ARMADA HOFFLER PROPERTIES

Third Quarter Earnings Call

Thursday October 31, 2019

CORPORATE PARTICIPANTS

Louis S. Haddad
President, Chief Executive Officer & Director

Michael P. O'Hara
Chief Financial Officer

MANAGEMENT DISCUSSION SECTION

Operator:

Thank you and welcome to Armada Hoffler's Third Quarter 2019 Earnings Conference Call. As a reminder, this conference call is being recorded today, Thursday, October 31, 2019.

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

Michael P. O'Hara
Chief Financial Officer

Good morning and thank you for joining Armada Hoffler's Third Quarter 2019 Earnings Conference Call and Webcast. On the call this morning, in addition to myself, is Lou Haddad, CEO. The press release announcing our third 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 December 1, 2019. 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, October 31, 2019, and will not be updated subsequent to this initial earnings call.

During this call, we will make forward-looking statements, including statements related to the future performance of our portfolio, our development pipeline, impact of acquisitions and dispositions, our mezzanine program, our construction business, our portfolio performance and financing activities as well as comments on our guidance and outlook. Listeners are cautioned that these statements are subject to certain risks and uncertainties, many of which are difficult to predict and generally beyond our control. These risks and uncertainties can cause actual results to differ materially from our current expectations and we advise listeners to review the forward-looking statement disclosed in our press release this morning and the risk factors disclosed in documents we have filed with, or furnished to, the SEC.

We will also discuss certain non-GAAP financial measures, including but not limited to FFO and normalized FFO. Definitions of these non-GAAP measures, as well as reconciliations to the most comparable GAAP measures, are included in the quarterly supplemental package, which is available on our website, armadahoffler.com.
Now I will turn over the call over to our Chief Executive Officer, Lou Haddad. Lou?

Louis S. Haddad
President, Chief Executive Officer & Director

Thanks, Mike. Good morning, everyone, and thank you for joining us today.
Before we go over our operating results and update you on our other activities, I'll first comment on a topic that may be a new focus for some listening on this call, but for us at Armada Hoffler a topic that has been part of our

corporate culture since our founding. Environmental sustainability, social responsibility and effective transparent governance, or ESG for short, are qualities that have been at the core of our business for many years.
When Dan Hoffler founded the business some 40 years ago, he insisted that good corporate citizenship would always be a focused initiative of our organization. We sum it up in one simple motto. We built trust -- the trust of our employees, the trust of our partners, clients, subcontractors and vendors, the trust of our investors and the trust of the communities in which we work and live. Simply put, a business built on trust produces positive results for all stakeholders.

Over the years we have won numerous awards for community leadership, philanthropy and, perhaps most importantly, workplace excellence. We have consistently been ranked as a best place to work based on employee responses to numerous regional surveys. ESG is the primary reason we are able to boast of the extremely long tenure of the majority of our staff.

Striving to add to the greater good has produced other tangible results in the marketplace. Many of our projects have been recognized for excellence in design and sustainability, with several achieving LEED certification. Undoubtedly these ongoing efforts, combined with the transparency we offer in our dealings, have been instrumental in our selection as the development partner in over 20 public/private partnerships with various municipalities and institutions.

Early next year we will publish a comprehensive view of our long history of ESG activities, as well as new developments in these areas.

In a few minutes Mike O'Hara will update you on the important highlights of the quarter. I'll first report on a couple of ongoing initiatives.

Last quarter we announced a strategic portfolio review being led by our CIO, Jonathan Morris, with support from our President of Asset Management, Shelly Hampton, and her excellent team of asset managers. While we've become well known for routinely trimming noncore assets from our portfolio to keep it fresh and of the highest quality, this effort is more comprehensive and longer term in nature than our previous reviews.

As anticipated, we have identified several assets with an approximate value of $125 million for disposition. Some of these have been released to the market and we anticipate launching the sales effort on the rest by the end of the year. It is unlikely that any closings will occur prior to year-end. This group includes the One City Center office building anchored by Duke University, as well as several of our well-established neighborhood centers.

I'll reiterate here that we are very comfortable with our current portfolio and its multiyear performance has been stellar. This is not a repositioning effort. It is simply a continuation of our long-established recycling strategy that we use to achieve the most efficient allocation of capital to maximize the growth and stability of the company. We believe that recycling capital to create value versus increasing the share count to simply increase size is a strategy that will best serve investors over the long term. Some of the anticipated proceeds may be used for balance sheet purposes to help fund the next development pipeline. Most will be used to purchase higher-growth assets through 1031 exchanges.

