August 3, 2023

Armada Hoffler Properties, Inc. (AHH)

Q2 2023 Earnings Call

Operator

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

(Operator Instructions)

This call is being recorded on Thursday, August 03, 2023. I would now like to turn the conference over to Chelsea Forrest. Please go ahead.

Chelsea Forrest

Good morning. And thank you for joining Armada Hoffler's second quarter 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, COO.

The press release announcing our second quarter earnings along with our supplemental package were distributed this morning. A replay of this call will be available shortly after the conclusion of the call through September 03, 2023. 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, August 03, 2023, 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 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 statements disclosure in our press release that we distributed this morning, and the risk factors disclosed in the 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 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 we reported earnings for the second quarter of $0.32 per share, in line with our expectations and consistent with our full year guidance. As you can see from our press release, the portfolio continues to deliver positive growth in same store sales and releasing spreads, while maintaining company-wide occupancy over 97%.

We continue to prove that best-in-market properties yield impressive results in most any economic climate. Shawn and Matt will give you the details on the quarter, as well as the current state of operations and financial metrics.

I'll give you an overview of our few longer-term initiatives we intend to pursue over the next 18 to 24 months. For years, we have been describing the advantages of our business model, vertical integration of the development process, asset class diversification, mixed use environments, and best-in-class properties are all important factors in our platform as well as our value proposition. This approach to real estate, 44 years in the making, has produced substantial growth over the last 10 years.

Since our IPO in 2013, we have increased our asset base over 5x, expanded our market cap nearly 4x, doubled our earnings per share and perhaps most importantly to investors outperformed the REIT Index on a total shareholder return state over the same period. All this despite the challenges of pandemic and the current disfavor of commercial real estate sector, which has impacted property values, consequently reducing our multiple and undervaluing our equity.

While this may be viewed as respectable performance by many, it's by no means satisfactory to us. Our goal remains to demonstrate the true work of superior assets, both property and human. And returned the equity value to its previous highs and beyond, regardless of the macro environment.

Over the next one to two years, in addition to continuing measurable growth in earnings and dividends, we intend to make strategic moves that should drive significant outperformance over our peers, as well as reinforce the flexibility, resiliency, and foundational strength of our diversified platform. Armada Hoffler has a well-established history of telling the market what we intend to accomplish, executing, and reporting back the positive results.

We expect similar performance going forward. We took an important step in this process last month when our board authorized a limited stock buyback program. This initiative is predominantly meant to give us a head start on retiring our preferred equity shares, which are callable next spring. It is our intent to eventually fully extinguish the entire series.

Around this time next year, we will complete all current construction projects at Harbor Point on the Baltimore Waterfront. T Rowe price will begin their move in process, and the adjacent allied departments will start the lease up phase. Shortly thereafter, we intend to begin marketing some combination of our joint ventures and or selected wholly owned assets within the development. Make no mistake, we believe strongly in the viability and growth prospects for all the uses at Harbor Point. In fact, we intend to continue developing there alongside our longtime partner BD Development Group.

That said, with four premier quality office buildings featuring many Fortune 500 companies on long-term leases and 700 luxury apartments. Selective disposition of some of the trophy assets in the development will significantly reduce our capital allocation, thereby enabling us to expand in higher growth Southeast markets, mitigate concentration risk and further deleverage the balance sheet.

By utilizing all the tools in our toolbox, construction capacity, preferred equity, mezzanine lending, and season development partners, we expect to achieve significant portfolio expansion with minimal strain on the balance sheet, while continuing to release the value created by our development activities. Shawn will update you later in the call on new multi-family opportunities that we are executing.

On a related note, although we don't anticipate exiting any assets at Town Center of Virginia Beach, we have decided against expanding the multifamily counts at the complex at this time. Instead, after we receive the adjacent Bed, Bath and Beyond site back, we will proceed with re-tenanting and expanding the property with new retail tenants.

