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Armada Hoffler Properties, Inc. (AHH)

Q1 2018 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 Operating Officer

MANAGEMENT DISCUSSION SECTION

Operator:

Welcome to Armada Hoffler's first 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, Tuesday, May 1, 2018.

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

Please go ahead.

Michael P. O'Hara
Treasurer, Chief Financial Officer

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

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

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

A replay of this call will be available shortly after the conclusion of the call through June 1st, 2018.

The numbers to access the replay are provided in the earnings press release.

For those who listen to the rebroadcast of this presentation, we remind you that the remarks made herein are as of today, May 1st, 2018, and will not be updated subsequent to this initial earnings call.

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

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

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

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

Now, I will turn over the call over to our Chief Executive Officer, Lou Haddad… Lou…

Louis S. Haddad

President, Chief Executive Officer & Director

Thanks Mike.

Good morning everyone and thank you for joining us today.
As some of you are aware, next week marks the 5th anniversary of our IPO. I'd like to begin this morning with a word of thanks to those of you who have been a part of the journey we've enjoyed. It has been a terrific one filled with several noteworthy accomplishments.

Our growth over the past five years has seen us nearly triple our market cap. Earnings, Net Asset Value, and dividends have grown each year. With a total return of nearly 60%, we have more than doubled the return of the RMS REIT index over the 5-year period. Investors can be confident that as the company's largest shareholder, management will continue to execute our business model in their best interests.

Many of you have come to realize that we are much different than a traditional REIT. With multiple product types in our portfolio, a robust development operation, a profitable construction business, joint ventures, municipal partnerships and mezzanine loans, ours is certainly a complex business model. It is also one that has been very successful for nearly forty years.

Our company is built to thrive in a wide variety of business environments. The current macro-economic backdrop is no exception. We believe that the opportunities afforded by a growing economy far outweigh the challenge of a higher cost of capital. The current climate is marked by increased opportunities in development, public-private partnerships, build to suit engagements, third party construction and tenant expansion. We believe these opportunities can more than offset the impact of gradually rising interest rates. We intend to further demonstrate the unique advantages of our integrated model in the coming months. As I've often said to investors, the best part of being in the real estate business is the transparency it demands. When all is said and done you either produced the results, or you didn't. The earnings and net asset value are there, or they are not. We are very comfortable with investors using this methodology to judge our performance.

This morning we reported first quarter results of 25 cents of Normalized FFO per share, which was in line with our expectations. While we are not inclined to adjust our guidance at this time, we are extremely optimistic about the company's prospects for the rest of 2018 and our ability to deliver on our promises. Perhaps even more importantly, we remain on track with our development pipeline and the expected corresponding increase in both earnings and NAV. Deliveries have begun and will continue over the next few quarters.

My optimism is rooted in our business model, that of a fully diversified, actively managed real estate company with multiple business lines.

For instance, one focus is on third party construction opportunities, and we are poised to sign several new contracts. Our expectation is for third party backlog to more than double over the next couple of months and to be well over 100 million by summers end.

We've backfilled a large portion of the office vacancy at Town Center and, as was anticipated, same store NOI has begun to recover from its temporary decline and we believe will ultimately return to the positive levels that we've enjoyed in the past. As construction on Phase 6 nears completion and leasing commences on the new multi-family units, the additional supply in town center allows us to begin substantial upgrades to the Cosmopolitan apartments next door without affecting our ability to meet ongoing demand. We will be cycling through the units over a two-year period to ensure this asset remains the premier luxury address in the submarket.

With regard to the rest of the development pipeline, leasing progress remains brisk on the newly delivered multi-family projects and reinforces our view of healthy spreads achieved through our development operation.
Currently, Annapolis junction is nearing the 45% mark with the prime leasing season yet to come.

Harbor point stands at nearly 40% leased despite delivery occurring only 6 weeks ago. We had high expectations for this project and even we have been pleasantly surprised by the pace of leasing thus far. In both of these projects, we expect proforma rents to be achieved.

We now anticipate that our Durham high rise, One City Center, anchored by Duke and WeWork will open at the end of the third quarter nearly fully leased.
Construction continues on the rest of the projects in the pipeline and scheduled deliveries remain unchanged.

As we have said before, our expectation is that delivery and stabilization of this half billion-dollar pipeline will contribute well over a dollar in NAV per share as well as a significant boost to earnings. While our intent is to retain ownership of all the projects in this pipeline, market conditions may lead us to monetize a portion of this healthy value creation in order to strengthen the balance sheet as well as help fund another round of exciting projects.

