February 22, 2024

Armada Hoffler Properties, Inc. (AHH)

Q4 2023 Earnings Call

Operator

Good morning, ladies and gentlemen. And welcome to the Armada Hoffler Fourth Quarter 2023 Earnings Conference Call.

(Operator Instructions)

This call is being recorded on Thursday, February 22, 2024.

I would now like to turn the conference over to Chelsea Forrest, Director of Corporate Communications and Investor Relations.

Please go ahead.

Chelsea Forrest

Good morning, and thank you for joining Armada Hoffler's fourth quarter and full year 2023 earnings conference call and webcast.

On the call this morning, in addition to myself, is Lou Haddad, CEO; Matthew Barnes-Smith, CFO; and Shawn Tibbetts, President and COO.

The press release announcing our fourth quarter earnings along with our earnings guidance and supplemental package were distributed this morning. A replay of this call will be available shortly after the conclusion of the call through May 23, 2024. 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 these remarks made herein are as of today, February 22, 2024, and will not be updated subsequent to this initial earnings call.

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

Listeners are cautioned that any forward-looking statements are based upon management's beliefs, assumptions, and expectations, taking into account information that is currently available. These beliefs, assumptions and expectations may change as a result of possible events or factors, not all of which are known and 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 that we distributed this morning and the risk factors disclosed to the documents that 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 armadahoffler.com.

I'll now turn the call over to Lou.

Lou Haddad

Thanks, Chelsea. Good morning everyone, and thank you for joining us today. In addition to analysts and investors, there are many of our Armada Hoffler family and joint venture partners on the call. On behalf of our Founder and Chairman, Dan Hoffler, the Board of Directors, and executive management, we sincerely thank you for being a part of our team.

Later in the call, Shawn and Matt will comment on our year-end results as well as our 2024 guidance. I will highlight two important actions that were taken by our Board of Directors last week.

First, as you probably have already seen, we've raised the dividend a solid 5% to $0.205 per quarter. This increase brings the dividend into alignment with our long-standing coverage parameters of approximately 80% of AFFO. More importantly, it is indicative of management's confidence in the trajectory of our business model, increased property NOI, strong leasing activity, and development income expected to come online in the fourth quarter. All factor into our confidence in our core business and sustainability of our current cash flows.

The second Board resolution was the promotion of Shawn Tibbetts to the position of President. Upon my retirement in spring of 2025, we anticipate Shawn will become CEO. Over the last five years, Shawn has shown remarkable business acumen, team building skills and leadership talent.

As a CEO who is nearing the end of his time in the top job, one of the most important duties is to find and mentor a likely successor. And if he does his job really well, he finds someone who has the potential to eclipse the accomplishments of his predecessor. We have found that person in Shawn.

This promotion is the first step in the succession plan approved by the Board last year. The next phase will be our Founder and Chairman, Dan Hoffler's, transition to Chairman Emeritus. He expects to remain on the Board as of our annual meeting in June. At that time, assuming shareholder approval, I will become both Chairman and CEO for an interim period, expected to be approximately one year, after which we expect to promote Shawn to CEO.

Dan and I are excited to start this transition to a new generation of management while continuing to guide the company to further growth and prosperity. I'll now turn the call over to Shawn.

Shawn Tibbetts

Thank you, Lou, and I appreciate the kind words and confidence you have placed in me to lead the company into the future.

As Lou stated, we concluded a challenging and successful year in 2023 and are looking forward to continuing to put in place the foundational elements necessary to further expand the company and bolster growth. This morning, I'll be focusing on performance during 2023, followed by our guidance for 2024, in addition to sharing commentary about our projections into 2025 and beyond. Matt will also follow up with more detail.

We released earnings for the fourth quarter and the full year 2023 earlier this morning. Quarter four ended at $0.31 of NFFO per share, while the year concluded at $1.24 NFFO per share. This outperformance represents a growth of 16% since the pandemic reset in 2021.