This decision affords us a much greater return with significantly less capital commitment and further enhances the retail and entertainment options for our patrons. This also allows us to redirect additional funds for multifamily investment in higher growth areas. Shawn will comment on these details as well.

This ability to pivot our emphasis among asset classes and sub-markets is an advantage that has enhanced our profitability for over four decades. With the continued strength of the portfolio, robust fee income, and the lease up of new properties, our expectation is for continued growth in earnings and asset value next year. Additionally, we believe that the strategic moves that I've described today will meaningfully accelerate year over year increases in virtually all our financial results in 2025 and beyond. Now, I'll turn the call over to Shawn.

Shawn Tibbetts

Thank you, Lou. The teams throughout our organization remain highly focused on disciplined execution in all areas of our business. Armada Hoffler's approach to value creation is bolstered by our commitment to company value, which in turn drives our actions and focus on achieving our goals even in this tough economic environment. We are operating efficiently with continued high levels of occupancy, healthy re-leasing spread and a substantial third-party construction backlog.

We believe that best-in-class performance 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. The supplemental package contains a recap of our operating highlights.

I would like to call out a few of the noteworthy metrics that are contributing to our continued growth and sustained high occupancy across the portfolio. 2023 quarter two year-over-year same-store NOI was positive in all segments and was 4.8% on a GAAP basis and 2.9% on a cash basis. Multifamily was 4.3% on a GAAP basis and 3.6% on a cash basis. Office was 1.3% on a GAAP basis and 2.0% on a cash basis. Retail was 7.5% on a GAAP basis and 3.1% on a cash basis.

2023, quarter two, year-over-year re-leasing spreads on the commercial portfolio were positive 8.9% on a GAAP basis and 7.3% on a cash basis. Our multifamily sector is growing consistently at mid-single digits on par with our forecast for 2023.

We are focused on optimizing both revenue and expense management as we look to grow residential portfolio within our geographic footprint over time.

The Retail segment is also experiencing sustained elevated levels of lease up, at 98.2% across our nearly four million square feet. In terms of office performance, we remain well leased at 96.2% inclusive of the Interlock acquisition, which contained a small amount of vacancy.

On that note, a portion of our team has been relocated within near Armada Hoffler tower near Town Center and KPMG has subsequently taken possession of their new space and we expect them to be in by the end of the year. This flight to quality has again increased the percentage of office space leased at Town Center, which currently sits at 99.4% of the nearly 800,000 square feet.

As a result of the high occupancy and continued demand, we are discussing future office needs with our tenants. These ongoing discussions create alignment and also provide insight into opportunities that may exist to accommodate additional tenants looking to relocate into Town Center.

Retail performance remains strong and we are capitalizing on the momentum. We have recently signed a long-term lease with LEGO for prime retail space at our Town Center of Virginia Beach. This is yet another example of a high credit tenant seeking out space in our flagship development.

We are excited about this new-to-market retailer and the positive effect the Lego following will have on traffic within our ecosystem. The tenants on our watch list remain materially similar to last quarter. Our focus has been on the opportunistic next steps for our two Bed Bath & Beyond store locations. Conversations with new tenants are continuing for the Durham, North Carolina space. We expect a positive outcome, and we will update you as soon as possible.

In Virginia Beach, the decision is based on an opportunity cost equation, with an emphasis on the best long-term value creation for the six acres. Ultimately, the outcome of our due diligence exercises points to a high-end, high-quality retail-focused redevelopment site.

We have narrowed the list of potential tenants to a preferred short list of suitors. The program will likely involve modifications to include one or two major high credit retailers with a very limited amount of high-end small shops supplemented by a strategic out parcel user. We intend to continue our relationship with Regal.

However, should the opportunity arise, we would look to redevelop Phase 2 as a supplement to the Bed, Bath and Beyond site that provides for a natural flow of town center expansion to the East.

As you may recall, our initial redevelopment plans included the potential for inclusion of multifamily units. We have determined that the capital earmarked for multi-family will be best invested outside of town center, given that we already own the trophy assets in the submarket and the retail opportunity set being negotiated will provide better returns.

