August 4, 2022

Armada Hoffler Properties, Inc. (AHH)

Q2 2022 Earnings Call

Operator

Welcome to Armada Hoffler's second quarter 2022 earnings conference call. At this time, all participants are in a listen-only mode. After management's prepared remarks, you'll be invited to participate in a question-and-answer session. At that time if you have a question, please press "star 1" on your telephone.

As a reminder, this conference call is being recorded today, Thursday, August 4th, 2022.

I will now turn the conference call over to Chelsea Forrest, Director of Corporate Communications and Investor Relations at Armada Hoffler. Please go ahead.

Chelsea Forrest

Good morning and thank you for joining Armada Hoffler's second quarter 2022 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 quarterly supplemental package were distributed this morning. A replay of this call will be available shortly after the conclusion of the call through September 4th, 2022. 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 4th, 2022 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, 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 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 that we distributed 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 armadahoffler.com.

I'll now turn the call over to Lou.

Lou Haddad

Thanks Chelsea, good morning. As you have probably already seen from our earnings release this morning, the second quarter reflected another strong performance from the company. Results were above our expectations for the 3rd consecutive quarter, and we have once again raised our full year guidance. Our mid-point of $1.18 is 10% above last years' results. These increases are primarily due to the sustained upward trend in virtually every leasing metric across our diversified portfolio over already robust levels. Whether it's high single digit increases in same store NOI, commercial releasing spreads, and apartment trade outs, or portfolio-wide occupancy setting another record of 97.3%, the pace of organic NOI growth from our properties continues to accelerate. We believe that this is a result of our continued emphasis on A+ properties in each of our asset classes. When you have premium properties amongst limited peer competition, you have the ability to sustain premium rents through virtually any macro-economic backdrop. Taking advantage of a flight to quality has always been central to our strategy.

We believe the types of assets we own, be they office, retail or multifamily, will outperform the competitive set through most any business cycle. What we've seen over the last four decades remains true today: high-quality facilities in mixed-use environments, located in desirable sub-markets, stand the test of time. This is why the Virginia Beach Town Center has had very little vacancy across all asset types for over 20 years and why Global companies continue to flock to Harbor Point in Baltimore. Real Estate has always been a show-me business, where the results should speak for themselves. We're very comfortable with that premise. Put another way, we expect our buildings to maintain the highest rate and occupancy in every one of our core markets, regardless of the asset type.

Later in the call, Matt will give you some highlights of the quarter, details of our updated guidance, and the new developments in our finance strategy. I'll use my time to recount the major events of the last few months as well as our expectations going forward.

Let's review some of the statements we issued in our last earnings call. We told you that in light of the continued undervaluation in our share price, we had decided to sell a few non-core assets to fund the remaining equity required for our active development pipeline. We relayed our expectation that those properties would yield a 4.5% cap rate on sale. The transactions are now complete, with gross proceeds of $177 million, the majority of which was from the sale of the Residences at Annapolis Junction at a 4.15% cash cap rate based on trailing-12-month NOI, resulting in a total blended 4.1% cap rate. The execution of these dispositions, in the midst of a very unsettled market, indicates the sort of value contained in our portfolio. While not surprising, needless to say, we are very pleased with these results.

As previously stated, we have no further need for capital through the end of the year and beyond. These low-cost funds will largely satisfy the remaining equity needs for our developments. Collectively, the projected return on cost of the new assets under construction is substantially higher than the cost of those funds. As a result, much of the anticipated income from our development pipeline is expected to translate into future FFO. For future needs, if the equity market for REITS remains unsettled, we will continue to fund our growth through similar high-value, non-core asset sales.

Last quarter we told you to anticipate another high-credit, global company taking space in Wills Wharf at Harbor Point, bringing the property to stabilization. In June, we announced that Franklin Templeton has leased 60,000 square feet in the building, which will bring occupancy to 91%. As we have said on multiple occasions, the competition for space in our trophy office properties is very robust. We realize that the demand we are experiencing in our office portfolio is counter to the narrative surrounding major markets where high-value tenants have multiple options for class A space, but the simple fact is that trophy buildings in our target markets face limited competition for top tier tenants intent on using the workplace as a showcase for attracting and retaining talent. Consequently, the most pressing issue facing us in the office portion of our portfolio for the foreseeable future is accommodating our existing tenants with expansion plans.