The next development pipeline is taking shape with large mixed- use projects in sought-after locations in large metropolitan markets with some likely to include public participation. Smaller, in-fill locations featuring mid-market multi-family and retail projects may also be included, as secondary and tertiary cities are experiencing re-urbanization as well. We expect to begin announcing these projects later this year

As I mentioned last quarter, our construction group will be building a 220 thousand square foot distribution center for a wholly-owned subsidiary of PepsiCo in Richmond, VA. In the negotiations with the client, we offered a menu of fee construction and development, build-to-suit purchase, or long-term lease, giving Pepsi optionality that is only afforded with our integrated business model. They selected the long-term lease arrangement. As we are not long-term holders of industrial real estate, we expect this project will be designed, built, occupied, and sold within 2018, all at the taxable REIT subsidiary level. Due to the favorable rates contained in the new tax law, it is practical for us to monetize the value creation in this manner. Therefore, profit recognition is expected to be significantly higher than just the typical fees we would have earned under a third-party construction contract.

As many of you know, our construction group receives this type of build-to-suit opportunity on a fairly regular basis. Since our IPO, we have executed on four facilities of this nature. The disposition of most of those buildings resulted in our acquiring other properties under a 1031 exchange. While tax free exchanges will still be a part of our strategy, lower tax rates will enable us to alternatively handle these engagements at the TRS level as well, with after tax proceeds available for balance sheet purposes.

We remain extremely bullish on the performance of our company. With an accretive pipeline nearing delivery and a solid balance sheet, we believe we are poised for significant growth over the next few years. We appreciate the confidence demonstrated by our board with their approval of a dividend increase of 5.3% this past February. This brings the total dividend increase since IPO to 25%. With a yield well in excess of five percent combined with consistent annual increases, we feel that we are delivering exceptional value to our shareholders.

At this time, I'll turn the call over to Mike to discuss our first quarter results.

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 our 2018 guidance.

This morning, we reported FFO of 26 cents per share and Normalized FFO of 25 cents per share for the first quarter, which was in line with our expectations.

As we anticipated, Same store NOI improvements have begun. As we have discussed the past couple of quarters, this metric was impacted from ongoing construction of Town Center Phase Six as well as by the relocation and expansion of two significant office tenants to 4525 Main Street, which is not in the Same Store NOI calculation. We have made progress in leasing this vacated space and with occupancy increasing later this year, we expect same store NOI to be positive.
As Lou mentioned, we began the renovation of the Cosmopolitan Apartments this quarter, currently there are 35 units off line. With these units not available for rent, the Cosmo is excluded from the same store NOI calculation and will not return until four quarters after the renovations are completed.

To illustrate what is truly happening with our portfolio, we continue to encourage you to look at our occupancy and releasing spreads. Our core operating portfolio occupancy for the first quarter was 96 percent, with office at 92 percent, retail at 97 percent and multifamily at 96 percent. Additionally, our releasing spreads were strong for the quarter, with positive 7.8 percent on a GAAP basis and positive 3 percent on a cash basis.

On the construction front, we reported a segment gross profit in the first quarter of 600 thousand dollars on revenue of 23 million dollars as compared to a 2.3 million segment gross profit in the first quarter of 2017. If not for this decrease in the construction gross profit, the first quarter 2018 normalized FFO per share would have been two cents higher than a year ago.

At the end of the first quarter, the Company had a third-party construction backlog of 31 million dollars. As Lou said, we expect construction backlog to increase in the next few months.

Now turning to our balance sheet.

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

Our initial 2018 guidance included the expected future acquisition of two Lowes Food shopping centers. With the current market environment, we decided to not acquire one of the centers. We are still planning to acquire the other center because this transaction is with a strategic partner who is taking back all of their equity in OP units which is consistent with our historic OP unit acquisition strategy.

In addition to not acquiring one of these centers, we have entered into an agreement to sell the Wawa outparcel from the newly acquired Indian Lakes Harris Teeter center for a 5.35 cap rate, with the proceeds being used for balance sheet purposes.

By passing on one of these acquisitions and the sale of the Wawa, we are reducing our expected capital needs in 2018.

We acquired the Indian Lakes center for a 7.1 cap rate and, net of this outparcel sale, we now have a Harris Teeter center that is yielding nearly 8 percent.

Due to equity market conditions, we did not issue any shares through the ATM program in the first quarter. Hopefully, the market will change before long, but we are not counting on it, so we are exploring other means for raising capital including selling assets. We are in discussions with brokers regarding opinions of value of various assets to determine our best capital strategy.

