point?

Louis S. Haddad
President, Chief Executive Officer & Director

A

That's a really good question, Rob. It gives me an opportunity to, again, reiterate our philosophy. We don't fall in love with real estate. All these assets have a peak value and we're constantly looking at the portfolio to see if we're at peak value and we'll be looking at slower growth going forward. So I would tell you that there are opportunities for recycling in there. There's nothing imminent just now, but it's something we're very mindful of and not afraid to pull the trigger.

Rob Stevenson
Analyst, Janney, Montgomery, & Scott LLC

Q

Okay. Then on the Southgate asset, you mentioned that Staples is a tenant in there. Have they already either leased or have been downsized into their smaller footprint or is that a risk for you guys going forward?

Louis S. Haddad
President, Chief Executive Officer & Director

Okay, Rob. I'm going to turn that over to Eric Smith, our Chief Investment Officer who headed up that acquisition.

Eric L. Smith
Secretary, Chief Investment Officer

A

Yes. I appreciate the question. So that lease is a 28,000 square foot store that comes up in 2017. Our reconnaissance, our due diligence process is that they're happy at the Center. We have not heard the specific request yet that they'll be looking to shave square footage off of that lease. We obviously are familiar with the general trend that you mentioned, so part of that diligence was if that tenant, or quite frankly (inaudible) the other larger box tenants there, show up and want to have that 3,000, 5,000, 7,000 square foot, etc. discussion to shave off some square footage, we're very comfortable in the ability to re-lease that space, and arguably at a rental rate pickup in the process.

Rob Stevenson
Analyst, Janney, Montgomery, & Scott LLC

Q

Okay. Then just lastly, on the Harper Hill Commons asset where you're 79% occupied, is that all small space or is there some big chunks in there to lease-up, and how is re-tenanting going in that space these days?

Eric L. Smith
Secretary, Chief Investment Officer

A

Again, this is Eric. It's mostly small space or can easily be partitioned into small space. The leasing, I would say, is reasonably solid. We think we have some things in the pipeline that we'll be able to talk about in the near future. So we're pleased with the activity despite the fact that you haven't seen that number move significantly quite yet.

Rob Stevenson
Analyst, Janney, Montgomery, & Scott LLC

Okay. Thanks, guys. Appreciate it.

Louis S. Haddad
President, Chief Executive Officer & Director

A

Yes, let me add something else to that, Rob. Again, something else we look at very closely. When we purchase an asset, particularly on these retail centers, obviously we're looking at credit and we're looking at location and all the things that you typically would look at. But something that's very near and dear to our heart is sales per square foot in the existing anchors. When we see real high volume in those anchors, then we feel real good about recapturing space and being able to re-lease it. When we don't see that, we don't pull the trigger or buy the asset.

I think if you look behind the numbers, and much more granularly, into what the actual tenants are doing in the space that we've acquired, you'd be pretty impressed with the kind of sales volume that they're doing.

Rob Stevenson
Analyst, Janney, Montgomery, & Scott LLC

Q

Is there any out-parcel or carve-outs potentially at Southgate given the size of that Center?

Eric L. Smith
Secretary, Chief Investment Officer

A

There is—I don't know if we've spoken about it before, but, as Lou mentioned, we acquired this asset from the same seller pool who had transacted Dimmock Square with us, and at the time that we looked at Dimmock Square a couple of years back, we had looked at this Southgate asset as well. At the time, it was anchored by a Kmart. We were not comfortable with the Kmart and so we honestly didn't transact at that time. Since then, that Kmart has been redeveloped and two-thirds of that pad square footage is now the new Burlington lease that was mentioned, the 15-year Burlington lease. There is the residual square footage of that pad that's available for redevelopment, so that is one opportunity that exists. The second opportunity is there is some parking lot area out up front. It is not a near-term opportunity because it is captured in some sightline clauses through some of the various leases, but longer term, as those leases come up and expire or are renewed and we have the opportunity to have those discussions about those sightlines, we think there might be an out-parcel opportunity there as well, longer term.

Rob Stevenson
Analyst, Janney, Montgomery, & Scott LLC

Okay. Thanks guys.