Our asset management team is now fully engaged in releasing the few anticipated 2023 and 2024 vacancies. We expect to have further news on those efforts by our next call.

Next up, we previously reported that our apartment project in Gainesville, Georgia was leasing up much faster than anticipated and that we expected it to hit stabilization by summer's end. This satellite city in the greater Atlanta region has seen tremendous growth over the last decade. Our project is located in the heart of a thriving downtown. Today, we're pleased to report that the project is 98% leased. With a timeframe of six months from start to finish, this may have been the fastest multi-family lease-up in our history.

Accordingly, this asset, along with the Wills Wharf office building, has been moved off of the active development page of our supplemental information package. Please note that the remaining active projects in development are predominantly comprised of multi-family properties or office space committed to credit tenants on long-term leases.

In addition, we are evaluating a number of other development opportunities, the majority of which are in the multifamily sector. Some on acreage we already own, some brought to us by development partners. Only those projects that meet our criteria for long-term growth and profitability will make it through our underwriting and onto the active development list. Our COO, Shawn Tibbetts is here to answer any questions you may have on our development activities and what we are seeing in the marketplace.

Combine all of the factors I just mentioned with retail NOI and multifamily rental rates at all-time highs; you come to understand the continued rise in our top-line numbers. Of course, in order to see those funds filter through to FFO, control of expenses and debt service must remain a priority.

As those who have followed the Company closely know, our strategy of keeping our debt virtually 100% fixed or hedged has been a trademark of Armada Hoffler for many years. Last quarter we told you that we expected our net interest expense would be largely unaffected by rising rates for the remainder of the year due to the fixed-rate, long-term debt on many properties, as well as the protection afforded by our hedging instruments which effectively cap the expense on our floating rate loans into early 2023. As Matt will detail later in the call, by employing a blend and extend strategy with our existing derivatives, we have now capped our exposure to interest rate volatility into 2024. This action, along with strong top-line growth and strategic debt paydowns, will go a long way to assuring the upward trajectory of our earnings continues.

Today's report marks an important milestone in the evolution of our company. With the upward revision in our guidance, we now anticipate that 2022 earnings per share will eclipse 2019 levels. Perhaps as important, this represents a double digit increase over 2021 levels. Long-time investors may recall that at the outset of 2020, we unveiled an ambitious plan to better position the company for long-term growth. After significantly outperforming the REIT index for five years and with the share price at all-time highs, nearly reaching $20, we decided to take several incremental steps to further strengthen the company for the new decade. Reducing the percentage of NOI derived from older retail centers, reducing the contribution from mezzanine interest income, increasing multi-family sector revenue, increasing the percentage of rent derived from high-credit office tenants, and ultimately adding liquidity to the balance sheet; these were the major objectives detailed in the plan.

At that time, we thought that these actions could lead to a year or two of fairly flat earnings and a somewhat stagnant share price in the high teens. We obviously did not factor in a two-year, world-wide pandemic. After taking the necessary measures to successfully steer the Company through an unprecedented period of disruption and uncertainty, we were determined to see the initiatives through, despite the upheaval. Having navigated through several previous major downturns over the course of 40 years, we believed that staying the course with our strategy was the best way to position the Company for the next cycle and beyond. With management being the largest active equity holder of the Company, long-term perspectives are always the norm for our group.

With a close reading of the detail offered in our supplemental package, investors can readily discern that at this point, we have essentially achieved all of those goals we set out to accomplish. More importantly, the Company is well-positioned to selectively pursue new investment opportunities and continue to thrive even in the face of another economic correction. Along with record earnings, credit quality and liquidity are higher than at any time in our history. Although we will continue to refine our model as circumstances dictate, we feel confident about our growth trajectory for the foreseeable future.

Earlier in the year we told you that we would continue to responsibly ramp our quarterly dividend back toward pre-pandemic levels. Last week, the Board of Directors voted to increase the dividend payout by 12%, now standing at $0.19 per quarter. We appreciate the Board's steadfast support of the Company and their endorsement of the strategies that have brought us to this point.

And speaking of our Board, you've probably seen that we've added Dennis Gartman, long-time publisher of the Gartman Letter, as another prominent independent director. Dennis' capital markets expertise and financial acumen will be of great benefit to the Company in the years to come.