Our 2023 earnings results were yet another record for our 43-year-old company, and amid significant headwinds, the earnings were consistent with our guidance. I want to take a moment and thank all of the talented and dedicated Armada Hoffler team members for their tremendous efforts and results while actively managing the challenges presented in the real estate and broader markets.

As you recall, we were awarded an investment-grade credit rating of BBB from Morningstar DBRS in January of 2023. To bring you up to date and as you may have seen in our press release, Morningstar DBRS has reaffirmed the BBB rating effective January 2024. We are proud of this accomplishment and remain optimistic that we will be able to leverage the rating to place private debt when the time is right. Matt will touch on this a bit later. Please refer to the supplemental package to review our detailed portfolio highlights.

In addition to our organic same-store portfolio NOI growth, we purchased The Interlock in West Midtown Atlanta. As you recall, we were the construction firm and mezzanine lender on that project. This was a significant win for our company's loan-to-own program and for our expansion more deeply into the Southeast markets surrounding Atlanta.

While on the theme of our real estate financing program, we have since selectively backfilled the mezzanine and preferred equity allocation with three additional high-quality multifamily projects. We now have five high-quality multifamily deals strategically located throughout growth markets in Virginia, North Carolina, and Georgia. We look forward to owning one or more of these assets should the opportunity present itself.

Turning now to office. Although the macro-office market has been grappling with occupancy issues, this is not the case for all office buildings. Our office portfolio is comprised of trophy assets, which are highly leased at 95.3%. And therefore, differentiation should be recognized when applying an earnings multiple.

As you know, our office products are best positioned in their respective submarkets and are integral to robust and active mixed-use ecosystems. These factors have resulted in Armada Hoffler's portfolio benefiting from the continued flight to quality evidenced by elevated occupancy and leasing activity, as well as establishing their own superior market rents that defied trends in the office space overall. We expect to maintain relative outperformance of the competitive set to not only continue but accelerate over time as employers prefer highly amenitized Class A assets in mixed-use environments.

An opportunity for leasing was recently created from our intentional removal of WeWork from The Interlock asset in Atlanta. We are not willing to impair our trophy asset with a long-term punitive lease, and therefore, we're not willing to accept the terms WeWork needed to stay in the building.

As a result, we canceled the lease and simultaneously reduced our forward exposure to the tenant while maintaining earnings consistent with our guidance target in 2023.

While this created a temporary blip in same-store office NOI, given the quality and location of The Interlock, we are confident that this space will be quickly re-leased with creditworthy long-term tenants. We have seen significant activity since the announcement and look forward to updating you on our progress.

As you may know, WeWork is in the second round of renegotiating with landlords, and we continue to work with them on a solution for our Durham, North Carolina asset. We will keep you apprised of the outcomes. However, we are close enough to closure to say that we are confident a solution will be had that ultimately results in a deal within market rent range.

Apartments began to experience pressure in 2023, specifically on a relative basis when compared to 2022. Our residential product performed well, meeting our projected low to mid-single-digit expectations. We recognize that supply has increased. However, household formation continues to grow while single-family home production remains constrained.

As a result, we believe that available supply will be absorbed and the projects now in development will benefit from delivery into a supply-constrained market. Regardless, our product type and location are intentional as we aim to be in the best location and, therefore, have the most desirable asset in the submarket. We continue to see relative outperformance due to our long stress-tested strategy at the higher end of the market.

Shifting to 2024. We are focused on excellence in our operations, disciplined execution, and meeting or exceeding our KPI targets. As you will often hear me say, we will focus on running our playbook as we believe that best-in-class operations throughout the portfolio, safe and reliable construction services, combined with seamless execution of high-quality development projects, will continue to create sustained shareholder value for years to come.

Let's take a few minutes to review highlights of our 2024 guidance presentation which was released this morning and can be found on the Investor Relations page of our website. On Page 3 of the guidance package, you will notice that we have taken a conservative approach to our guidance range, which I will elaborate on as we walk through each of the components.

