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Armada Hoffler Properties, Inc. (AHH)

Q3 2018 Earnings Call

CORPORATE PARTICIPANTS

Louis S. Haddad
President, Chief Executive Officer & Director

Michael P. O'Hara
Treasurer, Chief Financial Officer

MANAGEMENT DISCUSSION SECTION

Operator:

Welcome to Armada Hoffler's third quarter 2018 earnings conference call. At this time, all participants are in a listen-only mode. After management's prepared remarks, you'll be invited to participate in a question and answer session. At that time if you have a question, please press "star 1" on your telephone.

As a reminder, this conference call is being recorded today, Tuesday, October 30, 2018.

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

Please go ahead.

Michael P. O'Hara
Treasurer, Chief Financial Officer

Good morning and thank you for joining Armada Hoffler's third quarter 2018 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 November 30th, 2018.

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

For those who listen to the rebroadcast of this presentation, we remind you that the remarks made herein are as of today, October 30, 2018, and will not be updated subsequent to this initial earnings call.

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

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

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

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

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

Louis S. Haddad
President, Chief Executive Officer & Director

Thanks Mike.

Good morning everyone and thank you for joining us today. As you will hear from our discussion this morning, we have a lot going on here at Armada Hoffler. As I mentioned during our last conference call, our company is built to thrive in a variety of macro-economic environments and the current backdrop is no exception. The growing economy has yielded increased opportunities in development, public-private partnerships, build to suit engagements, third party construction, mezzanine lending and tenant expansions. We believe these factors more than offset the impact of gradually rising interest rates.

Before we talk about our results, guidance and pipeline, I'd like to spend a few minutes on our business model. Many who follow our company have correctly pointed out, that we do not fit neatly into the standard REIT box. Certainly, with third-party construction profits, build to suit asset sales, and mezzanine interest income, our platform has a unique complexity that can't be measured wholly by traditional REIT metrics. These additional income streams are expected to continue their upward trajectory due to the ever-increasing volume of these types of opportunities coming our way.

That said, please do not overlook the positive trends in our operating property portfolio. While we are very proud of the growth in our NAV, normalized FFO and, of course, the annually increasing dividend over the past four years, it's important to note that our rental property NOI has nearly doubled over the past five years. We expect yet another double digit increases in property NOI next year as our development deliveries stabilize and the mature portfolio continues to excel. Although we will provide 2019 guidance early next year, preliminary forecasts indicate that it is shaping up to be a very strong year in all of our income producing areas.

This morning, we reported 24 cents of Normalized FFO per share for the third quarter. Same store NOI was positive across all product types on both a cash and GAAP basis. Occupancy was higher portfolio wide and now stands at 96%. Releasing spreads in the retail sector were quite a bit higher as well. As you know our retail portfolio is dominated by strong grocery anchors, home improvement stores, restaurants, entertainment, and discounters. We expect continued high occupancy, positive spreads, and strong sales performance in our centers over the coming quarters. Overall, across all property types, our stable portfolio continues to perform at a very high level.

As we announced earlier this month, we have reached an agreement to sell our at-cost purchase option to the developer of the multifamily project, The Residences at Annapolis Junction. As many of you saw in our previous press release, we are allowing the developer to refinance the project and extend the mezzanine loan. This will allow the project to achieve stabilization prior to the ultimate sale, enabling him to recognize the full value of the project. We expect the option payment to be received in the fourth quarter, however the 5 million dollars of profit will be recognized over the next four quarters. This effectively moves approximately 4.5 million dollars of FFO into 2019 and also gives us the opportunity to earn additional fees and interest. Overall, this change in profit recognition has caused our 2018 full year guidance to be updated to a dollar to a dollar three. Mike will give you the details on our updated guidance.

As we have said on many occasions, we expect the multi-family segment of our overall portfolio NOI to grow significantly over the next couple of years. The sale of our purchase option on this project should be viewed as a one-off opportunity that we chose to take advantage of, as opposed to any shift in overall strategy.

With over 60 million dollars raised year-to-date under the ATM program, the 5 million dollars of profit on the option sale, and the anticipated partial repayment of our mezzanine loan, we remain confident in the overall strength of our balance sheet. We continue to believe that the Company is well-positioned to execute on the opportunities in our development pipeline.

Starting with Town Center for the development updates, the Premier, previously referred to as Phase 6, is leasing very quickly inn both the retail and multifamily segments. Despite only being open since August, retail is leased or under letter of intent at 75% and multifamily at 50%. Also, the second floor performing arts theatre celebrated their grand opening bringing additional activity to this newest phase of town center.

Point Street apartments at Harbor Point continues its upward trajectory with no sign of slowing down and now stands at 82% leased. We are projecting stabilization in the first quarter of 2019 which is also the timeframe that we anticipate bringing the project on balance sheet through execution of our purchase option.

The office portion of City Center in Downtown Durham is complete and leased at nearly 90%, and the retail is leased or under letter of intent at 66%. We are in conversations with multiple tenants for the last few available spaces.

The Greenside apartments in Downtown Charlotte, formerly known as Harding Place, have begun delivery and stand at 31% leased. This project is ramping in line within our expectations.

Our 325,000 square foot Wills Wharf office development at Baltimore's inner harbor has started vertical construction and stands at nearly 60% pre-leased with several strong prospects interested in the additional space.

All other previously announced pipeline projects are on track for their scheduled 2019 deliveries.