We continue to work on the five 2018 loan maturities. During the first quarter, the Sandbridge Commons center was extended for 5 years and both of the Columbus Village loans were paid off. Of the remaining two maturities, we have a term sheet from TD Bank to refinance the JHU student housing project loan for 7 years with a lower spread than the current loan. The other maturity is the Lightfoot Marketplace loan. We are in discussions with the lender and expect to extend the loan well before the maturity date. In addition, during the quarter, we added assets to the credit facility borrowing base and increased the capacity of the facility by 30 million to 330 million.

The lending environment has changed during the past couple months with spreads substantially lower. We are taking advantage of this environment and are in discussions with our lenders with whom we have floating rate debt. We expect to lower spreads by 35 to 65 basis points on over 100 million dollars of debt.

At the end of the quarter, we had total outstanding debt of 595 million dollars including 108 million dollars outstanding under the 150-million-dollar revolving credit facility.

We continue to evaluate our exposure to higher interest rates and look for opportune times to hedge our interest rate exposure. At quarter end, 91 percent of our debt was either fixed or hedged. This past quarter, we purchased a 2-year, 50-million-dollar interest rate cap at 2.25 percent.

As part of our hedging strategy, we have always evaluated interest rate caps and swaps to mitigate exposure to interest rate risk. The market has typically overestimated the path of LIBOR, which resulted in a steeper yield curve making swaps more expensive relative to caps. For this reason, we primarily relied on caps for interest rate protection.

As the Fed has been increasing short term floating rates, the yield curve has flattened and the premium to convert to fixed rates has fallen to more attractive levels. Additionally, market expectations more closely align with the fed's rate projections, which has limited some of the upside of caps. In the current market, we believe swaps are a better option to mitigate interest rate exposure than caps. Thus, subsequent to the quarter, we entered into a 5-year swap for 50 million dollars and expect to enter into more in the future.

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

Now I'd like to go through the details of the updated 2018 guidance.

First, starting with our assumptions:

- The acquisition of a retail center in the second half of the year
- Sale of the Indian Lakes Wawa during the 2nd quarter, with proceeds used for balance sheet purposes.
- Raising 42 million dollars through the ATM program assuming favorable market conditions.
- The sale of the distribution center in the fourth quarter. Since the FFO would be recognized at the time of sale, fourth quarter Normalized FFO would be substantially higher than the previous three quarters.
- Interest expense is calculated based on the Forward LIBOR Curve which forecasts rates rising to 2.25 percent by year end.

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

- Total NOI in the 79.5 to 80.2 million-dollar range,
- Third party Construction Company gross profit in the 4.4 to 7.5 million-dollar range.
- General and administrative expenses in the 10.7 to 11.0 million-dollar range.
- Interest income from our mezzanine financing program in the 9.3 to 9.5 million-dollar range. As of quarter-end, the aggregate loan balance of these mezzanine loans was 88 million dollars.
- Interest expense in the 19.8 to 20.3 million-dollar range.
- And, 63.6 million weighted average shares outstanding.

Now I'll turn the call back to Lou.

Louis S. Haddad
President, Chief Executive Officer & Director

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.

Our first question is from Dave Rodgers with Robert W. Baird. Please proceed

David Rodgers:

Lou, on the office side, looks like leasing volume picked up nicely in the quarter with really good rental rates. Just wanted maybe you to comment on – that’s got to be a Town Center. Economics look like maybe, it was hard to tell they were up or down, but TIs and LCs were up, but term was longer too. Maybe just kind of comment on the signings of the quarter and then your view on overall connectivity for office in and around the Town Center?

Louis Haddad:

Sure. So it was a good quarter for backfilling the vacancies caused by moving the tenants into the New High-Rise. Spreads were really good as you can see and terms are lengthening as well. What is most exciting to us is that we finally have the pieces of the jigsaw puzzle put together, so that the remaining space is essentially is in 3 chunks. Again, forgetting what's in and out of the metric, our office portfolio at Town Center is about 800,000 square feet, and there are 3 decent size chuck of space that are left. Two 10,000 foot spaces and a 20,000 foot space. Our expectation is to get hopefully 2 of those filled, between now and end of the year, and office occupancy will, once again, be in the high 90s. There is a good amount of activity, a lot of optimism out there, and we look forward to taking advantage of the rest of it, with this place back to where it traditionally has been on our office basis.

David Rodgers:

And then with regard to the retail acquisition activity -- I know we've talked about this in the past -- but you continue to buy some retail centers, and obviously the returns there are pretty good for you, but with all the concern about retail and tenancy, I mean, should we be looking at this as kind of building retail to only sell a little bit on the back end to continue to, kind of, clean up the exposures? Do you just like that business and continue to want to grow it? And then talk a little bit more about that especially in the context of Bed Bath & Beyond to continues to be rumored out there as a potential problem?