That said, please bear in mind that the decision to market an asset is not necessarily a decision to sell that asset. We are very comfortable owning these properties. So if we feel any one in particular is not receiving appropriate value from the market, we will not transact on that property. We expect to give you further clarification on this initiative with next quarter's results.

Secondly, we previously reported that we viewed the pending expiration of the 84,000 square foot Dick's lease at the Town Center of Virginia Beach as a major opportunity. Subsequently a number of entertainment concepts as well as back-office users expressed interest in the space. As we announced yesterday, we decided to lease the space to Apex Entertainment. This New-England-based group has proven to be creative and savvy operators. We believe that their facility will complement the existing entertainment and dining choices at our center. The intent is

that Apex Entertainment, with its multiple family-friendly attractions, will further expand the already diverse customer base at Town Center. As we suggested earlier, the redevelopment and build-out of the facility will last through the better part of next year and we do not expect an appreciable income contribution during 2020.
Most of you have seen in this morning's earnings release that we reported $0.30 of normalized FFO per share this quarter, which was slightly ahead of our expectations. Perhaps more importantly, the core portfolio continues to show robust performance with increases in renewal spreads, occupancies and same-store NOI across all property sites. This is the sixth consecutive quarter of increasing same-store NOI. High occupancy and steadily increasing income have long been hallmarks of our portfolio and we expect these trends to stay consistent over the long term. Given the strength of our properties, year-to-date acquisition activity and the stabilization of several pipeline projects, our current projections show a double-digit increase in portfolio NOI in 2020.

Please bear in mind, as we have previously said, we expect lower mezzanine income in 2020, resulting in moderate earnings growth versus the 14% increase we anticipate this year. While the ancillary income from third-party construction fees and mezzanine interest will continue to be an important part of our business, our primary focus remains on increasing NAV through amassing a top-quality portfolio. This strategy has led to impressive returns over the past several years and we believe we can continue to reward shareholders with outperformance in the future.

As many of you know, the majority of our current development pipeline has been delivered and the properties are well on their way to stabilization. In fact, the 3 multifamily projects delivered in the last year, 1405 Point in Baltimore, Premier in Virginia Beach and Greenside in Charlotte have all reached stable occupancy.
More recently, we delivered Hoffler Place, the first of our student housing projects in Charleston. That facility opened in its first year at over 85% leased, which is somewhat higher than we anticipated. We are also in negotiations with a national retailer that we expect will occupy the majority of the ground-floor retail space. This convenience retailer should give the facility a tremendous advantage over its peers in attracting students. As we reported last quarter, the second Charleston student housing project, Summit Place on Meeting Street, remains under construction while we gear up for the fall leasing season. This project will be open for the fall of 2020 semester.

Construction continues on the Wills Wharf office building at the Inner Harbor in Baltimore. We are expecting an on-time delivery toward the end of the first quarter. Two recently signed leases have brought total preleasing to nearly 70%. This project, in concert with our adjacent James Street Wharf building and the apartments at 1405 Point give us a critical mass of trophy-quality properties in this highly sought after submarket at the Inner Harbor of Baltimore. We intend to continue building out Harbor Point with our partners at Beatty Development into a world-class, mixed-use destination.

Nexton Square, a lifestyle center where we hold the mezzanine loan and discounted purchase option, is in the greater Charleston market. Although construction won't be completed until early next year, the first handful of tenants have opened and leasing is over 90%. Due to the mezzanine structure on this project, along with our discounted purchase option, we anticipate using some of the disposition proceeds from the expected asset sales I mentioned earlier in a 1031 exchange for this property.

Southern Post, the mixed-use project in Roswell, Georgia that we announced last quarter, is the latest addition to our development pipeline and is on track to commence construction in the spring of next year. This $95 million infill project located in a fast-growing area of the Atlanta MSA has already received significant tenant interest from office users, retail concepts and apartment renters, despite being nearly 2 years from completion.

Our development group is hard at work underwriting a number of new opportunities. Although deal flow is at an all-time high, we remain committed to keeping our new development run rate in the $200 million range over an 18-month timeframe. This discipline helps to ensure that only the most promising projects are selected for investment. Currently a couple of mixed-use urban infill projects similar in size and nature to Southern Post will likely be the next projects to be announced, hopefully by year-end.