To sum it up, good companies survive downturns, great companies use downturns to make the adjustments necessary to excel in the subsequent cycle. Alongside our Chairman and Founder, Dan Hoffler, I have had the privilege to lead this great Company for many years. Often overlooked amongst all of the performance metrics of the Company is the strength of our management team. While it's great to have sought-after properties in great markets, outperformance only happens when you have a top-flight asset management team that are passionate about their work. State-of-the-art buildings that are a source of pride for the communities and tenants we serve only happen with a seasoned construction group that prioritize quality in everything they do. We understand that this is a skillset uniquely ours across the REIT universe. Combine those attributes with a nimble, solution-oriented finance team and high-character professionals in virtually every other aspect of our business, and you have the key to our 40-plus years of success.

Since coming public nine years ago, we've been extolling the virtues of mixed-use assets, a diversified portfolio, the advantages of self-performing development and construction, and a strong emphasis on company culture. The benefit of these attributes become even more apparent in unsettled times. We look forward to continuing to demonstrate outperformance in all aspects of our business model.

Now I'll turn the call over to Matt for some additional detail on the quarter.

Matthew Barnes-Smith

Good morning and thank you Lou. It is a pleasure to be here this morning and afforded the opportunity to report on another productive quarter.

For the second quarter of 2022, we reported FFO of $0.31 per diluted share and Normalized FFO of $0.30 per diluted share, another quarter above our expectations. As Lou touched on, our outperformance in Normalized FFO is due to virtually every core real estate metric across the portfolio continuing to trend positively. Correspondingly, for the second successive quarter we have increased our guidance range, with Normalized FFO now at $1.16 to $1.20 per diluted share, which represents a 10% increase over 2021 results. If achieved, 2022 will be the best earnings year in Armada Hoffler's history, outperforming our 2019 earnings high with materially less reliance on fee income. Our blend and extend debt strategy that Lou mentioned resulted in sacrificing a penny of earnings this year in exchange for extended rate protection into 2024. Later on the call I will discuss our debt management efforts in a little bit more detail.

Speaking to our robust operational metrics, I am pleased to report that stabilized operating property occupancy increased by 20 basis points to 97.3% this quarter. The combination of our strong Asset Management teams lease-up efforts, coupled with the high-quality trophy assets located in strategically selected submarkets continue to produce winning results. Although all sectors increased, the standout segment this quarter is our Office portfolio at 97.9% occupied. Portfolio wide same store NOI was up 6% for the quarter on a GAAP basis and 7.4% on a cash basis with our multifamily segment posting 12.5% growth in both GAAP and cash same store NOI.

Our commercial releasing spreads continue to remain strong with the office segment at 13.1% and the retail segment at 9.9% on a GAAP basis, and both are positive on a cash basis. Similarly in the multifamily segment we are seeing unit trade out metrics at 8.1%. High releasing spreads coupled with our operational focus has enabled the team to drive efficiencies and reduce expenses on a per unit basis across the multifamily segment resulting in our high NOI growth statistics.

Leasing activity continues to outperform expectations across all our property types. Along with 450,000 square feet of renewals, we have leased over 150,000 square feet since the beginning of the year, an impressive feat against already historically high occupancy levels.

As you are all aware, above expectation operational performance needs to be supported with sound fiscal management. For the second quarter of 2022 our stabilized portfolio debt to stabilized portfolio adjusted EBITDA leverage reduced to 5.5x. This reduction is a result of the continued implementation of our overarching financing plan that deploys capital in the most optimized way, giving us the ability to self-fund our exciting development pipeline. As stated last quarter, we aim to keep our stabilized portfolio leverage in the 5.5x range.

Continuing the topic of our balance sheet, in early July we implemented a blend and extend hedging strategy with $285 million of 50 basis point strike rate caps that were maturing at the beginning of 2023. Using the potential future upside of these caps we were able to place a hedging corridor on the same notional amount, effectivity capping the $285 million at 100 basis points and extending the terms to mature throughout the first half of 2024. With the anticipated renewal of our swap contracts on the term loan portion of our credit facility we are now confident that our debt will be 100% fixed or hedged well into 2024, reducing the risk of uncertainty in this rising interest rate economic cycle. As we continue to unencumber assets, such as our Whole Foods center in Delray Beach Florida, our Red Mill Shopping Center and Hilltop Marketplace here in Virginia Beach, and place specific hedges on our new floating rate construction loans, we are able to allow our $100 million cap that matures in February 2023 to expire without renewal, and still maintain our 100% fixed or hedged strategy.