Louis Haddad:

Sure, let me take that 1 at a time. As you've heard me say before, we feel very comfortable with the retail that we own. The sectors that we are active in is the grocery-anchored centers, and secondary and tertiary cities along the mid-Atlantic. We're not seeing any pressure there in terms of sales or occupancies or anything that has been different over the last many years. We expect to continue to build out that part of the portfolio selectively. It's still all about location, just like it always has been, and so you have to maintain caution in that area as well as any other. We also like discounters. That continues to be a big feature in our portfolio, home improvement and discounters anchoring the non-grocery anchored traditional centers in the portfolio. And lastly, our mixed-use retail, which as you have heard me say before, is a bit of misnomer. Probably the least amount of space in that portion is traditional retail, with the majority being professional office and restaurants and for-profit schools. And that will continue to be feature, as long as we continue mixed-use development.
Around the edges, obviously, investors pay us to stay in tune to what's going on in real estate. We've talked before about a couple of centers that we ultimately don't believe we'll own long-term. We have talked about Bed Bath as a company that, as everybody knows, is under some duress. They're in 4 of our centers. And quite frankly, we'll be happy to get the space back in all 4 of those centers. I don't believe that's happening, as those stores apparently are doing very well for that company, so we'll see what happens long-term. But we continue to be believers in retail. As you all know, as the pipeline comes to delivery, the percentage of retail in our portfolio will continue to shrink on a relative basis. But our expectation is that we will cautiously add to that portfolio because, as you said Dave, the prices are where they need to be to get some good accretion with very high value tenants. So on an absolute basis, it'll continue to grow somewhat, but obviously, shrink on a relative basis. Hope that helps.

David Rodgers:

It does, and then last 1 for me. I just want to ask about the return on the Cosmo spending. I know the way you've put in the supplement, Cosmo has much higher than Encore, but I think a lot of that has to do with unit size. So can you just talk about what type of bumps you are looking to get out of the unit renovation program at Cosmo?

Louis Haddad:

Sure. So once we deliver the Premier, which is the apartments in Block 6 or Phase 6 of the Town Center, we're going to have 3 different styles of units at 3 different price points. With Premier being small, either one bedroom or efficiency units. The Encore being, again, skewing towards, on a smaller side but more traditional units. And thirdly, the Cosmo, which is been the larger luxury units and more of a traditional high-rise. That property has enjoyed the highest rates in the submarket. It is now nearly 12 years old and the refresh is going to be significant. Mike can talk to you about the numbers, but our thoughts are that is mainly going to be seen in occupancy. As opposed to rate, however, the rates are going to stay above, and again, we have to look at this on a per unit basis, because that how people are renting these things in this area. It's going to be the highest cost per unit in this space. And it needs to stay as a leader of the pack.

Operator:

Our next question is from John Guinee with Stifel. Please proceed.

John Guinee:

First, Mike, how much are you assuming in terms of after-tax proceeds on the PepsiCo deal in your underwriting?

Michael O'Hara:

Approximately $4 million on the sale at a 6.25 cap.

John Guinee:

Okay, $0.06 or $0.07 per share?

Michael O'Hara:

Correct. It'd be just over $0.06.

John Guinee:

Okay. Should we assume if the midpoint is $1.03, should we assume $0.24, $0.24, $0.30 for the next 3 quarters?

Michael O'Hara:

Yes, it'll be $0.06 on the Pepsi sale. At the 6.25 cap, we'd put it to the high end at a $1.05.

John Guinee:

Okay, got you. And then second, Lou, your big sort of transformational year in terms of acquisitions, where you sold a lot of office and some tough high CapEx product and you bought about $260 million of retail -- basically a lot of Harris Teeters in mid-Atlantic -- or about $260 million low cap rate, maybe, low 7s cap rate on average? If that product came on the market today, is it still low 7s or it high 7s or it low 8s? Any sense for that?

Louis Haddad:

Good. That's a great question, John, it's something we talk about here a lot. I do not know if it's the answer, but I can give you our market sample of 1. We're not seeing any loosening of cap rates on the high-quality grocery centers. And in fact, it seems to be going the wrong way or the other way, if you will, depending on where you sit. So, the Publix, the Harris Teeters and Whole Foods, they're all either compressing or staying the same. Now at the low end of the scale or the value end, if you will, there's a lot of widening, because there's a lot of competition out there; and, frankly, there's going to be -- there has been some consolidation. So at the regional grocery level, you all saw what happened with Southern shopping group. Food Lion centers, I think would be out in the high 8s at this point, but the kind of centers that we want to own, we're not seeing the bargains out there that you would hope.