On the redevelopment front the upgrade to the units at The Cosmopolitan apartments in Town Center continues to receive rave reviews. Newly refreshed apartments are leasing at a 10% premium to the same unimproved units. Our other project currently under redevelopment, Columbus Village I, is well underway and will bring 3 new tenants to the region -- Steak Shack, which opened earlier this year; Barnes & Noble's new concept; and Cava. In the first quarter of next year we will begin redevelopment for Apex Entertainment in the 84,000 square foot retail space currently occupied by Dick's Sporting Goods here in [downtown]. This ability to attract new-to-market tenants gives further proof that Town Center is the premier mixed-use destination in the region.

As development has become a bigger part of our business we added expanded disclosures, starting with this quarter's Supplemental and going forward. We intend to show that the capital we invest in redevelopment will produce yields that rival, if not exceed, those of our ground-up developments with even less risk.
The construction group continues to perform at a very high level. On-time completion of Hoffler Place highlighted the quarter. We also continue to track scheduled completions for the rest of the development pipeline currently underway. The value of controlling the construction of our development properties cannot be overstated. Offering dependable delivery dates to demanding tenants gives us a meaningful advantage over our peer group.
Similarly, control of the construction process gives us the confidence to pursue the mezzanine lending strategy that has led to significant cash generation, thereby reducing our reliance on the capital markets to fund our portfolio growth.

Reliable construction timeframes are also a large factor in our team's selection by third-party clients on a repeat basis, which solidifies the steady fee income that we have enjoyed for a number of years. Third-party contract backlog stands at $173 million. With several potential engagements in the pre-construction phase, we are anticipating an outstanding year in this division for 2020.

Remember, Armada Hoffler is first and foremost an opportunistic real estate company that employs multiple strategies to enhance profitability and create value. These have been our central tenets for 40 years and investors can count on this to remain our primary focus. As the company's largest equity holder, a position we maintain despite a nearly fourfold increase in our market cap since inception, management will continue to operate a business model that includes a variety of deal structures.

We are extremely optimistic about the company's prospects for the rest of 2019, as well as our ability to deliver on our promises over a multiyear timeframe. As we look forward we feel strongly that our investors will continue to realize great value creation well into the future.

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

Michael P. O'Hara
Chief Financial Officer

Thanks, Lou. Today I want to cover the highlights of the quarter, thoughts on our balance sheet and our 2019 guidance.

This morning, we reported FFO of $0.29 and normalized FFO of $0.30 per share for the third quarter. The largest difference between these 2 metrics is a noncash mark-to-market adjustment relating to our hedging activities. Our core operating portfolio occupancy for the third quarter remains high at 97%, with both office and retail at 97% and multifamily at 96%.

Same-store NOI was impressive again this quarter with all property types positive for the quarter and for the year. This is the sixth consecutive quarter of positive same-store NOI growth. GAAP was positive 6.3% and cash was positive 6.4%. Most significantly, our multifamily GAAP same-store NOI was positive 16%. The majority of the increase relates to our JHU student housing asset, where rents were increased by nearly 15% and higher summer occupancies since the transitioning to 12-month leases.

Office and retail same-store NOI were also strong this quarter. Retail GAAP was positive 4.3% and cash was positive 3.7%. Office GAAP was positive 4.4% and cash was positive 16%. And for the trifecta, GAAP and cash releasing spreads were positive for both retail and office. GAAP was positive 6.2% and cash was positive 3.9%. All these portfolio metrics demonstrate why Lou said we are very comfortable with our current portfolio.

On the construction front, we reported segment gross profit in the third quarter of $1.2 million on revenue of $27.6 million. At the end of the quarter the company had a third-party construction backlog of $173 million Now for an update on our mezzanine program. The Decatur Whole Foods Center loan was paid off in the third quarter. This was a very successful project for all involved. The developer sold it [in an asset] at attractive cap rates and we made a profit of $3.4 million on a loan that was outstanding for 26 months.

The Interlock projects in Atlanta are well under way and we anticipate fully funding these loans by year-end and expect the balances to remain outstanding well into 2021.