The final piece of our long-range financing strategy is to, surgically over time, move to a more unsecured balance sheet. The first step in this process is to recast our credit facility that we started at the end of this last quarter. Working with our diverse lender base we are looking to increase both our term loan and revolving credit facility by $100 million each, giving the company the additional flexibility and liquidity in our capital stacks. This represents an initial step to reduce the secured segment of the balance sheet from roughly 75% to 50%. We aim to close the credit facility recast by mid to late August.

The last part of the balance sheet I will touch on are the remaining note maturities in 2022 and 2023. As previously indicated, the final 2022 note maturity on Hilltop marketplace will be paid off next month. Looking forward to our 2023 expirations, Nexton Square was refinanced this quarter, the three Town Center Loans will be repaid at maturity, and 1405 Point will move to unsecured debt under our credit facility recast. This takes care of all of our expirations through the end of 2023.

As Lou stated earlier, to ensure that our fantastic top line numbers translate through to earnings, we need to control and de-risk our debt service expense. The plan outlined above will continue to ensure that we are largely unaffected by the interest rate volatility that the economy is currently experiencing. We believe our robust financing strategy will guide the organization through the next 24 months of market uncertainty setting us up with a prime platform for superior future earnings growth.

Lou detailed in his remarks the sales of our non-core assets for gross proceeds of $177 million at a blended cap rate of 4.1%. This only further strengthens our liquidity position which stood at over $140 million before the Annapolis Junction transaction. As stated last quarter, any excess funds over that of the equity requirements in our development pipeline will be deployed surgically in the highest and most advantageous places. Adding high quality tenants in prime locations through opportunistic acquisitions will supplement our portfolio and steadily add NOI to the earnings base, whilst we work through our development pipeline.

As you all heard, operational excellence continues to be the key theme in Lou's remarks and better than expected performance is anticipated throughout the remainder of the fiscal year, which is reflected by the increase in our guidance range. The strength and speed of lease up in our Gainesville multifamily asset, coupled with our high occupancy and strong releasing spreads, are the main drivers of this projected increase. For specific assumptions affecting our guidance range, please turn to page five of our supplemental package, which is available on our website.

Our results speak for themselves. We believe it is only a matter of time before the market fully appreciates not only the significant value that this management team has already delivered this year, but also the significant future value creation in store in the years to come.

I will now pass it back over to Lou for his closing comments before the question and answer session.

Lou Haddad

Thanks Matt.

One more note before Q&A. Although office is less than one-third of our portfolio, we've gotten a lot of questions regarding office usage of late. There is a statistic out there that is developed from key fob swipes. Nationally, this activity is down as much as 70% as compared to pre-pandemic levels. As most of you know, on its own, this is a fairly meaningless statistic as it gives little insight into how companies are thinking about their current and future needs. We take a hands-on approach; we stay in regular contact with our tenants.

Our two-million square foot office portfolio is concentrated in two areas: Harbor Point in Baltimore and Town Center in Virginia Beach, both of which are the top addresses in their respective regions with an abundance of walkable amenities on site.

At Harbor Point, our largest tenant, Constellation is a Fortune 500 clean energy company occupying over 440,000 square feet in the Exelon Building. This showcase asset, one of the largest LEED platinum facilities in the country, is Constellation's National headquarters and is indicative of their long-term commitment to the city of Baltimore. Elsewhere at Harbor Point, RBC just expanded, Morgan Stanley just expanded, T. Rowe Price just expanded their size commitment, and another group is poised to expand into the soon to be vacated Johns Hopkins space. This is what's happening at trophy locations in our core submarkets.

In Virginia Beach, our asset management team recently met with over 35 of our largest Town Center office tenants representing nearly 600,000 square feet, hoping to find someone willing to relinquish some space to accommodate other tenant's expansion plans. We found two companies who may be willing to shrink their footprint in 2023. The vast majority are standing pat and cited the mixed-use environment as key to their recruiting and retention efforts. We also found seven more tenants who are hoping we can accommodate future expansion plans.

Facts are facts, and the fact is the flight to quality thesis continues to be proven by the outperformance of our office assets in Baltimore's Harbor Point and Virginia Beach's Town Center. Not surprisingly the retail and multifamily assets in these locations are performing similarly. The synergistic aspects of our mixed-use environments create a whole that is greater than the sum of their parts.