Our analysis is that multifamily investment outside of Town Center combined with the focus on a retail driven program at the Bed, Bath and Beyond site ultimately results in yielding the highest overall return on shareholder equity, the best use of the property, a more diverse geographic footprint in the southeast, and a greater contribution to NAV.

As you can see our portfolio, comprised of state-of-the-art properties and superior locations continues to operate consistently well throughout economic cycles, the complimentary property types and trophy assets in superior locations combined to outperform the competitive set. The T Row Price Global headquarters project at Harbor Point is continuing to take shape and is on track for turnover in the summer of 2024. The adjacent 312-unit Allied Apartment Tower is also on plan for delivery in the third quarter of 2024.

At Southern Post in Roswell, Georgia. We are making significant progress toward the initial delivery early next year. Since our last earnings update, the retail space has moved to 86% leased or under LOI. As we noted last quarter, we are working through lease arrangements with a high credit tenant who is targeting approximately 40,000 feet of office, equating to 40% of the office space.

Chandler Residences, the recently named multi-family component at Southern Post is a high-quality offering in a market with a limited supply of leasable residential units. Programming and marketing efforts for the project have been very well received and we expect considerable success and speed in the lease up.

Additionally, I would like to elaborate on a few noteworthy strategic topics, some previously mentioned by Lu. Last quarter, we discussed strategic growth initiatives underpinned by both acquisition and development of high-quality well-located trophy real estate.

As you know, we at Armada Hoffler create value for shareholders through leveraging both our construction and development expertise as well as our extensive partnership network to manufacture and acquire well located trophy assets. Additionally, we are fortunate to be able to leverage those partnerships created along the way that provide access to high quality assets on an off-market basis.

Last quarter, we focused on the acquisition approach, while transacting on the interlock, demonstrating that our strategy continues to produce results. We are settling into the management of this trophy asset while studying opportunities to create upside beyond the NOI acquired in the transaction. We look forward to updating you on our initiatives as they come to fruition.

To continue the theme of sourcing high quality real estate via existing relationships, one of our largest unit holders. Affiliates of Venture Realty Group presented us with a unique opportunity to invest in the development of a new 280-unit Class A multifamily apartment community – The Allure at Edinburgh.

The transaction requires minimum upfront capital and provides us both a preferred return on our investment and the ability to acquire the asset upon completion and stabilization, and a future OP unit transaction. Both the average and median household incomes in the zip code within Chesapeake, Virginia are the highest among all the markets in which we invest, including Atlanta and Charlotte.

Consistent with our overall investment thesis, we are excited about the potential to own what will be the best asset in a growing secondary market with strong fundamentals at an attractive going in basis and yield.

We have sourced two additional high-quality multifamily projects that will fill our preferred equity and mezzanine platform allocation. Solis Kennesaw and Soles Peachtree Covers are both located in a submarket outside of Atlanta. These developments will be executed by our trusted partners at Terwilliger Pappas.

Together, these opportunities allow us to continue increasing exposure to the Greater Atlanta markets and may ultimately yield the opportunity to own either of the assets, thereby creating additional concentration in these high growth markets. Finally, thank you to the talented colleagues at Armada Hoffler, who manufacture and managing high quality assets within our portfolio.

We are performing well. However, as Lou previously stated, we are not satisfied with our equity value and as a result, we will remain laser-focused on our mission of leading in the REIT space by consistently creating long-term value for our shareholders. I will now turn the call over to Matt.

Matthew Barnes-Smith

Good morning and thank you Sean. Another compelling performance by our team continuing to deliver consistently strong results across all operating metrics. We have reported FFO of $0.35 per diluted share and normalized FFO of $0.32 per diluted share, in line with guidance and slightly above analyst consensus.

We maintained our guidance range accordingly and normalized FFO of $1.23 to $1.27 per diluted share. Our stabilized leverage metric remains in our target range at 5.5x. When our ancillary debt is included, leverage has risen to 7.1x, slightly elevated from last quarter. This metric will temporarily increase over the next few periods, until the assets in our development pipeline start producing cash flow.