John Guinee:

Okay, very consistent with what we hear elsewhere. And then last question, do you have a sense for, if you're able to acquire at your fixed purchase price, the mezz deals that you did? Or the Durham JV? Do these come in at 5 yield on cost or 8 yield on cost?

Louis Haddad:

In terms of about where our options to purchase sits, those are in the high 6s. As far as the Annapolis Junction at Fort Meade and Baltimore's inner harbor, and in Durham, it's in the mid-7s. What we're talking about there, as you heard from Mike's commentary, is we're deciding whether it's going to make more sense to hold a number of these long-term, or to go ahead and reap some of that spread. Because as you know, multifamily rates are really low at this time, cap rates, as well as high-value credit on the office side in CBD. So I think, John, you probably had the best insights a couple of years ago, when you endeavoured to explain how that mezz program worked. And with your 4 quadrants, whether it is going to make sense for Armada Hoffler exercise their option or to sell. I think that's still a pretty good guide.

John Guinee:

You mean I have to re-read that? Alright, will do. Thank you.

Operator:

Our next question is from Rob Stevenson with Janney Montgomery Scott. Please proceed.
Robert Stevenson:

Can you talk about what the expectations are for the construction segment, as we move throughout the year? The backlog's down to $31 million, are we going to see a meaningful drop off before it picks up again? Or are there projects about to start here in the second quarter that we're not aware of, that keeps the segment more even keeled throughout the year?

Louis Haddad:

So the construction business by its nature is a bit lumpy. Our expectation, as Mike alluded to, had we been booking the appropriate fees on the Pepsi engagements then you would think to see things a lot smoother. Because of the way we're doing it and because we have the ability to make a lot of extra profit, it's going to be, by its nature, lumpy. However, I think, at the end of the day, you're going to see that the construction company had its best year ever last year at $7-plus million, and our expectation is that, depending on the exit cap rate of that Pepsi distribution center, that this year will rival that. What's shaping up in backlog, as I alluded to, I think, you're going to see that backlog well in excess of $100 million by the end of summer. We're very close on a number of different contracts. And while, as lumpy 2018 is going to be, I think, 2019 is going to be much smoother because we will be coming into the year with a significant backlog.

Robert Stevenson:

Okay. And then, Mike, in terms of that guidance that you were talking about before -- about the, I guess, the sequential drop in the second and third quarters before the $0.04 bump back in the fourth quarter because of the sale -- What is that? Is that the removal of the units of Cosmo plus some fall off in construction plus something else? What else is in that, sort of, when you're thinking about a sequential decline in FFO?

Michael O'Hara:

Well, it's mainly going to be the increase in the share count as we get into the ATM program. So that's the main thing, we don't see any big drops. And on the Cosmo, the plan is we start with taking 10% of the units offline is after we roll through that initial 10%, is to keep 5% offline, so that we will hopefully ride at the natural vacancy at that 5%.

Robert Stevenson:

So if you guys don't issue shares under the ATM, then there shouldn't be a sequential drop in earnings?

Michael O'Hara:

Well, it depends on if we sell something and lose the NOI associated with that sale.

Robert Stevenson:

Okay. And then remind me, the capital needs for 2018 in the guidance, doesn’t anticipate either the purchase or the sale of Point Street or Annapolis Junction out of the mezz pool? They stay in the mezz pool for the full 2018?

Michael O'Hara:

Correct.

Robert Stevenson:

Okay. And then -- in addition to Cosmo, anything else that you guys are nearing redevelopment of at this point in the portfolio?

Louis Haddad:

No. That's pretty much it. Cosmo is a bit of a special case. Like, when you have the market leader, you really can sit on your laurels. We've got to continue to have that “wow” people in order to get that kind of rents.

Robert Stevenson:

But nothing in the retail portfolio that you guys are thinking about doing any substantial redevelopment or anything like that at this point?

Louis Haddad:

Well, as you know, we purchased the 2 centers adjacent to Town Center with an eye towards redevelopments and we continue to work on various schemes with the tenant centers there as well as the city. And ultimately, those will be done but that is not imminent. We also -- we've been telling you folks for a while -- our old, outdated Kroger in Waynesboro, Virginia, we had anticipated that Kroger wouldn't renew that. They're not going to renew it, so we'll be redeveloping that. We actually have some tenants that are looking at that now. But other than that, it's really pretty much it. I think you're going to see that CapEx go down pretty noticeably next year, but for the continuing of the Cosmo.

Operator:

Our next question is from Jamie Feldman with Bank of America, Merrill Lynch. Please proceed.

Kimberly Hong:

This is Kim Hong on for Jamie. I think somebody already asked this question on the spike in Tis this quarter for the office lease, but can you just talk broadly across the market what the general rent growth is? And how TI and concession trends are trending for both the office and the retail segments?