Operator, we would now like to begin the question-and-answer session.

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 "#". If you're using a speakerphone today, please pick up your handset before entering your request.

Q&A Session

Operator

[Operator Instructions]

The first question we have is from Dave Rogers from Baird.

Dave Rogers

Maybe first question for Shawn. I heard in Lou's comments that you are still working on a development pipeline on owned land, mostly multifamily with some partners as well. I'm curious, I think you took out maybe the extra page in the supplement that kind of detailed that future development pipeline and some of the additional projects you might be pursuing. So Shawn, maybe we could get an update on kind of where you are pursuing, what that pipeline looks like and development starts here maybe over the next 6 to 12 months.

Shawn Tibbetts

Sure, Dave. We appreciate that. I think what you're seeing there is on Page 17 of the supplemental. The active development projects are just that active. And we wanted to reflect our kind of conservative posture here and being judicious with the capital that we have. Frankly, the number of opportunities, if you will, and what you're referring to that page or that piece of the page that was removed. We kind of pulled that back because there are so many of them under review and so many opportunities -- as we sit here and look at these, and we want to make sure that we deploy this capital in the most opportunistic and the most -- the way that creates the most value creation.

We did not want to list tens and tens of projects out there because, frankly, we're under review, taking a look at these things and there are tons of deals out there. So we felt it was best to represent what's in motion currently. And as we come closer to deciding on the next move, we'll convey that to the market.

Dave Rogers

That's helpful. Is there anything in the near term that would restrict you from moving forward with those projects, either anything you're seeing economically, construction loan financing? Just trying to get a sense for how near term that next level pipeline might be for you?

Shawn Tibbetts

I think it's going to be deal dependent, right? And as Lou mentioned in his comments and Matt as well, we have capital available. Financing is not an issue as we sit today. The question becomes what fits within our strategic kind of core crosshairs, number one. And number two, what's the yield look like. As you're well aware, this kind of inflationary background also is affecting construction, but we feel we're best situated to handle that. When we bake all those things together, we kind of want to watch and see and take a very -- again, disciplined approach to underwriting these and trying to understand what this next couple of months looks like in terms of volatility. I think all that said, we're in a good position. We just want to make sure that we dot every I and cross every T.

Dave Rogers

Great, Shawn. Thanks. I appreciate that. And then, Lou, maybe turning to the mezzanine portfolio. I think you're down to 3 major loans in there. Interlock being the largest, and that's in the guidance to be kind of paid off later this year. Can you give us an update on Interlock one? And kind of do you get paid off, what's that process look like? What are the other possible outcomes? And then the second part of that would be anticipated having some outstanding on the mezz program going forward. Is that still the case? Do you expect it to be smaller or larger than where you were previously?

Lou Haddad

Thanks. For those of you who don't know, the Interlock is a large mixed-use asset located in the heart of West Midtown Atlanta, perhaps one of the hottest submarkets in the country. We were the contractor as well as the mezzanine lender on that project. The building is currently 90% leased, and the developer SJ Collins is now accepting offers to purchase. The base case in our guidance, as you mentioned, Dave, is that the sale will close later this year with a full payoff of our loan, returning another $80 million or so to the balance sheet.

Although we will gladly accept the cash, make no mistake, we would love to own this asset long term. And if cap rates have widened enough that we can make the purchase at a number that works for us, we won't hesitate to make an offer to our partner. But as I said, that's not the base case.

With regard to the program going forward, as we've mentioned numerous times on these calls, we were looking to reduce that mezzanine program with this payoff, and we anticipate another early payoff first part of next year on the Solis Nexton project. Our expectation is that we'll redeploy some of that capital into the mezz program. Our construction company is now at an all-time high on backlog of third-party clients -- third-party contracts.

And it would seem that at least 1 or 2 of those may well turn into mezz opportunities without controlling costs through the construction side. So my expectation would be that, that program will have a couple of smaller additions next year. As we said earlier, the program is going to top out around $80 million in total. Of course, we couldn't achieve that goal until the Interlock resolves itself.

Operator

And the next question we have is from Rob Stevenson from Janney.

Rob Stevenson

Just following up on Dave's question. So on the mezz preferred investments, I mean, given the rising cost of your capital, where does underwriting need to be on a rate perspective today for you guys in order to do a new investment? Can you still legitimately do 11%, 12%? Or does it need to be higher? And where is the market these days for these types of projects that you would want to provide financing on?