Timing of the Annapolis Junction loan payoff changed this past quarter. Our partner decided to sell the asset and offers started coming in this past week. With expected closing early next year, we are working on a loan extension. Now turning to our balance sheet. Over the past quarter, we have completed most of our 2019 capital plan and we believe we are well positioned going into 2020.

Our 2019 guidance issued in February consists of the following to achieve our leverage target for the year. First, the disposition of our grocery- anchored shopping center. During the quarter we closed on the sale of the Lightfoot Harris Teeter Center for $30 million, representing a 5.8 cap rate. Second, as I just discussed, Decatur Whole Foods Center was paid off and the Annapolis Junction loan is expected to be paid off early next year. And third, we anticipated raising $50 million through the ATM program in 2019. With the stock trading at all-time highs and above consensus NAV this past quarter, we took advantage of these favorable market conditions. During the quarter we raised $34.6 million at an average price of $17.72 and in October we raised another $9.9 million at an average price of $18.14. Year-to-date we have raised $82.7 million at an average price of $16.48. If AHH continues to trade at these levels, we will continue to be active with the ATM program. Updated guidance includes raising a total of $95 million in 2019.

In addition, in the second quarter we raised $63 million through our first preferred equity offering. We think preferred is a good source of capital, but limited to 10% or so of our equity. We now have permanent capital at a fixed rate of 6.75%, which we believe will be less expensive than our common stock over time. We also have a number of new, well respected institutional investors who invested in the company for the first time.

As Lou said, we are evaluating a number of new development opportunities, the first, Southern Post in Roswell, Georgia, which was announced during the quarter. We acquired the land last week, with construction expected to begin in the spring. The other development opportunities that we are underwriting will not begin construction until well into 2020. As is typical with development projects, the initial capital requirements are modest and ramp up during the construction schedule.

We believe our execution of our 2019 capital plan reflects management's commitment to managing the balance sheet and leverage as we have in the past, with core debt to core EBITDA in the mid-6x range.
We added several new metrics in the supplemental package last quarter, reflecting preferred equity, including additional leverage metrics and fixed-charge coverage ratios.

This quarter we made another change to the core EBITDA calculation due to the new GAAP REIT standard. We are the leasee on 2 ground leases, which under this new standard are considered financed leases. This requires the ground lease payments to be treated similar to loan payments, with most of the payment classified as interest expense and therefore are not including rental expenses or EBITDA. In our new core EBITDA calculations we unwind this GAAP treatment and reflect the actual ground lease payment in EBITDA. We believe it is appropriate even though it's detrimental to our leverage calculation.

This month, we closed on an amendment to our unsecured credit facility, which extends the maturity of the revolver portion to January 2024 and the term loan to January 2025. This also includes some minor changes to loan covenants and the credit spreads are reduced by 5 to 15 basis points, depending on leverage.

We've also been working on our 3 2020 loan maturities. We signed an application with a life company for a 10-year, $34 million loan with the interest rate fixed at 3.17% for Greenside Apartments. This week we closed on a 5-year loan extension with the current lender, with the interest. rate lowered to LIBOR plus 1.55% for the Premier. And finally, we have proposed terms from the existing lender on 1405 Point. And all the loan closes are due in the next couple of weeks.

At the end of the quarter we had total outstanding debt of $952 million, including $110 million outstanding on the revolving credit facility. At quarter end, 85% of our debt was hedged or fixed. With interest rates falling we have been patient with buying new interest rate caps and entering the swap lot.

Now I'd like to go through the details of updated 2019 guidance. The assumptions of the guidance are raising a total of $95 million through the ATM program in 2019, assuming favorable market conditions. Interest expense is calculated on the Forward LIBOR Curve, which forecasts LIBOR, at 1.74% at year-end.

Our updated 2019 normalized FFO-per-share guidance is $1.16 to $1.18 per share, predicated on the following updated components -- full NOI in the $102.8 million to $103.2 million range; third-party construction gross profit in the $4.5 million to $5.1 million range; general and administrative expenses in the $12.3 million to $12.6 million range; D&A was increased this quarter due to legal, accounting and IT expenses; interest income from our mezzanine finance program in the $16.3 million to $17.6 million range, which is net of $5.5 million of interest expense and also includes the remaining $4.5 million recognized in the amortization of the Annapolis Junction apartments purchase option; interest expense in the $25.1 million to $25.6 million range, which does not include interest expense related to the mezz program; and 72.6 million weighted shares outstanding.