Louis Haddad:

Sure. Well, on the office side, it's pretty small microcosm of what's going on the market. So I wouldn't want to comment on the macro level here. We have here at the Town Center an 8,000 square-foot office portfolio that stays pretty much fully leased, for the last 15 years. Spreads are good. You see this past quarter, we are few percent on the positive side on a cash basis, and we think that they'll continue to be good. And again, that's a very small demographic, right. We have very few square feet left to lease and so we can be -- on one hand, we can be pretty selective and pretty stiff on the pricing -- on the other, it would be nice to have it gone. So it's kind of too small of a market sample to make any general statement.

Kimberly Hong:

Okay. And is it the same case for retail?

Louis Haddad:

So retail is a bit broader. Our retail centers are throughout the mid-Atlantic. And again, this portfolio is predominantly anchored by either grocery centers, home improvement centers, or discounts -- discounters. That makes a large part of the NOI very stable, #1, but not growing very fast, #2. When you take the rest of the occupancy, I think, Mike said that the occupancy on the retail is somewhere around 97%. There just isn't enough movement to create. So for us to comment on a trend, we had significantly higher releasing spreads this past quarter; that has been the norm. At the same time, it’s a small enough market sample that one renewal, for less, could skew the results the other way. For us, that underlying strength in the retail center is what gives us an awful lot of stability, over which we can do our development business. That's the way it's been designed, as we have mentioned on numerous occasions, the depths of the Great Recession, the occupancy in those centers went all the way down to 92%. And that's what it's constructed for, not so much the growth, but the stability to keep that dividend well covered.

Kimberly Hong:

Got it. And it seems like next year, you have some expirations both in office and retail portfolios? Can you speak about any future move out risks in those portfolios? And any progress on backfilling the major vacancies? I know you spoke about the 3 in the Town Center.

Louis Haddad:

So in the -- again, in the office portfolio, on a relative basis, it's pretty small. We've got a couple more lawyers that are left to downsize. Each lawyer in Town Center has renewed and taken less space. Our expectation is that what's going to happen on the 2 remaining, that roll over next year. Although, those are on a smaller square foot basis, so the impact won’t be as great. The other major office tenants, we're already in discussions for renewals. So again, we're -- the expectation is that the occupancy, office occupancy at the Town Center is going to be in the mid-90s through a combination of those events. As far as the retail, today, we don't see anybody giving up their space. We do have interest from a couple of larger tenants that want to buy their space. We’d rather see -- not see that happen, but they’ll have the ability to do that. Right now, we're not seeing anybody making noise as if they would like to leave. Of course, things change, it’s a rapidly changing landscape and we need to stay on top of it.

Kimberly Hong:

Okay. And the last one is on the pre-leasing progress on the delivered but yet stabilized assets. I think there are two of the them and they are scheduled to deliver this year. So just wondering what the progress is on that? And if -- I noticed that you've added some projects to the development pipeline I saw, so can you speak to the new ones too?

Louis Haddad:

So on the office deliveries, the office delivery for this year is the City Center in downtown Durham. With the signing of the WeWork lease, the office space is sitting about 13,000 or 14,000 square feet left to lease beyond Duke and WeWork. Our hope is that it's going to be leased by the time we open. On the retail side, it's about 20,000 square feet of retail there, and it's about half spoken towards so far. But we are optimistically thinking that building is going to open pretty much full. That is it for the office deliveries of this year. The multifamily -- I'm not sure that was part of your question or not -- The multifamily projects, Annapolis Junction at Fort Meade and Harbor Point at Baltimore's inner harbor, both of those now have delivered and are in lease up. And we're extremely pleased with those multifamily projects and their rate of lease up at this point. The few projects that were added -- I'm sorry, go ahead.

Kimberly Hong:

I was talking about the Brooks Crossing and the Lightfoot Marketplace. So the 2 retail assets.

Louis Haddad:

Yes, so Brooks Crossing is -- that is a small center, that is a part of a large public/private venture with the city of Newport News. We're under construction with the 100,000 square feet of office. That is 100% leased, but that won't deliver until the first quarter of '19. The few thousand square feet that is in the retail center there, it's an adjoining retail center, some small shop space, have a couple of tenants there that are circling -- again, our expectation is going to be all but full here by the end of the year -- but again, it's only going to be 14,000, 15,000 square-foot center. Lightfoot Outparcel is a new project in development pipeline that is fully spoken for with a few out-partial tenants. That will break ground a little bit later this year, and ultimately be delivered midway through next year. Those are a 100% leased and spoken for already. The last piece, the market at Mill Creek, which is Mt. Pleasant, SC, that's a Lowes-anchored shopping center that we just started construction on.