Lou Haddad

Yes. For us, Rob, again, the program is going to be deemphasized, but we're looking for a double-digit spread versus our cost of capital in the interest rate. And so that was -- that afforded us to do loans in the 12%, 13% range earlier. Now that's going to creep into the mid-teens. And as you might expect, other than multifamily in really healthy markets, the developers aren't going to be able to access that capital.

So it's going to be a kind of a self-regulating situation. And -- but that's where it ends up. And fortunately, there are a number of opportunities where it seems like we'll be able to get the money deployed.

Rob Stevenson

Okay. And then if I take a look at the development pipeline now, you guys are still, I think, $30-some million odd or excuse me, $100-some-odd million left to fund on the owned and then $85 million of equity is -- it looks like on the JV or 139. So when you take a look at what you need to spend on the 4 existing projects versus what you now have after the apartment sale and the outparcel sales, what more do you need to raise capital wise, to complete those 4 projects? And then how are you guys thinking about any of the incremental starts in the back half of the year? Is that still going to just be, at this point, additional sales? Do you have enough in the near term to fund any second half 2022 development starts on hand?

Lou Haddad

Yes. Our model shows, Rob, that we're -- we basically have everything we need to fund the remainder of the projects through the year and well into next year, as I mentioned. Our expectation again is that there's going to be a significant payoff of the mezzanine loans over the next 6 to 8 months that resolve themselves in some form or fashion. Those on their own would complete everything and then some. But obviously, there could be another case. We don't anticipate at this point any further sales necessary. But Matt, do you have any more anything to add to that?

Matthew Barnes-Smith

No. Specifically, as I mentioned on the earnings call remarks, we have $140 million just under our liquidity today. That does not include the AJ sales. So when you add the net proceeds in from that, you also add in the two mezzanine finance in the Interlock that we believe will come back later this year, early next year. For the next mezzanine financing, that total was another $100 million of capital coming in, plus a few strategic refinances that we are doing takes care of all the capital requirements that we have.

Lou Haddad

Yes. Let me just expand on that real quick, Rob. That's something we're -- as you might expect, we're pretty proud of. With those dispositions, combined with the ones earlier in the year and the payoffs that we're talking about, as well as the $140 million worth of liquidity on the balance sheet, we're looking at -- we're closing in on half a billion coming back in over the course of 2022. And therefore, not only will be funding the entire development pipeline, but we believe that we're going to be an opportunistic purchaser, particularly if the current market conditions caused some disruption in cap rates on high-quality assets. So we're excited about where we're headed with this liquidity position.

Rob Stevenson

Okay. And then last one for me. You noted in the release that the third-party construction backlog was the highest in the company's history, just under $550 million or so. Where are you in terms of capacity in that business? I mean, from a personnel standpoint and a capacity standpoint, is this pushing the upper limits? Is there still capacity to do additional projects? Or are you sort of tapped out at this point until some of these get delivered and you can reallocate resources?

Lou Haddad

Yes. So it's -- the answer is a little bit of both there, Rob. I appreciate the question and give a little bit more color on what's going on there. It is the highest backlog in our history, which is ultimately going to lead to one of our best years in history as far as third-party construction fees and probably the same for next year as well.

In terms of personnel, the fortunate part is 2 pieces. One is that there are a few projects that end before the end of the year. But perhaps more importantly, a huge concentration of that backlog is at Harbor Point with the T. Rowe Price building and accompanying infrastructure contract. So that is where -- as you know, we have a satellite office there with some 30 people in it. And so it makes for easier management, although my guys will be quick to correct me in that there's nothing easy about construction.

But we're still also actively recruiting. What we don't want to do is expand the construction operation much beyond where it is now. We've been really fortunate in that they've got a collection of really high-quality clients on the development side, predominantly multifamily. They're doing multiple projects for these folks. And as you might expect, savvy developers are reticent to change horses in an environment like this. Our guys come through over and over again. Obviously, inflation is out there. It hits us as well. But we think and our clients think on the third-party side that we're best positioned to mitigate those effects.

Rob Stevenson

Okay. I guess what I was sort of alluding to was, are you having to turn away business with previous clients, et cetera, that you ordinarily would have done because of Harbor Point or because of the overall size of this? Or you still have the capacity to do good deals when they come through the door with long-term partners?