In January 2020, we have another new GAAP standard will go into effect, currently expected credit losses, which is known as CECL. This new credit standard requires companies to establish a loss reserve on most receivables and loans. In establishing these reserves companies need to estimate the impact of future business cycles that would have an impact on loans. We are working through how to apply this new standard, purchasing external loan default data and assessing the effect on our financial statements. While we do not know the impact at this time, we expect it will reduce our 2020 reported mezz interest income.

This makes 3 years in a row with a significant new GAAP standard which we believe for our business makes the financial statements less relevant. We believe adjustments we are making to GAAP measures in arriving at normalized FFO and adjusted EBITDA results in better [metrics] to understand our business. There have been a couple of articles recently in The Wall Street Journal discussing that most companies are now defining their own non-GAAP performance metrics. Although these articles are very critical of this practice, we believe it is necessary and appropriate. Under GAAP, as discussed, our ground lease payments are now treated as amortization and interest expense and therefore are not included in NOI or EBITDA, which is not consistent with how real estate is valued. With this change in GAAP it increases NOI and therefore creates the illusion of increased value of our properties. Changes in GAAP do not make our real estate any more or less valuable.

While it's too early for our 2020 guidance, I want to give some insight into next year. As in the past, earnings growth has been lumpy with the delivery of development projects, but with earnings growth over the long term. 2020 will be one of those years where growth slows versus the 14% growth in 2019.

Some of our other 2020 earnings headwinds are we are expecting 3 of the current mezz loans to be paid off during the first half of 2020. This reduces the outstanding balance significantly for most of the year. In addition, [interest] income will be lower due to the absence of amortization of the $4.5 million in the Annapolis Junction purchase option; the 84,000 square feet Dick's space being vacant for at least 6 months during renovations; the (inaudible) student housing real estate taxes are increasing by $600,000 because of the expiration of the real estate tax abatement. This will also have a significant effect on same-store NOI.

As discussed earlier, we expect to have raised approximately $95 million under the ATM program this year. These extra shares will be dilutive to 2020 earnings. At this time we do not know the earnings impact of our asset recycling, but expect it to be a drag on 2020 earnings. And lastly, as discussed, the new GAAP standard, CECL, will reduce our reported net income next year.

After an expected 14% increase in earnings this year, our focus for 2020 will be concentrating on enhancing portfolio quality and increasing NAV.

Now I'll turn the call back to Lou.

Louis S. Haddad
President, Chief Executive Officer & Director

Thanks, Mike. As some of you already know, Mike and I will not be attending the NAREIT conference next week. We are at a critical juncture on several pipeline and unannounced developments which require our presence for final negotiations, loan closings and lease executions. The timing required for these agreements makes travel to the West Coast for the better part of a week not in the best interests of the company. We're happy to take your questions on this issue or any other topic this morning.

Operator, we're ready to start the question-and-answer.

QUESTION AND ANSWER SECTION

Operator

(Operator Instructions) Your first question comes from Dave Rodgers from Baird.

David Rodgers
Thanks for the detail in the prepared comments. Lou, wanted to start on the development side. You just kind of touched on it at the end in your NAREIT comments. But you said you've got a record level of kind of activity in the pipeline, but also that you wanted to limit it to the $200 million. So curious, one, on what you're seeing in terms of kind of more color on what's out there. Are you seeing compression in the development yield due to the amount of competition that's out there? And then maybe a little more color on the $200 million soft cap that you kind of mentioned over that rolling period.

Louis S. Haddad
Sure. Well, first of all, we are seeing compression but it's mainly coming from the increase in construction prices. We're getting a lot of pressure, upward pressure, on pricing. And obviously that tends to compress you, which makes us more cautious about all these opportunities.

Not really seeing it in terms of competition. In the markets where we're playing with the partners we have as boots on the ground, it's really a situation where we're in the enviable position of being able to cherry-pick the opportunity.

The $200 million, again, is a run rate. That's consistent with the pipeline being at a level of $400 million to $500 million, which it had been until all the deliveries of this year. So don't look at that as a cap, but just simply a gauge of how fast all this gets put into place.

David Rodgers
And then on the portfolio review, the $125 million, sounds like you'll take all that to market, maybe not sell all of it but at least try to get it out into the market next year. Looking at One City Center as a piece of that, it looks like about half retail centers and half of that One City Center project, plus or minus.