Leverages anticipated to decrease back into our target range as EBITDA continues to grow. Our debt service coverage ratio and fixed charge coverage ratio was 2.7x and 2.3x, respectively, demonstrating our team's ability to manage and execute our balance sheet strategy in the adverse market conditions we are experiencing.

Our liquidity position continues to be strong at roughly $130 million more than ample to cover the 2023 cash requirements for our remaining development pipeline and the preferred equity investments that Sean mentioned earlier. This combined with our well-structured debt maturity ladder means that we can continue to grow earnings while supporting the team and achieving our growth objectives.

For reference, as stated last quarter, we have no debt maturities in 2023, and we expect small amount of debt maturities in 2024 and 2025 to be paid off at maturity, adding these previously secured assets to our unencumbered borrowing base. As interest rates continue to fluctuate, we will monitor the environment to ensure we either convert the variable rate debt to long-term fixed rate debt in the private placement markets, or layer in new hedge positions when our current set of positions mature.

Lou discussed our growth strategy earlier on the call and we continue to strengthen our balance sheet to support these efforts. In June, we started the process of increasing the capacity of our revolving credit facility, looking to add $100 million through the accordion feature. We're excited to report that we have had over 75% of the funds committed to date. In addition to our established lending group, we are adding Barclays Bank as a new lending relationship.

Attracting top talent, whether that be internal colleagues on the team or external support from our partners is key to driving success. Adding this full-service financial institution clearly demonstrates our capacity to grow and execute the strategy Lou described. As we look ahead over the next 18 months, the funds from plan disposition coupled with our expected capital market activities are anticipated to be split between growth in the southeast and de-leveraging our balance sheets.

Another item of note this quarter was attracting an additional partner to our unsecured term loan used to fund the interlock acquisition. This additional $20 million allows us to pay down the capital that we use from our line of credit at closing. As you will recall, we swapped the whole $100 million at an all-in fixed rate of 4.7%, which is very competitive in today's environment.

Continuing the theme of our derivative program in early July, we made two transactions that limited the exposure of interest rates to remain higher for a longer period than was initially anticipated. Both transactions involved selling our corridor positions and using the proceeds to buy down the rate on the swaps to 3.4%. The combined notional $250 million is the same notional amount as the initial corridors and will have the same maturity schedule.

Whilst these derivative transactions do not have a material effect in 2023, we anticipate a lower cost of debt for 2024 as a result of these transactions. Some of our derivatives mature in early 2024, and we will either convert the variable rate debt to long-term fixed rate debt in the private placement markets or layer in new hedged positions. I'll now pass the call back over to the operator for the questions and answers session.

Q&A Session

Operator

(Operator Instructions)

Your first question comes from the line of Rob Stevenson from Janney.

Rob Stevenson

Lou, I know you said you aren't going to be moving forward with another apartment development at Town Center right now, but you have call it rough numbers, 800,000 square feet of office at Town Center that's basically fully occupied. Is there incremental demand there for another tower there? And how are you thinking about office at town center today?

Lou Haddad

Yes, there continues to be strong desire for more office space here at Town Center. We are actually looking to shoehorn in a couple more tenants in the remaining space. Hopefully we can get some space back, from a couple of folks that might be downsizing. At this point in time, we are not inclined to launch a new tower that would take a significant anchor, at a much higher rent then, I think, the market's willing to bear, at this point. So we are going to continue to sit here within and raise rents at sustained level, with full building.

Rob Stevenson

Okay. That's helpful. And then, Sean, any known moveouts in the office or retail portfolio of consequence at this point that's popped up?

Shawn Tibbetts

There's very little to speak of. I was actually looking at this yesterday, Rob, that we have got a couple of folks were negotiating on a renewal basis. But no, we don't expect any, of consequence to move out.