Lou Haddad

Again, good deals with long-term partners, we're always going to find room for. What we are not willing to do at this point is expand that client base in any meaningful way. We want to -- again, our clients have been very loyal to us. And so we want to be loyal to them and make sure they get serviced first. And we are not interested in just hiring personnel to do projects that doesn't work in our industry. We've built a reputation over 40 years of client service, and that's why people hand us work as opposed to having to go bid for it. The minute you start to break that trust, then that relationship goes away. So I appreciate the question and the opportunity to expand on that a little bit, Rob.

Operator

(Operator Instructions) The next question comes from James Feldman from Bank of America.

James Feldman

I just wanted to talk more about your thoughts on leverage. I know you said your goal is to keep net debt-to-EBITDA around 5.5x, which I know is your stabilized number, but the actual number is kind of

8.3. You're talking about adding more loans to the portfolio, maybe doing some opportunistic buying. Can you just talk us through how you think that might deviate from your -- that 5.5x target if you do put more capital to work? Or no, you can actually do it by being on track at 5.5x?

Lou Haddad

Thanks, Jamie and good morning. I'll let Matt answer that specifically. But we are not interested in taking that leverage metric up. When we say our target is 5.5x, it might be 5.3x. It might be 5.6x. But we will be adding properties if and when we can keep that metric the same. Discipline has been our story for a very long time. And it's important, maybe we obviously -- our main avenue growth is through development. Development by its nature, no matter how good you are at it, and we think we're pretty darn good is a risk business. And so therefore, we're not willing to take risk in our base portfolio. And that's why those metrics need to stay the same. That's why we insist on high credit and trophy properties. Matt, you want to expand on where that's headed?

Matthew Barnes-Smith

Yes. Thank you, Jamie. I appreciate the opportunity I enjoy getting to talk about our average metrics here. So yes, as Lou said, we managed that 5.5x. And what that means is as we kind of work through the portfolio, we unencumber assets when we strategically feel that is appropriate. We use the -- kind of optimize that capital use and leverage up on our development pipeline. And that's where you can see that 7.2x, the ancillary debt. We use that for the best cost of capital. So then when we bring it back into the stabilized portfolio, we kind of deleverage that to get to the 5.5x.

As I stated, we are moving through from a secured balance sheet to a more unsecured model. We are increasing the credit facility by a couple of hundred million there. So that also allows us access to a cheap kind of cost of debt to work through that. But we don't anticipate, as Lou said, that leverage number go in too much out of that 5.5x range, and we make sure that we derisk the portfolio by managing that leverage metric.

The 8.3x number that you alluded to includes our preferred equity. So not something that we look at purely as debt the way maybe you as an analyst would, but the best way we see is these 3 buckets, the stabilized piece, this is the portfolio that we operate, and then the ancillary debt to total adjusted EBITDA, which includes the mezzanine book of business and the development pipeline. Lou made a very good comment on our last earnings call. Said in a different way, if we recall all of our mezzanine loans or we sold all of our development projects at cost, our leverage metric would be 5.5x.

James Feldman

Okay. But I guess if you're -- like let's just say you ramped up the Mezz book, it sounds like you would use the capital coming in from the mezz book to fund the rest of your development pipeline. You're saying, I guess you just wouldn't go beyond where you have excess capital?

Lou Haddad

Correct.

James Feldman

Do you see having to raise more capital in some other fashion if you find enough opportunity?

Lou Haddad

Probably not, Jamie. Again, we're not interested in selling cheap stock. So I guess, never say never. If there is some unbelievable opportunity that was out there. It just couldn't pass up, then we'd have to look at that hard. But right now, we want to stay in our lane. We're on a steady growth trajectory. The properties that are coming through the pipeline, Gainesville being one. You see the results there. Chronicle Mill, we're expecting similar results. And then later on in 2023, Southern Post will come online. Our trajectory is fairly cemented. Obviously, there's all these things that could happen. And so we don't want to -- we're not about to start being cowboys and see what else we can do unless it really fits in our lane.

James Feldman

Okay. All right. Thank you.

Operator

Thank you. The last question is from Peter Abramowitz from Jefferies.

Peter Abramowitz

Yes. I just wanted to ask about some of the construction cost increases. It looks like you had on your development disclosure. Could you just talk about potentially the impact of yields and how you're thinking about and quantifying kind of how that impacts your underwriting?