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

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

Q

Great. Yes, I've got some questions on Page 16, but, first, hey, Michael, could you re-explain the profit on the police station; exactly how much that was and what lines that ran through?

Michael P. O'Hara
Treasurer, Chief Financial Officer

A

Yes. Good morning, John. This is—we contracted or, say, did a purchase and sale agreement with the City of Newport News to develop the police precinct at the Brooks Crossing project. That was structured as a sale, and negotiating the sales price would be a City Newport News—you know, they knew our cost upfront as we went into that and basically set that up as our gain on that sale would be equal to our construction fee, which was $430,000. On our income statement, that's included on the gains on sales of real estate, so it's in there. On the income statement and in our FFO calculation, when we go from net income to FFO, we back out the gains on sale. We're only backing out the gains from the Richmond Tower in there and thus leaving the $430,000 in FFO.

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

Q

Got you. Okay. All right. Then focusing on Page 16, Lou, who is the developer on Johns Hopkins Village, Point Street Apartments, and Annapolis Junction?

Louis S. Haddad
President, Chief Executive Officer & Director

A

On Johns Hopkins Village, it's us; on Point Street Apartments, it's Beatty Development Corporation. Somerset Construction or an entity affiliated with Somerset Construction on Annapolis Junction

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

Q

Okay. What you've got essentially, on this page, your total estimated cost plus purchase option is about $347 million against the total enterprise value of roughly a billion dollars. So, basically you're going to be a serial equity issuer as these come on stream; is that a fair way to look at it?

Louis S. Haddad
President, Chief Executive Officer & Director

A

Not really, John. Again, this is the benefit of it being an integrated Real Estate Company. As Mike alluded to, we may well monetize those upon completion. We can also use them for 1031 exchanges with existing property. I would see—I would think it highly unlikely that we would simply keep all three and raise equity to properly lever them. I don't believe that's in the cards. Of course, you never know, but that's not our thought at this time.

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

Q

Okay. Then on Main Street, essentially initial occupancy a couple of years ago stabilizing in a year, but you've got about 100,000 square feet to lease. Are there any tenants out there in the marketplace?

Louis S. Haddad
President, Chief Executive Officer & Director

A

John, we actually have got a lease working for 14,000 or 15,000 feet right now. It's been slower than what I would've liked to have seen. We're happy to have some capacity here at Town Center. For many years, we had to say no to the smallest of tenants, so I feel comfortable about having some space to lease going forward. But I would tell you that I would've—my expectation would've been that we be further along right now. The velocity of tenants just hasn't been there in those, as far as the payers in that upper 20 rental rate. But, again, I feel comfortable that they'll be there. This remains the best address in the region.

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

Q

Then on One City Center in Durham, my understanding is that's an office retail plus a condominium?

Louis S. Haddad
President, Chief Executive Officer & Director

A

Yes, as well as multifamily for rental.

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

Q

Okay. So you've got condo and for rent?

Louis S. Haddad
President, Chief Executive Officer & Director

A

Not us, but yes.

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

Q

But you're in there. You're in the entire project as a 37% joint venture, but in the office and retail... How exactly does that work?

Louis S. Haddad
President, Chief Executive Officer & Director

A

Yes. Let me make sure we make this clear. We are not a participant in either the residential for rent or the residential to own. Our joint venture partner will own both of those segments, which will ultimately be 63% of the venture. Our 37% is a 100% stake in the office and retail. Quite frankly, we believe that our partner is going to do real well with his residential. We could not get comfortable with the underwriting in order for us to participate there, and that's, again, exercising some discipline. We insisted that our stake be limited to what we felt comfortable with.

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

Q

So how are you able to do that on an off balance sheet basis if you only are owning 100% of two of the four components?

Michael P. O'Hara
Treasurer, Chief Financial Officer

A

John, the way the joint venture is structured, so from a debt standpoint, what we have here is one loan with two notes that the joint venture took out, with us guaranteeing the office and retail, and our partner guaranteeing the residential piece. The big area from a GAAP standpoint, the reason that it stays that way is because the notes are cross-collateralized, so there is a cross-collateralization there, certainly we've done everything in the operating agreement to protect ourselves if anything happens with our partners during this standpoint.