Rob Stevenson

All right. And then last one for me. Lou, you talked on the prepared comments about taking out the 6.75 preferred. I understand doing that when debt was, call it, four something percent, but in the current environment and given that it never has to be repaid and is it treated as at least quasi equity? What's the thought process here, especially with these interest rate caps burning off next year in the current interest rate environment?

Lou Haddad

Well, again, Rob, we'll have to look to see what next spring brings in terms of rates, and whether that still may sense. Currently, with the preferred trading at a discount, we'd actually be purchasing back at basically an 8% rate. So that was the reason for the authorization of the buyback. Whatever we can get at a discount, we are going to take And then we will see what -- we'll see if the market gives us, next May when we could get some more.

Operator

Your next question comes from the line of Wes Golladay from Baird.

Wes Golladay

Good morning, everyone. I want to go back to the Virginia Beach Bed, Bath application. I think you mentioned you might do some high-end retail. Just wondering what kind of halo effect, you may get. Are you looking at bringing in maybe a Tesla, an Apple, and just kind of build up the whole area?

Lou Haddad

There are some very prominent tenants that are eyeing that site. It remains to be seen, what we will actually transact on. Remember, we have got an entire ecosystem here with, Wes. And what we are looking for is things that will add to the mix as opposed to more of the same. And so there is a couple of unique tenants that may be better fits. But, hopefully, by the end of the year, we will be able to make an announcement or two on what's coming. But it's very exciting, here for Town Center.

Wes Golladay

Okay. And then, the multifamily starts at the end at the nation. I've been somewhat resilient and just kind of curious what you are seeing on the grounding. You talked about a lot of the developers. You provide a lot of financing. Do you get the sense that those are going to start to fall off pretty dramatically?

Lou Haddad

Again, from a macro level, perhaps from a market-by-market level, we are in the highest growth market that, people continue to migrate to. And so the developers we are dealing with predominantly in Charlotte, Raleigh, Atlanta, Charleston are still seeing unprecedented growth.

At some point, you would imagine that, that would change. But we continue to read the headlines about being five million housing units short, and particular in the markets that I was talking about. So, for now, it appears to still be office. And as you know, cap rates widened a bit on multifamily but not so much to dissuade people from executing on top quality sites.

Wes Golladay

And then maybe just one more big picture question for the portfolio. You're going to, you kind of mentioned moving more to the southeast is maybe taking down leverage a little bit. How does this look maybe three years from now? Is it going to be a dramatic shift or is it just going to be at the margin 5% or 10% geographic allocation change and then leverage maybe down a half a turn or a turn? And how should we think over a multi-year view?

Lou Haddad

I'll take the last part of that first, but I'd look for leverage to go down a between a half and a full turn. Basically, what we want to do is move the portfolio further south on an incremental basis. We love the properties that we own in Baltimore but we want to redeploy some of that capital down south. And so yes, you're probably looking at a 10% move maybe as much as 20%.

Operator

Your next question comes from the line of Peter Abramowitz from Jefferies.

Peter Abramowitz

You mentioned a tenant that is interested in about 40% of the office space at Southern Post. Just wanted to ask about overall demand for the rest of that space potentially kind of what you're seeing on the ground there. How many prospects you have on, on sort of the overall office component there?

Lou Haddad

Yes, it's a pretty healthy prospect list. And now that the buildings are at a point where they can start to be toured, we're seeing a lot of activity. We've got another lease for about 7,000 square feet. So, and then, as you know, the office -- I'm sorry, the retail is almost completely spoken for at this point. We're seeing good activity, Peter. It's a small amount of office and a very hot sub-market with limited opportunities for any kind of space. So, we're very excited about what Southern Post is going to do in terms of earnings in 2024.

Peter Abramowitz

And then more question on kind of the macro here. I guess since your last call, the possibility of kind of a soft landing and a quicker recovery has become the prevailing narrative. Any sense of, of how tenants are thinking in terms of their behavior on the office or retail side? Are you noticing any changes and them feeling more optimistic and more willing to take on more space? I guess, any impact you're seeing? In terms of their decision making?