Lou Haddad

Sure. Thanks, Pete. I'll let Shawn answer that specifically. He's immersed in all things, development at this point. But let's start from a macro level, you should understand the way we underwrite these things. Again, we've been doing this for a very long time. And so both on the cost and the income side, our underwriting before we pull the trigger is extremely conservative. We will underwrite current construction costs with a factor for what we think escalation may be. Obviously, that escalation factor is pretty write current rents. And that has proven to be an extremely conservative posture and has led to a lot of pleasant surprises, and we expect it's going to lead to pleasant surprises, again, to help mitigate that -- those increases as those projects go through the pipeline.

So that's where it starts. Again, we're for a development-oriented REIT. We're extremely risk-averse. And that pay dividends really through whatever market you might be in. Shawn, do you want to expand on what's going on out there?

Shawn Tibbetts

Sure. Sure. Thank you, Lou, for setting that up. I think at the end of the day, Lou's comment about conservatism needs to be kind of repeated. The projected return on the cost as a result of us conservatively underwriting these deals still remains substantially higher than the cost of the funds that are being deployed to support these projects, right? So I think we're in good shape there. Again, that conservatism is tried and true. That being said, on Southern Post, for instance, we saw about since the last update, you had seen about 4.5%, 4.4% increase in construction costs there.

And that's -- we think that's relatively mild given the macroeconomic backdrop. That being said, we underwrote this months and months ago, 12 months ago, if you will. And we have multifamily rents growing there. We have rents in general growing there. But we also have an interesting dynamic in that particular deal, which is a high barrier to entry. You can't build apartments in [Roswell], Georgia, except for the ones that we're building. So we feel very, very good about that position, that kind of moat around our apartments around our deal there. That makes huge deal.

So to Lou's point, as a result of conservative underwriting and as a result of our agility and ability to kind of control and be agile in the construction space, we feel like we've got a good handle on that. On the T. Rowe Price deal, I mean I think the easiest way to say that and the best way to characterize that is the yield is fixed. There's an equation there. So as the total cost of the project moves, so move our rent payments. I think I'll leave it at that. But just understand that's a function and equation, and that's a deal that essentially has a fixed yield. So we feel okay about that, with our partners at T. Rowe.

On Parcel 4, there are a couple of different dynamics there. Yes, we've seen an increase of about $25 million there since the last update. A lot of that has to do with construction costs. Some of that has to do with some cost for us preserving the right to do a Phase II in other words, infrastructure cost. But in the same regard, we have not trended rents there either. Just to give you an idea, it's about a 12.5% increase on cost in the last 30 days trade out in our building next door, another advantage we have. We have a real market data. The 30-day trade out in our building next door was about 13.5%. So again, costs are moving, but rents are moving. So as we update our pro forma, we feel that the yield is largely unaffected because of the conservatism upfront both in terms of underwriting the income and the cost numbers.

Peter Abramowitz

Okay. Got it. That's helpful color. And then my second question is just on the multifamily portfolio. Do you track rent to income among your residents? Kind of where is that at today? Just so we can get an idea of how tenants in your portfolio are kind of able to absorb these rent increases?

Lou Haddad

We don't track that specifically, Pete. We -- I mean obviously, we're -- our properties are at the top of the market. They're largely white-collar users. Do we have any kind of factor, Matt, on rent collection?

Matthew Barnes-Smith

Yes. So we had very, very limited amount of bad debt again for Q2. $138,000 of bad debt for the quarter in the multifamily segment. That is around about 0.5% of revenue and around about 1% of NOI. We've actually seen a downtick in our trending numbers when you look at them on a percentage of revenue, but have bad debt in the multifamily segment of around 0.5% to revenue is very, very low numbers. From a collection standpoint, we monitor this, and we are not worried today at all with those trains.

Lou Haddad

I think you would see more dislocation as you move down the quality ladder into B and C quality apartments.

Peter Abramowitz

Got it. All right. That's all for me. Thank you.

Lous Haddad

Thank you.

Operator

(inaudible) We have reached the end of our question-and-answer session. I would like to turn the call back to Louis Haddad for closing remarks. Please go ahead, sir.

Lou Haddad

Thanks again, everybody, for giving us the time this morning. We look forward to continuing to update you. We expect to have more news during the quarter, and I look forward to talking to you again. Take care. Bye-bye.

Operator

Thank you. This concludes today's conference. Thank you for joining us. You may now disconnect your lines.