The other thing is we do not have a majority vote in this joint venture. We have some blocking rights, but we do not control the venture.

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

Q

So it's two individual construction loans, each guaranteeing the cross-collateralize, which means essentially you're guaranteeing everything?

Louis S. Haddad
President, Chief Executive Officer & Director

A

Just through construction.

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

Q

Well, yes, you're guaranteeing it all, right?

Michael P. O'Hara
Treasurer, Chief Financial Officer

A

Correct. But certainly, John, we spent a long time on this thing and making sure that within the operating agreement we have the protection that we need on this project.

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

Q

But help us just understand this. You are guaranteeing the loan, both loans, because they're cross-collateralized, so you are effectively guaranteeing the loan on the condominium aspect of this?

Michael P. O'Hara
Treasurer, Chief Financial Officer

A

It's a little more complicated. You know, maybe we could talk about this offline, but I don't want to get into the way our partner structured his loan, but there's other aspects with what the bank wanted and the structuring of the loan that we felt comfortable with. I'll gladly talk with you about it offline so we don't have to get in—you know, publicly talking about someone else's loan.

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

Q

A very good friend of mine bought the top floor condo in that building, so thank you.

Louis S. Haddad
President, Chief Executive Officer & Director

A

We'll be glad to go through that with you, John, offline. We got very comfortable with the way it was structured on his end.

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

Bill Crow
Analyst, Raymond James & Associates.

Q

Good morning, guys. Bigger picture question and then a smaller picture question. Bigger picture is: with occupancy down in all three segments and some of that due to basically just portfolio recycling, etc., but certainly there's got to be some impact from the broader economy. I guess my question is: is it feeling a little toppy, a little like we're nearing an end to the cycle? Maybe it persists for a while, but have we seen the best of times now?

Louis S. Haddad
President, Chief Executive Officer & Director

A

Again, that's a fairly long discussion, Bill. I appreciate the question. First, let me say that 100% of the dip in occupancy was due to capital recycling. Essentially, when you sell 100% full properties and acquire some that are in the 90s, that's what happens. So we have not seen any decrease in occupancy in the Core Portfolio. However, our take is a little bit different. We believe that we've been kind of bumping along the bottom for quite a while and I'm not sure that there's an end in sight. What we're not seeing and haven't seen for quite some time is the general list of our tenants expanding. I think as long as the economy just continues to do what it's doing, we're not going to see a whole lot of internal growth from existing tenants. I hope that that happens at some point. Maybe this election will yield some results for us all.

But, no. we're not seeing toppiness. We're seeing status quo and, quite frankly, we're getting a little tired of it.

Bill Crow
Analyst, Raymond James & Associates.

Q

I hear you. The second question is: given the pipeline and the development in Construction Company, are you comfortable at this point giving us an idea of where you think the fee income could be in 2017?

Louis S. Haddad
President, Chief Executive Officer & Director

A

We haven't run those numbers yet. You know, I'd like to think for the third or fourth consecutive year it's going to skew towards the higher end of the range, certainly going to be some significant backlog. But not ready to comment on that.

Bill Crow
Analyst, Raymond James & Associates.

Okay. Thanks, guys. That's it.

Operator: Our next question comes from the line of Laura Engel with Stonegate Capital. Please proceed with your question.

Laura Engle
Stonegate Capital Partners

Q

Good morning. Well, most of my questions have now been answered, but I wanted to see if there was—I guess, as far as the information you give us on the project with the residences at Annapolis Junction, is there just a little more specifics on where you are exactly with that project as far as timing and moving on to next phases of that project?

Eric L. Smith
Secretary, Chief Investment Officer

A

Sure. This is Eric. We've broken ground on the project. As you can see from the disclosure and the supplemental, 2Q'16 starts with initial occupancy at the beginning of 2018, and stabilization if possible a year later, and so we're comfortable with that timeline.

Laura Engle
Stonegate Capital Partners

Q

Okay. Then I know you've gotten a lot of questions on industries and your thoughts, but is there anything that really—what most concerns you about the upcoming year and changes in what you see with rates and occupancy, things you've already covered, but aside from that, I know you've given a lot of positive information. Anything that really concerns you going forward that you all will really look for or avoid as you consider your capital recycling and what types of weights you're going to put in the portfolio going forward?