Operator:

Our next question is from Craig Kucera with B. Riley. Please proceed.

Craig Kucera:

As you mentioned in your prepared comments, the 2 multifamily developments in Maryland are leasing up pretty nicely, maybe even faster than expected and rents are at your Proformas; but can you give us an update on when you might invert those loans? And although, it's not in your guidance, is there any chance and event could fall in the 2018 for either of them?

Louis Haddad:

There is that possibility, Craig. I mean, so we have -- what we model is that we would be purchasing those at the end of the year. Obviously, with the pace of leasing as fast as it is, we've got to look at whether or not we would rather do that earlier. And the other piece of that, as Mike mentioned, is that we also are seeing a pretty healthy spread in what that could bring, what those projects could bring on the open market. So a lot depends on -- the analysis we look at is we've been talking about the spreads in our development pipeline for 5 years now. We have demonstrated how healthy those spreads are with a number of sales. The equation we look at is what it is going to cost us to have that long term on our portfolio versus the projects that are forming in a new development pipeline and would be rather fund those with those -- with that spread, essentially free money, versus raising money in the market. If everybody would just let the stock go to $25, we wouldn't have to worry about these decisions, we would just own everything. But as the market is as it is, we want to be selective in what we do. Eric?

Eric Smith:

Yes, there's -- I just want to add one thing to that – there’s an interesting narrative that's prevalent in multifamily space right now, which is some of the larger institutional money is willing to take market. Some market-specific and asset-specific lease up risk, in exchange for taking interest rate risk off the table by investing in a multifamily development and facing a potential 3 years, maybe 3 years plus of interest rate risk. So those buyers are willing and very interested to look at strong assets with strong lease up trajectory that are in the -- as well as 25% but certainly 50% plus pre-leased arena. That, combined with all of the money that flowed into the bridge loan space is providing the capital that's allowing these institutional buyers to bridge that purchase lease-up and to purge the debt. So we are seeing and hearing across the multifamily space, again, for high-quality products, is that discount you may take as a seller has compressed to as well as, in some cases, 25 basis points or so. So I think it's necessary and prudent for us to look at that sale option given those dynamics in that space. To Lou’s point, relative to bring it on balance sheet, as attractive as some of those sale opportunities are prior to full lease up.

Craig Kucera:

Got it. And I guess, when you think about, sort of that current environment, looking down the road, does that make you more inclined to maybe control more multifamily development off balance sheet through mezzanine lending? Or are you may be going to focus more on that line of business on the Whole Foods development?

Louis Haddad:

I'd say both. So the model is very successful on both sides. On the Whole Foods side, that is more of a traditional mezz opportunity, where you are trying to simply make money on your mezz, as well as leverage your construction company and a very good partner. Ultimately, with Whole Foods trading, as we've seen them as the low as sub 5 cap rates, that we probably would not end up acquiring those. And we'll see how that pipeline rolls out once Amazon and Whole Foods starts accelerating the expansion. On the multifamily side, those opportunities continue to exist -- we're seeing -- what's coming in the new pipeline is extremely exciting for us, because it is right in our wheelhouse. We can bring the maximum amount of our expertise to bear in mixed use facilities, and in highly dense areas combining multifamily as well as retail and office. Those are the assets that we really want to have. Those have stood the test of time for a very long time. So we'll see, we'll where that ends up. But the mezz program will continue in some former fashion across the product types.

Craig Kucera:

Got it. One more from me, just going to the office side, I think, you have 3 Art Institutes that are expiring next year. I guess, I'd be curious to any update on any discussions? Have you started them and, sort of, can you handicap what you think whether or they're going to renew?

Louis Haddad:

Yes, if I were to bet today, I'd say they're all going to renew. We're already in the discussions for the one here at Town Center. So that, we think they're doing pretty well in our locations and we're not hearing any noise about anything other than renewing. Again, it's somewhat early, but it looks positive so far.

Operator:

Our next question is from Bill Crow with Raymond James. Please proceed

William Crow:

Lou, in the anticipated increase in the construction backlog, you talked about some mixed-use projects in larger markets. Just wondering if you can give us any example of maybe some of the markets that you're looking at either expanding in or maybe entering for the first time?

Louis Haddad:

Sure. And again, 2 different things. The construction contracts that we are close to signing are not -- don't quite overlap with what we're talking about in the new pipeline. The construction contracts, some of them are local and some of them, as far as Baltimore and all the way down to Atlanta. As far as what we are looking at…

William Crow:

Which is the same geographic are that you have kind of focused on historically from a company perspective?