Our earnings range midpoint of $1.24 represents 16% growth over the post-pandemic 2021 earnings results and 19% growth assuming we achieve the high end of the range at $1.27. Coupled with the dividend increase, the targeted earnings per share represents healthy growth in total shareholder return in an otherwise challenging real estate environment.

Income is growing steadily, primarily driven by increased rents, cost controls, strengthening portfolio NOI, incremental income from development projects, and consistent fee income. As you can see on Page 4, the upward trajectory of property NOI continued this year at an increase of 5% over 2023, net of the impact of WeWork. Specifically, we wrote off nearly $2 million of accrued rent in 2023 and canceled nearly $2 million of annual rent on a go-forward basis.

Our construction team continues to produce record results as we manage the nearly $0.5 billion third-party backlog remaining at the end of 2023. We look forward to another record year in construction, producing a target gross profit of over $13 million as we continue to build for strategic partners and deliver high-quality assets destined for our own portfolio.

G&A expenses were held flat for 2024 guidance as a result of diligent planning and savings by our team. The inflation effect on G&A has been largely mitigated this year as we look forward to continued process excellence and refinement across our company.

Interest expense remains a focal point as the cost of money has increased over 2022 levels, which has obviously had an impact on our per share growth. Matt will talk to you in more detail about this and other financial metrics. However, I would like to commend Matt and his team on their performance this year while managing the interest rate challenges and creating capacity with which to finance our investments.

The graph on Page 4 illustrates our continued growth in income allocated by source. The NOI growth across our properties is complemented by the fee income streams that will remain relatively constant in 2024. Please note the introduction of JV income in 2024 and growing into stabilization. The portfolio NOI continues to grow despite the decision to eliminate WeWork at The Interlock, as discussed previously, and placement of a few tenants on bad debt.

On Page 5, we have illustrated the current portfolio composition as well as the evolution of the NOI makeup inclusive of the JV income. The organic growth of the portfolio, the stabilization of the development pipeline, and the opportunity cost of the JV income create a significant growth opportunity for our company. Although we have remained conservative in our underwriting of 2024, we are bullish on our continued earnings growth given the significant opportunities in 2025.

Finally, on Page 6, we have summarized the consistent growth and trajectory that our team has sustained over the past few years. NOI, EBITDA and NFFO trends are included here as some of the key financial metrics that continue to grow over time. And we expect that we will continue the trend into 2025 in the future.

As stated in previous conversations, we understand that our narrative is inconsistent with that of the broader market. That said, our product is robust, high quality and primarily trophy class. We will continue to leverage the quality of the portfolio to create continued and increased shareholder return, with an expectation that the market values the earnings stream and underlying real estate with the quality multiple it deserves.

Finally, we continue to look for opportunities to grow as we work through 2024 and prepare for significant growth into 2025 and beyond. Thank you to our greatest asset, our employees, for continuing to invest the time and energy, which results in our outperformance.

I'll now turn the call over to Matt.

Matthew Barnes-Smith

Good morning, and thank you Shawn. Once again, the team have produced another strong quarter of financial results, in line with our guidance and analyst expectations.

As Shawn indicated, for the final quarter of 2023, we reported FFO of $0.13 per diluted share and normalized FFO of $0.31 per diluted share. The difference between the two numbers being the negative $16 million unrealized change in fair market value of our derivatives due to the updated declining forward yield curve. The fourth quarter also produced a robust set of operating metrics across our portfolio, achieving exactly what we committed to our shareholders whilst absorbing the WeWork leases.

For the full 2023 fiscal year, we achieved FFO of $1.02 per diluted share and normalized FFO of $1.24 per diluted share, achieving the midpoint of our guidance and outperforming our 2022 fiscal year earnings high by just under 2%. This is a remarkable achievement for the team against the backdrop of the highest interest rate environment in a decade, executing on Armada Hoffler's largest-ever development pipeline and navigating through the tough office leasing sentiment. Shawn highlighted our portfolio's operational performance, and our supplemental financial package provides additional insight if required.