Louis S. Haddad
President, Chief Executive Officer & Director

A

Laura, that's a lot of question.

Laura Engle
Stonegate Capital Partners

Q

So you're sleeping well at night and we're all good?

Louis S. Haddad
President, Chief Executive Officer & Director

Q

I wish I could tell you we're sleeping well at night. Like I said before, we're not entirely comfortable with what's going out there in the economy. It'd be nice if there was a rising tide and all the boats were being lifted. That's certainly not the case. We're having to do a tremendous amount of due diligence, more than we've ever done, before we decide to pull the trigger on a project. One, because as you know, the underlying economy isn't all that strong; secondly, when you look at the multifamily sector, we believe it's very late in the cycle and so we're getting a tremendous amount of those opportunities thrown at us, and for the vast majority, they're going to be thrown back. But it takes a lot more due diligence these days for us to decide when and if to deploy capital.

Unfortunately, I don't see that changing anytime soon. I can't wait until we can get on the phone here and give us the all clear, but we're not there yet.

Laura Engle
Stonegate Capital Partners

Okay. Well, again, thanks for all the good information, as always, and we will look forward to following the story.

Operator: Our next question comes from the line of Craig Kucera with Wunderlich Securities. Please proceed with your question.

Craig Kucera
Analyst, Wunderlich Securities

Q

Hey, good morning guys. I may have missed this, but what was the pricing on the OP units issued for Southgate Square?

Eric L. Smith
Secretary, Chief Investment Officer

A

Sure. Great question. So when we valued that asset, we—as you know, price of OP units and cap rate are somewhat of a fungible conversation between the two. As we were valuing that asset, we put the value in the kind of low 7 cap range, 7.25-ish. At the time that we were negotiating that deal, our shares were trading anywhere from on the high side just getting into the $11 handle, and on the low side $10.40 or so. So we priced those with an $11 handle, I think $11.10, which puts it, like I said, the cap rate in our minds in that lower end of the 7 cap range. But, again, as you know, that math is somewhat fungible depending on where you want to place OP unit value at the time of the transaction and then associated cap rate.

Craig Kucera
Analyst, Wunderlich Securities

Q

Got it. Were there any nuances to this structure where the seller preferred taking a dividend payment or anything like that, or was it just straight OP units?

Eric L. Smith
Secretary, Chief Investment Officer

A

No. It was just straight OP units. That nuance in the previous deal was that without the associated with outside development opportunity. In this case, similar to the Dimmock Square transaction we did with the same group of folks, just OP units.

Craig Kucera
Analyst, Wunderlich Securities

Q

Got it. Okay. Going to the dispositions of the non-core retail properties, I know at the time of that acquisition, I think the overall portfolio was about a 7 cap. I think the core were at about a 6.5. Are you hitting the—for the assets that we (inaudible) under LOI, are you hitting sort of the cap rates that you thought you would or has there been any move to the upside just given the choppiness in the debt market?

Eric L. Smith
Secretary, Chief Investment Officer

A

You know, we're actually really pleased with the way this has unfolded. Take you on a walk through a little bit of history over the last four or five months in our disclosures. So the initial disclosure was that we were going into this portfolio on a cash basis just out of 7% for the entire portfolio, and then followed up that disclosure I think on the conversation on our previous earnings calls, that after we disposed of the non-core asset, that would leave the residual Core Portfolio with kind of the 6.5 cap rate range. Through a combination of a number of positive things, our Asset Management Team getting a hold of the asset, scrubbing the various contracts with vendors and managing expenses as our Asset Management Team does very well, getting into leasing activity, both renewals and some smaller new leases, etc., they were able to add some NOI to the ones we're selling, and improve the sales prices relative to the acquisition price for the non-core ones under contract, which obviously helps to apply that—those increased proceeds against the price of the remaining Core assets.