Lou Haddad

I haven't seen a whole lot of difference. In terms of retail, that the sales have been off the charts. I don't want to generalize too much, but I'd say the predominant amount of tenants in our facilities have well surpassed 2019 levels in terms of sales. And I think, the largest issue that that is facing them is staff. Everybody's still hunting for staff.

On the office side, as you might expect, a lot depends on what business you're in. We're heavily weighted to architecture and engineering as well as financial services. And those folks all seem to be pretty bullish. You remember earlier this year, we re-upped 250,000 square feet with Morgan Stanley on it for 12 more years at Baltimore.

We continue to see T. Rowe Price, expanding into all of the space that they thought would be for additional growth, with their new layouts. So it seems folks are pretty optimistic. And we are right with them. It's interesting in our prior lives, as private real estate developers, we love this kind of environment, with unemployment at all-time low.

Since we became a REIT, it appears that, you are supposed to pray for a recession, so that rates will go down. Unfortunately, we are not getting that message, or I guess I should say fortunately. We are in full growth mode, interest rates in our minds are normalized now to where they have been historically through most of our career. And we want the economy to keep chugging along and we are going to keep expanding.

Peter Abramowitz

Sure. And then one last one for me, kind of big picture here. So obviously, you have had a lot of success at Town Center and your kind of close to reaching critical mass at Harbor Point. As you think about the future, do you see opportunities to do sort of development on that scale? Maybe not at the Town Center scale, but Harbor Point where you are kind of creating overhauling an entire submarket.

Do you see the opportunity to do that in other places? And is that something you want to do, or is it kind of more, a case of blocking and tackling on just the one-off things you see in the portfolio in your markets as you are doing with the opportunities right now?

Lou Haddad

Well, it's an interesting question. Obviously we would love to do more mega development in a growing submarket, and in a location. Those opportunities are few and far between. We will always have our eyes out for them.

I think more naturally, what you are going to see is, the kind of thing that we are doing in Southern Post. In these satellite cities around the major metropolitan is, again, the Charlotte, Raleigh, Atlanta satellite cities are presenting a lot of opportunities for mixed use developments in revitalizing, older downtowns, where people are, where the population is growing pretty significantly. So I think you will see more Town Center-ish type development, but it's going to be on a smaller basis in selected cities.

Operator

Your next question comes from the line of Chris Sakai from Singular Research.

Chris Sakai

Hi. Good morning. I had a question on office occupancy. It looks like, it ticked down a percent this quarter. I wanted to get your idea of what were the drivers there and how do you guys see, occupancy rates in your guidance for 2023?

Lou Haddad

Sure. I'm going to let Sean answer that specifically. But I think there is only one factor that's contributed there.

Shawn Tibbetts

We feel good about the offense occupancy. Actually, we feel great about it. As I mentioned in the comments, when we acquired the Interlock last quarter, there was some vacancy, some upside vacancy that came along with it, which obviously added to the denominator on our total square footage.

So we have been rather consistent. And if you look at the renewals, and the releasing, we have done well. There just hasn't been much activity because there hasn't been much change. So for us, we feel good about that. And again, we have got upside to lease up between 27,000 and 30,000 feet down in Atlanta. And we're active in that space. So again, that'll just add to the overall income.

Lou Haddad

Chris, I think, if you took interlock out of the equation, you'd be right back to that 98% on the office. So, again, that was pretty much the entirety of the change.

Chris Sakai

And then it looks like interest income in your guidance has picked up about 2 million or so from last quarter. What's driving that increase?

Matthew Barnes-Smith

This is Matt. The increase of that is the three preferred equity deals that Shawn mentioned in his remarks that we close one of them in quarter and then the other two subsequent to two quarter ends in early July.

Operator

There are no further questions at this time. Please continue.

Lou Haddad

Thanks very much. I appreciate your attention this morning. And stay tuned for more announcements and now to discuss in future. Thanks very much. Take care.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for your participation. You may now disconnect.