But I guess on the flip side of that, what do you like? What do you put that into? Where are you really confident deploying that capital on a 1031 basis? Is it some land? Is it all retail? What are your thoughts on that as you sit here today?

Louis S. Haddad
Sure. Well, one thing it definitely is not land. As most of you know who've followed us, that's been a tenet of ours for 40 years, that we don't speculate on land unless obviously we have an anchor tenant and can start development right away.
At the same time, we've got our eyes, Dave, on the types of properties that we think will offer the best growth and it's really not necessarily the product type. As you know, we loved mixed use. We love walkable environments for a number of different reasons. So in a perfect world we'll acquire more mixed-use assets. And if we can't find things to our liking in that regard, we'll look to redevelopment. And if we can't find things in that regard we'll make our own mixed-use batch of acquisitions.

But, again, remember what we're doing here. You don't want to sell something unless you've got a better use for the money. We've identified what we believe we can reap and sow into something better. But we're prepared to be wrong. Like I've said on many occasions, we're very comfortable with the assets we hold. And if it turns out those become the best things available, that's what we're going to do.

Dave, you know. You've followed us from the beginning. We're under no pressure to increase the size of our business. We're under a lot of pressure to increase the value of our business. And unless the transaction is going to do that for us, we're just simply not going to transact.

David Rodgers
One last question from me. Go to Mike on this and Lou can chime in if you want. But you had a pretty long list of 2020 guidance impacts. You kind of talked about a slower pace of growth. I guess maybe one, a more direct question, is there a risk that 2020 earnings is lower than '19? And then, Mike, maybe some added details on how Summit Place could also impact and any potential office move-outs like Hampton University. How also would that impact the guidance as we try to start to hone in on a number?

Michael P O'Hara
So hopefully won't be lower than 2019. Certainly, that's not what we're looking to do. Where we're talking about a big impact here is on the mezzanine program where we have 3 loans getting paid off in the first half of the year, which is going to reduce that substantially.

Another thing, also with the new credit standard, we do not know the effect on that at this point in time. So that's certainly something we've got to work over here in the next few months.

As for Summit, that will be a drag that will be placed in service come mid-summer, June/July timeframe. But obviously no income coming in until August.

Louis S. Haddad

Unique timing on that as well, Dave. You've followed us over the long haul. And you know are big years of earnings growth coincide with development deliveries and stabilizations. So if you look over the last 6 years of history, it effectively worked out to reasonably every other year being a significant increase followed by every other year being a moderate increase. Our expectation is that's what's going to happen this time around, with no significant development deliveries in 2020.

Operator
Your next question comes from Alexander Pernokas from Bank of America.

Alexander Pernokas
I was just wondering if you could give us your updated thoughts on WeWork as a top tenant. Do you see any exposure to the kind of scale-back, or any urgency to scale back this exposure given the recent drama with their IPO.

Louis S. Haddad
Sure. Alex, I guess I want to look at this in a little bit of a broader context. For us, it still comes down to proper underwriting of your assets for the long term. By almost all accounts co-working space is here to stay. It has a small but not insignificant portion of the Class A office market. Most folks are saying somewhere between 3% and 10%. We look at WeWork as simply one of a host of operators in this space. And if you're confident in your underwriting, that co-working space is a positive contributor to the NOI of your asset in a given location, then the particular brand is not as important as the quality of your build-out and your position in the submarket. We are comfortable with this use in the 2 facilities that we have them in, in Durham and in Baltimore.

That said, we're going to continue to closely monitor the actual performance of these locations and keep our exposure limited on an overall basis. That's one reason why we may end up selling One City Center.

Conversely, we are actively trying to create some vacancy at Town Center in Virginia Beach for the purpose of attracting an operator to lease a relatively small amount of co-working space to add to our mix of our million-some-odd square feet of office space. So we're kind of intrigued by the drama as everybody else is, but you've really got to look beyond that into what that use is and if it's a good fit for where you are. I hope that answers your question.

Alexander Mark Pernokas
Yes. That's very helpful. And then my second question is just taking a step back and looking at long-term strategy, are there any markets that you're looking at for expansion, either new markets or markets that you're currently in?