You then combine those same asset management activities on increased NOI and leasing, etc. to the Core. All that ends up putting you at a going in cap rate on the whole portfolio on a cash basis along the 7.2 range, and it leaves you with the Core assets after you dispose of the four we've talked about in a 6.8 cap rate range, which on a GAAP basis is a little bit north of 7.2%. So we're really pleased that we've seen about 30 basis points of movement, whether you talk about the entire portfolio or you're talking about the residual cap rate on the Core Portfolio in the I-85 corridor.

Craig Kucera
Analyst, Wunderlich Securities

Q

Got it, and I appreciate the color. One last one here just because we're getting towards an hour. Just wanted to talk about the mezzanine loan funding. The new loan at Annapolis Junction at a 10%; is that all current or is any of that accrued?

Michael P. O'Hara
Treasurer, Chief Financial Officer

A

Yes. It's all current

Craig Kucera
Analyst, Wunderlich Securities

Q

Got it. How should we think about the funding of both that and Point Street? Are those—you know, will those capital outlays be sort of put down in line with any other debt, or how should we think about when those would be fully deployed?

Michael P. O'Hara
Treasurer, Chief Financial Officer

A

So it certainly has kind of—the deployment is going to—based upon the construction schedule and draws as we go along here, it will take probably most of the year until those funds are out.

Craig Kucera
Analyst, Wunderlich Securities

Q

Got it. So as we look at our 2017, then you should have, call it, $67 million outstanding at least until you guys decide whether or not to exercise your options; is that correct?

Michael P. O'Hara
Treasurer, Chief Financial Officer

A

Correct, yes.

Louis S. Haddad
President, Chief Executive Officer & Director

A

One second. I'd like to make one point clear on—there was a question earlier about OP units. Since our IPO, we've done a number of these transactions and now with this latest one, we're closing in on $50 million worth of OP units that we've issued in acquiring properties. In each of those transactions, the units were prices higher than the then stock price, and in each of those transactions, the Unitholder has made money. As you might expect, that has more and more people bringing properties to our door. We're going to continue to be selective about what we add to our portfolio, but that program is working exactly as we had hoped and the opportunities are continuing to increase.

Next question?

Operator: Yes. The next question is a follow-up from the line of John Guinee with Stifel. Please go ahead with your questions.

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

Q

Okay. Yes. Just going back to these mez investments, I think just to clarify—somebody had asked you whether these were current or accrued and you answered current. In reality, the mez—the interest payments on these mez loans are being funded out of the loan proceeds, correct?

Michael P. O'Hara
Treasurer, Chief Financial Officer

A

Correct. It's structured just like a typical bank loan. It works the same way as the construction. You know, the nature is to reserve built within the loan and it funds out of that.

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

Q

Then if these deals work well, it's very easy to understand your purchase option at 88% upon completion, but if they don't work out well, you're still essentially buying these, aren't you, because you're in the mez financing position? This isn't really an option, in that on the downside, you almost have to buy them because you're the mez lender.

Louis S. Haddad
President, Chief Executive Officer & Director

A

Like any mez lender, we have that right, obviously. The developer has the right to take us out. We feel very comfortable with the investments that we've made, again, as a mez lender would, and we feel comfortable at the level that we're in at on that wholesale level. But, yes, in essence, you are in first position to take that asset, good, bad, or indifferent.

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

Q

So when you're saying—when you're sitting there with your Board and you're talking through this kind of situation, are you better off being a general contractor with (inaudible) and an option and protecting your balance sheet optically, I think, or are you better off just being 100% primary developer on something like this?

Louis S. Haddad
President, Chief Executive Officer & Director

A

Well, again, you don't have the ability to be 100% primary developer because you have developers that have worked for a few years to get these things to where they are and those people want their share of equity, as well as development fee. So then more properly, you have the option of being a joint venture partner from day one with essentially the same investment but without any benefits that Mike has described.

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

Right. Okay. Thank you.

Operator: Thank you. At this time, there are no further questions and I'll turn the call back to Management for closing remarks.

Louis S. Haddad
President, Chief Executive Officer & Director

Well, thanks very much. Appreciate all the time that you guys have given us this morning. We appreciate you following this story and we look forward to having a great year, and hopefully you'll continue to follow it. Thank you for your interest.

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