Over this last year, we have spoken at length regarding our balance sheet transformation towards long-term fixed rate unsecured debt. We are pleased to report that we continue to make progress executing our fiscal strategy and have retained our BBB credit rating from Morningstar DBRS.

For the fourth quarter of 2023, the ratio of our stabilized portfolio debt to stabilized portfolio adjusted EBITDA was 6.5x. This is elevated from our stabilized leverage target range of between five to 5.5x, and predominantly due to our self-funding of our development pipeline whilst equity prices were suppressed. We anticipate our leverage to reduce back towards its target range once we enter the ATM market, set our positions in one or both of our joint ventures, and realize the funds from our preferred equity projects in our real estate financing book.

Morningstar DBRS identified several strengths supporting the reaffirmation of our investment grade credit rating, including our market-leading positions in the Mid-Atlantic and trophy assets in Baltimore, a high degree of diversification across asset classes within our commercial tenant base that mitigates exposure to cash flow volatility. We will monitor market conditions and look to transact in the debt private placement market when the environment is favorable.

In the fourth quarter, our weighted average cost of debt remained at 4%, illustrating the success in maintaining our debt is 100% fixed or hedged. Due to interest rates being higher for longer, we proactively replaced our expiring derivatives, achieving a cheaper cost of debt in the short term when compared to the debt private placement market. Ultimately, in the medium term, we expect to reduce our reliance on derivatives, transitioning to long-term fixed rate debt.

Assuming the forward yield curve stays reasonably consistent with the current projections, our expectation is that our weighted average cost of debt stays consistent around 4% for 2024 and 2025. This is higher than what our cost of funds were in the previous two years. Please review Page 12 in our supplemental financial package for details on our debt management.

Our debt remains well laddered with a small amount of expirations in 2024 and 2025 being paid off at maturity. The two construction loans that we hold had extension options, however, we expect to transition these to unsecured financing using the free capacity on our term loans with a lower cost of debt.

As you can tell, the execution of the balance sheet transformation continues to go well. We have solid leverage metrics competitive with our peers, a low cost of debt, and limited maturities in the next two years. Coupled with our strong liquidity position, we're intentionally structured to achieve our growth strategy, as Shawn mentioned in our guidance slides, ready to support our projected business growth well into the future.

I will now turn the call back to Mr. Haddad for his closing remarks.

Lou Haddad

Thank you, Matt. As we reflect on our performance throughout the fourth quarter and the year, I'm proud of our team's dedication and resilience, which has translated into exceptional results. Best in-market properties in healthy markets give us the ability to continue adding to earnings and dividends, while we wait for the market to recognize superior performance.

I'll now turn it over to the operator for the question-and-answer session.

Operator

(Operator Instructions)

Your first question comes from Rob Stevenson from Janney.

Rob Stevenson

Shawn or Lou, how are you guys thinking about WeWork in terms of near term, longer term? I mean the company's tenuous future at best, keeping them and maybe punting and having to possibly re-tenant this thing two years down the road when it may be a better or worse office leasing environment, versus just ripping the band-aid off and re-tenanting this space now? Is there not -- how are you guys characterizing demand for these assets? And how are you guys thinking about having to answer questions about WeWork for the next few years?

Lou Haddad

Thanks for the question, Rob. As Shawn mentioned on the call earlier, we took the proactive measure of taking them to a cash basis, which reduced our 2023 results by a couple of million dollars, and they'll be going forward on a cash basis in the Durham space. I'll let Shawn comment on what's happening in Durham as well as our confidence in the Atlanta space.

Shawn Tibbetts

Sure. Yes. I think let's break it down by location, and thanks for the question, Rob, and good morning. In Atlanta, we said the risk-adjusted posture should be removal and that's what you saw us do. We think that was the most prudent and conservative approach.

I'll say we have approximately 10 deals, different kind of areas of formation, from LOI to a couple of smaller leases that are close to done. A lot of activity, as I said, in that space. But we couldn't be more excited about that given the 10 prospects that we're trading paper with currently.