Louis S. Haddad
Sure. And we're in a number of high growth markets and hopefully when we can public the new projects that are coming out you'll see it coincides with our existing markets. We're very active in the Raleigh-Durham market, the Charlotte market, Charleston, Atlanta, as well as the Inner Harbor of Baltimore. And I think this next pipeline group will probably come from those areas. We're also looking at ancillary areas. Some of you have seen the big announcements of our foray into South Florida with Dania Beach in a public/private partnership. We'll see if that ends up bearing fruit. But we don't see a whole lot of reason to go very far afield. There's just a tremendous amount of opportunity in the markets where we're very comfortable in.

Operator
Your next question comes from Barry Oxford from D. A. Davidson.

Barry Oxford
You mentioned that you would be looking at some mixed-used properties for acquisitions. And I know you are in different marketplaces and so the cap rates can range kind of wildly from market to market. So what are you seeing on cap rates for properties like mixed-use property?

Louis S. Haddad
Barry, it really depends on the mix and the contribution of NOI from the various product types. The way people are evaluating things, retail obviously with the highest cap rate, followed by office, followed by multifamily. So it really

depends on the mix there. But in a good quality mixed-use center they are trading in the mid-6s in our markets. And that's a fine place for us to play.

Barry Oxford
Then do you want to maybe help us with a range on the $125 million for (inaudible). I know you don't want to kind of peg it, but what might we be looking at as far as overall range, not commenting on the one building, but a range of what you guys might be looking at out of that $125 million.

Louis S. Haddad
Sure. I'm not sure I can give you that color from the standpoint of whatever this does in the short term is not really our focus. What we're looking for is the ability to have a higher-growth asset. So with what we're selling versus what we're buying, I would say it could be slightly negative and that -- again, it's hard to say, depending on the mix. If it looks like we're not -- based on our values for what we believe these things are worth, it would only be slightly negative if negative at all. If we're not getting the kind of value that we believe these things have earned, then we're not going to transact just for the sake of transacting.

Operator
Your next question comes from Rob Stevenson from Janney Montgomery Scott.

Rob Stevenson
Lou, how extensive are the tenant improvement for Apex at Town Center to convert from a Dick's to an indoor amusement park essentially? And how are the rents versus Dick's?

Louis S. Haddad
Yes. You probably heard us say before that the Dick's lease was not a very favorable lease. We and the city worked very hard to attract them -- attract what was then [Galleons] with a very attractive deal. The building is 17 years old, so the majority of the money that we're spending is in redoing HVAC and electrical systems and the like that were going to need to be done for whatever tenant came in.

So fortunately with Apex, they can use the physical plant pretty much as is. The tenant improvements were moderate, I'd say. I don't want to go into too many specifics. But we've got a moderate amount of tenant improvement and a moderate increase ultimately in the rental income from the property.

Again, I want to reiterate what I said last quarter. We looked at this as a major opportunity to do something at Town Center that you really typically can't do. By the vacancy created in this kind of a box, we had the ability to do back-office space, which you really can't do at Town Center, which would have been a better financial deal in the short term. But we were looking to add something unique that's not in the market, that could increase the customer and client base here at Town Center for all the other mouths that we feed in the multifamily and the retail and the restaurants and the office space. And this fits that bill perfectly.

We've had to -- we've all grown up here with Town Center. And in running this place it's not trying to make the maximum amount of money on every deal. It's increasing the value of the entire center. And we believe that really does this. It just so happens that it also is slightly accretive to what we were getting from the old tenant.

Rob Stevenson
And does this pose any parking issues, either in the evenings or especially during the summer when the kids are out of school and it's raining outside during the day?

Louis S. Haddad
Oh, I think we're in good shape. In each -- this is a great partnership we have with the City of Virginia Beach. They own the 5,000-plus parking spaces that underpin our buildings. With each phase that's added to Town Center we get a new parking study done by a third-party expert that's been with us for the past 20 years. And this fits within the mixed-use parking scheme that has worked so far. Now we're -- that's a great question because it's something

that we have to be mindful of in terms of day/night uses that are here at Town Center. But this one fits the bill exactly.

Rob Stevenson
And then can you talk about where the construction company's flow or deal flow is today? I mean the contract value is roughly $577 million, the backlog was $173 million at September 30. But between the Armada Hoffler projects slated for start in 2020 and third-party deals you're kicking around, how does it compare to previous years? Because I mean you've been cautioning for the last few not to extrapolate growth in that business. But their trailing 12 months you're up to over $7 million of profit. How should we be thinking about what's going to be happening with the construction company over the next 12 to 18 months?