Louis Haddad:

Correct, correct. As far as what's developing in the pipeline, those large areas that we're looking at, again, it's kind of more of the same. It's Baltimore, it's Raleigh/Durham, it's Charlotte and it's Atlanta. And we're looking forward to making some announcements soon in all of those locations.

William Crow:

Maybe, Mike for you, the Cosmo investment, is there a return expected on that investment? Or is it just more defensive in nature, just trying to maintain the competitive nature and maintain -- I think you talked about rents are kind of staying flat? Is it fair to think of this as more defensive spending?

Michael O'Hara:

Well, I would say it's a combination of both. I think the main part of renovations is the kitchens and floorings, which certainly has changed and you want to keep that there. And certainly we would like to – you can pick up the -- you can pick up a nice return on that investment by having an occupancy in the high '90s versus the low '90s. But I'm hopeful that when you drive occupancy, it gets up into the high '90s, then we can start pushing rates. And we do know that, in talking to the tenants, obviously, they all want new units. So I'm hoping that they look really -- come out really well and we can drive rent.

William Crow:

You think that is a fair timeline? 10, 12 years? You kind of need to go in and redo in multifamily at this point?

Louis Haddad:

I thank for the most part, again, the -- if you were at the mid-market property, you may not have to do as an extensive job as what we're talking about now. When you try to stay at the top of the market, then, I think you have got to look at that every decade or so or you are not going to be at the top of the market.

William Crow:

Okay, fair enough. And finally, from me, if we pull the $0.06 out -- assume that doesn't occur in '19; and I think you've got some puts and takes next year and some timing issues without, I guess, giving us guidance -- but you think next year is poised to be an up year from FFO per share, assuming you hit that kind of $1.05 this year with the full $0.06?

Louis Haddad:

Great question. So Mike and I have been saying for quite a while that this pipeline when it gets delivered, you're going to see significant NAV and earnings growth. Our expectation is that that's exactly what you're going to see. We are not changing that at all. I'd say that there couldn't be a better time for our business. We have been operating this model for a very long time. We've always done better in a growth economy than we have in a stagnant economy. And like I said earlier in our prepared remarks, shame on you if you can't overcome gradually rising interest rates when there's always an opportunity out there. We're not seeing any reason why we can't deliver on what we've been promising with the delivery of this pipeline with the assemblage of the next pipeline, as well as continuing on where the high volume construction and good proceeds in the mezz program. So we are -- all systems are good for 2019.

Operator:

Our next question is from Laura Engel with Stonegate Capital Partners.

Laura Engel:

I just have a clarification. Again, on the mezz program, can you just -- you commented on the Whole Foods and the potential for those as far as the option to purchase that -- but can you comment just on the stabilization for Point Street and Annapolis Junction let's say, first half of '19? And then at what point would you make a decision on what's the likelihood on this purchase options?

Louis Haddad:

I think the likelihood is high. I mean, right now, the discussions here are that people are somewhat giddy about the pace of leasing. And so, I guess, at this pace, we're going to have those decisions a lot earlier to make versus later. But our – management has not changed the guidance. Our expectation is that those will be purchased around the end of the year, and as we have alluded to, we're looking at our optionality to not do that, as opposed to raising capital for the next pipeline. And we just going to make the best decision we can at the appropriate time. It's just nice to have the backdrop of really good leasing velocity in order to make those decisions on top of.

Operator:

Our next question is a follow-up from John Guinee with Stifel.

John Guinee:

Mike or Lou, when you do the math, obviously, if you can sell your assets at a 4.5 cap and your stock is at $11 a share, you're a seller of the assets versus an issuer of your common, but on the other hand, if there's a cap rate is at 6 and your stocks at $15, you go the other way. Have you done enough analysis to understand where the break point is? Where you had rather issue equity versus sell the assets?

Louis Haddad:

Well -- yes, you're talking about where those lines cross and – boy John, I wish that was a stagnant model. Part of that -- with just those 2 factors, those lines do cross in the 15s. But the subjective piece that you have got to layer on to that, is a very exciting group of opportunities that are forming behind that. And whether or not, you're going to be able to sustain raising the amount of capital needed to keep everything. And so that's kind of the mitigating factor that has us, essentially waffling on what exactly we're going to do.

Operator:

Ladies and gentlemen, we have reached the end of the question-and-answer session. I would like to turn the call back over to management for closing remarks.

Louis Haddad:

Thank you, and thanks, everyone. We appreciate your interest in our company. We look forward to updating you on our activities and results in the coming quarters. Take care.

Operator:

This concludes today’s conference. You may disconnect your lines at this time and have a great day.