That's Atlanta. So, to your point, we feel good about re-leasing that space. Absolutely the right move. Certainly dampened the '23 results and the '24 outlook, but we think that's the right move long term for the company and for the shareholders.

In Durham, the location is healthier. We think that, as I said, we're very close – as a matter of fact, I was on the phone with WeWork yesterday afternoon. We're very close to a deal there that makes sense for us that we believe puts us back kind of to market range.

You may see that deal structurally a little bit different than it looks today. And we think that that is a good bet.

That being said, again, the fundamentals of that particular location are actually much better than Atlanta. So we feel good about it in that -- in those terms.

Lou Haddad

They have some strong tenancy down there, Rob. And our expectation is that that's going to fortify their ability to pay rent there. And if, in fact, they ultimately aren't able to do that, the tenancy basically will speak for itself, and we'll try to quickly convert those into leases for our own -- for our own landlord.

Rob Stevenson

Are they going to keep all of the Durham space under the current negotiations or are they going to get back a little bit?

Lou Haddad

Yes. Ultimately, it's going to shrink, and to be a much more manageable size for us. But our expectation is that we're not going to miss a beat once that happens.

Rob Stevenson

Okay. How should we be thinking about the GC pipeline beyond the current projects? I mean, you guys have talked for a couple of years about the sort of great level of activity, and I think it varies with [time], caution people not to just straight-line this in growth going forward.

But are we really going to see a material slowdown in '25 or thereafter? I mean it seems like there's this much business in a world with little office and modest retail development. Is this the new sort of run rate going forward? Is there anything that you guys see going forward that would really temper things, other than some sort of major economic collapse?

Lou Haddad

Rob, our expectation is that there will be, for us, a slowdown at some point in time. Every year, we say it must -- it's probably going to go back to the center line in the not-too-distant future. And every year it seems to outperform.

That's partially because -- I think that may be unique to us, maybe not completely unique, but unique from the standpoint of being in business for the last 45 years in the markets that continue to experience growth have led to the development of a number of really strong relationships with well-heeled partners that continue to produce. We wouldn't want people to underwrite $13 million worth of construction profit for the next 10 years. But we don't really see a material slowdown anytime soon.

Shawn Tibbetts

Lou, if I can – Rob, just the number, if you think about it this way, to Lou's point, is somewhat enlarged or inflated by the T. Rowe price 50% JV. And so, if you think about it, to Lou's point, on a consistent basis, we net that out, the number drops down a little bit. But we feel good about staying relatively consistent net of that large piece of that level, if you will.

Rob Stevenson

Okay. And are you guys the GC on all five of the mezz apartment projects?

Lou Haddad

Not all of them. No. A couple of them are modular type construction that has a proprietary system, where we won't be performing in the construction.

Rob Stevenson

Okay. And then how should we be thinking about those five projects today? Are you viewing any of these as likely purchases for the REIT? And do you get a prepayment penalty if they refi early? Because it seems like that the completion date for the construction is much closer than the expiration of the debt, and I would assume that they'd want to refi at more modest rates if rates come down than your 13% to 15%.

Lou Haddad

Look, to start with your first question, we'd love to own all of them. It's -- but our eyes are a bit bigger than our stomach. So, the expectation is that, as Shawn mentioned, at least one of these will end up on our balance sheet.

They do carry a minimum interest line so that we have protection against an early refinance. So that's going to be a great avenue for us to continue to add to the portfolio without having the drag of the development process.

Rob Stevenson

Okay. And then speaking of the development process, do you guys anticipate starting any new on-balance sheet developments in '24? At this point?

Lou Haddad

We anticipate starting a redevelopment of the Bed Bath site that we've been talking about for a while. Right now, developments don't pencil -- don't pencil with our cost of capital. That's why we're going to be reliant more on the preferred equity and the mezz platform in order to grow the portfolio.

But right now, construction costs have not come back in line. Interest rates remain elevated. And you don't have a ton of rent growth. Ironically, where we would have the most room is in office space, but obviously, because we're completely full in the locations that we have, and under normal circumstances you'd be launching new office with anchor tenants, obviously, that's not going to be the case right now and as we wait to see how the office market on a macro level shakes out.