Louis S. Haddad
Sure. One thing to remember there, Rob, is that there was an outlier in those last 12 months in that the construction company built and effectively sold the Pepsi distribution center for a significant profit over and above the fee, something that we take a lot of pride in doing these build-to-suits. So it was a little bit inflated there.
That said, we think we're headed to a really good year coming up in 2020. The mix is going to be -- the pendulum is going to swing much further to the third party, which is the actual fee income portion of the business, because on the development side we'll be ramping up and those new projects in the pipeline won't be putting in as much volume. So it's going to be more fee generation than we saw this year. Things are shaping up really well for that business. The guys are doing a fantastic job in a really tough environment. It's really difficult to find good people as well as good contractors. But we've got a lot of 30-year employees that are really chopping the wood for us. So looking forward to a great, great year in that sector.

Rob Stevenson
And then just one last for Mike. Didn't want him to get off scot-free here. You talked before about the $0.01 difference between normalized and NAREIT FFO being the mark to market on the hedging. Does that $0.01 gap stay constant or the amount stay relatively constant and over what period of times does that burn off?

Michael P. O'Hara
No, it's not constant. It's whatever the LIBOR is versus where the caps are at that point in time it goes to mark to market. Certainly for each particular cap it goes away when that cap expires. But certainly one reason we don't give any guidance on that is we have no idea where those are going to price out and go mark to market.

Rob Stevenson
Okay. And is there anything else other than that that's known at this point is a gap -- is a difference between NAREIT and normalized FFO for fourth quarter at this point?

Michael P. O'Hara
No.

Operator
Your next question comes from Bill Crow from Raymond James.

Bill Crow
Lou, and I'm sure this has come up on prior calls. I just can't recall your response. But to what extent does Armada Hoffler have the interest in looking at broken malls and the ability to use your skills to redevelop into mixed-use facilities?

Louis S. Haddad
Bill, that's something that's been intriguing for a long time. There's a great opportunity in a well-located mall that's outlived its usefulness in that business obviously with what's happened in the retail landscape. We just haven't found the right place to play. We've looked at a number of those opportunities. As you might expect as a mixed-use developer a mall in trouble we're certainly one of the groups that somebody would reach out to. Just haven't

found the right circumstance yet. But you're very prophetic. I'm hopeful that you'll see an announcement on that in the not-too-distant future where it's someplace we can get involved in in a big way.

Operator
Your next question is a follow-up question from Dave Rodgers of Baird.

Dave Rodgers
Hey, Mike, just one detail on the mezzanine. And as you think about the CECL rules which go into effect next year, what's the equity on top of your mezz? I mean, what's kind of the last dollar or last percentage exposure of a project that the mezz is for you guys? Just I'm trying to approximate some estimates.

Michael P. O'Hara
Yes, Dave. So what we're always looking at, obviously is what's the exit cap rate versus what's the total capital stack? And certainly on the ones we're involved in, especially Whole Foods centers and those kinds of things is -- what we see is plenty of spread and it's something we obviously update the cap rates as we get market data each quarter. And so far we've been really comfortable and we haven't had any losses. But under the new standard, there's the assumption that a loan is going to go bad. And because of our history, not a long history, even though we've had a few loans paid off we're going to have to go out and get market data as how other mezz loans have performed. And then we're going to have to take that information and kind of overlay that on to what we have to come up with these new loss reserves. So unfortunately at this point in time we just don't have an idea what that's going to look like until we get further along.

Louis S. Haddad
What we do know, Dave, is that whatever that reserve, it's going to have the effect of delaying recognition of income, some portion of the income, until the loan is paid off, which as Mike said -- you heard the frustration in his voice -- it kind of skews what's actually going on in the company. But obviously we'll comply and that will be the new standard and we'll make it work.

Operator
Thank you. We have reached the end of the question-and-answer session. I will now turn the call over to Lou for closing remarks.

Louis S. Haddad
Thanks again, everybody, for your interest in our company. We appreciate all the attention. It sounds like this one went a little bit longer, but hopefully you found it useful in your deliberations.

And we're, Mike and I -- again, we're not going to NAREIT in a few weeks but we are available for follow-up calls from any interested party. Thanks again. Have a great day.

Operator
This concludes today's conference, and you may disconnect your lines at this time. Thank you for your participation.