Rob Stevenson

Okay. And one last one for me, for Matt. How should we be thinking about the $1.7 million of JV property income drag from Allied Harbor Point this year? Is that going to be significantly larger than that in the first half of the year? And as that comes online, goes to 0 and then closer to positive territory?

Is that ratably throughout most of the year? How should that be – your thinking about timing as it impacts earnings?

Matthew Barnes-Smith

Yes, Rob, all of that negative drag or income depending on what JV you're looking at, whether it's T. Rowe or possibly for the Allied comes in in the last quarter of 2024. So that's a very, very small portion. Obviously, T. Rowe price will occupy and be nearly 100% full for renting there, so we'll get income or our share of the income day 1.

And then obviously, as we go lease up through stabilization on the Allied, there will be a negative drag that is offset.

So as Shawn mentioned in the guidance presentation, we expect that to be positive in that last quarter, to the extent of roughly around $1 million worth of FFO.

Rob Stevenson

Okay. So, all in the fourth quarter, nothing earlier in the year. All right.

Operator

(Operator Instructions)

Your next question comes from Camille Bonnel from BofA.

Andrew Berger

This is Andrew Berger on behalf of Camille Bonnel from Bank of America. Just wanted to touch real quick on guidance. If you could maybe give more color on the part about funding a new real estate project in the second half of 2024. I guess, what are you seeing today in the market? Where would your preference be?

Shawn Tibbetts

Sure. Thank you for the question. So, this – our – let's start with the preference. Our preference would be, as we have been in the multifamily space, in a growth market in the Carolinas or in Georgia. So, we have a couple of prospects, we're in discussions with our partner. And our intent would be to ladder these in.

As you could imagine, one, the oldest deal is closer to rolling off. We expect the sale of that deal, and therefore, a payback of our principal and, obviously, the interest. And our intent would be to redeploy that capital in order to keep consistent fee coming in the door and also keep our program at the size that we've committed to, roughly $80 million outstanding.

So again, probably similar to something you would see on the other five deals. If you could imagine just copying and pasting one as one removes off, we would add another back. So that's our intent. We've seen a lot of high-quality deals out there and a lot of interest in our program given the constraints in the kind of senior markets.

Andrew Berger

Got you. That's very helpful. And then, I guess, turning to the piece on the ATM program. Just wondering, any color there, maybe what we should expect from a timing standpoint, if you're able to talk to that?

Matthew Barnes-Smith

Yes. Andrew, we anticipate as soon as we come out of blackout period here and we filed the 10-K, that we will go into the ATM. Obviously, the equity price is not exactly where we want it to be, so we will be somewhat conservative with that. But in order to grow, we need to add some equity into the model, and we anticipate doing that throughout the whole of this year.

Andrew Berger

Got it. And if I could just squeeze in one more, just turning to the debt side. So, I know you discussed replacing the derivatives as they expire. It looks like there's a pretty big one, I think, $200 million coming out in March. Just wondering, how is the cost of replacing these swaps and caps maybe versus, call it, six months ago or one year ago?

Matthew Barnes-Smith

Yes. So, great question. We have, in fact, replaced all of those derivatives. So, if you look on our debt management, Page 12 of the supplemental, you will see that we are over 100% hedged. So that one in March has already been replaced. We replaced those in October or November of 2023.

What we have done, as I've said, is our weighted average cost of debt across the whole portfolio is now 4%, and we expect that to remain consistent through '24 and '25 when those set derivatives expire in the latter half, last quarter of 2025.

Operator

There are no further questions at this time. You may proceed.

Lou Haddad

Thanks very much. Thanks for all your time and attention this morning. Please stay tuned for further announcements as we backfill that WeWork space, as well as some other leases that are on the horizon. Have a great day.

Operator

Ladies and gentlemen, this concludes your conference call for today. We thank you for participating and ask that you please disconnect your lines. Thank you.