This morning we announced our fourth project in the greater Charleston MSA, Nexton Square. This 45 million-dollar, open-air lifestyle center is expected to contain up to 148,000 square feet of the area's best restaurants, retailers, and service providers. Nexton Square sits at the entrance of a large master planned development of more than 10,000 homes. It is strategically located between the Boeing facility and the new Volvo assembly plant. The project is nearly 65% pre-leased or under Letter of intent with the first tenants opening in the second quarter of 2019. We will provide mezzanine financing as well as development and construction management. In addition, we will receive a below-market option to purchase the project upon completion, which we ultimately intend to exercise. Furthermore, the asset would be available as a candidate in a tax-free exchange in order to potentially cycle out of an older center.

Last quarter, we announced The Interlock, a partnership with Georgia Tech and SJ Collins to develop 300,000 square feet of office and retail space in West Midtown Atlanta. In addition, we are in negotiation with Terwilliger Pappas to be the investor and general contractor for the multifamily portion of this project, Solis Interlock. We expect this upscale product to contain approximately 350 apartment units with an anticipated completion in the fourth quarter of 2020. In addition to our construction company's participation in the project, we will provide approximately 20 million dollars of mezzanine financing. We expect to finalize negotiations with Terwilliger Pappas over the next few weeks and expect ground breaking on the entire Interlock complex in the current quarter.

We are currently working a few other opportunities to round out the current pipeline. These are exciting large CBD infill opportunities in Charleston, Charlotte and Nashville. This opportunity set is primarily weighted towards Class A office, followed by multifamily, with a small amount of ancillary retail. We hope to have further announcements regarding these projects in the not too distant future.

Despite this increase in development activity, be assured that we continue to be extremely selective with regard to the projects we pursue. The vast majority of the opportunities that present themselves do not meet our criteria and are quickly removed from consideration. Beyond the aforementioned opportunities, I would not expect any further significant development engagements until we open a number of our 2019 deliveries.

Our construction company continues to perform at a very high level. We expect to finish construction and close on the sale of the build to suit distribution center in the current quarter.

Our backlog of third-party contracts stands at 25 million dollars and we expect to execute another 80 to 100 million dollars of contracts this quarter which will leave this division in a very comfortable position looking forward to next year.

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 nearly forty years, and investors can count on this to remain our primary focus. As the company's largest equity holder, management will continue to operate a business model that includes a variety of deal structures as well as disposition of development projects, at cost options, and stable assets. We are extremely optimistic about the company's prospects for the rest of 2018 and 2019 as well as our ability to deliver on our promises over a multi-year timeframe. As we begin to look toward 2020 and the number of projects we intend to deliver and stabilize at that time, we feel strongly that our investors will recognize continued great value well into the future.

As we gauge the ultimate size and construction schedules of the pipeline projects, we will be evaluating further dispositions and use of the ATM as a part of a continuing strategy to maintain a strong balance sheet and grow NAV over the long term.

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

Michael P. O'Hara
Treasurer, Chief Financial Officer

Thanks Lou.
Today I want to cover the highlights of the quarter, thoughts on our balance sheet, and our updated 2018 guidance.

This morning, we reported FFO and Normalized FFO of 24 cents per share for the third quarter.

On October 4th, we issued a press release regarding the anticipated 5 million-dollar third quarter gain from the Annapolis Junction purchase option sale and its effect on our 2018 guidance. We anticipated the property being sold, our loan being paid off in full and recognizing a 5 million dollar gain during the third quarter. During the quarter, we agreed to allow our partner to refinance the project and extend the maturity of the mezzanine loan in order for him to realize the full potential value upon expected stabilization in 2019. In addition, we have the opportunity to earn additional fees and interest income. The expected restructured loan is for approximately 35 million dollars at 10 percent for 12 months. The loan includes two one-year extension options to coincide with the new senior loan. With the loan being restructured, instead of being paid off in full, the accounting of the 5 million dollar gain from the sale of the purchase option changes. The GAAP treatment of the 5 million dollar payment for the purchase option is now considered as part of the loan restructure, not a sale, therefore it will be recognized as interest income over the term of the new loan, which is 12 months. Assuming a mid-November closing, 5 hundred thousand of interest income will be recognized in 2018, with the remaining 4.5 million in 2019 prorated through October.

Now turning to our property portfolio. We are happy to report that our properties and development projects did not sustain any damage from the recent storms.
As we anticipated, Same store NOI continues to improve, with this being the second consecutive quarter being positive in all three property types. The negative impact on this metric from the Town Center relocations and construction activity is over.

Our core operating portfolio occupancy for the third quarter was 96 percent, with office at 94 percent, retail at 97 percent, and multifamily at 97 percent.

Additionally, our releasing spreads were positive 6.2% on cash and 7.8% on GAAP basis in the retail portfolio. There were no renewals in the office portfolio. All of these positive metrics are a reflection of the strength of our properties.

During the quarter, we closed on the Lexington, South Carolina Lowes Foods Shopping Center for 27 million dollars. This transaction is with a strategic partner who is taking back all of their equity in OP units which is consistent with our historic OP unit acquisition strategy.

On the construction front, we reported a segment gross profit in the third quarter of one million dollars on revenue of 20 million dollars.
At the end of the third quarter, the Company had a third-party construction backlog of 25 million dollars. As Lou said, we expect construction backlog to increase over the next few months.

Today we announced a new mezzanine loan, development project, Nexton Square, in Summerville, SC. This project is being structured utilizing our mezzanine loan structure which includes a below market purchase option. It is our intent is exercise this option upon completion. We are using this structure for two reasons. First, our involvement in the project was late in the process. The project began construction in the spring before we were involved. We preferred not to take development risk and have an ownership position in the project this late in the development process. And second, we have the optionality of using the property as a 1031 tax free exchange candidate for a future disposition.

As discussed, we are in final negotiations with the developers of the multi-family portion of the Interlock mixed use project in West Midtown Atlanta. We are partnering with Terwilliger Papas, who are long time multi-family developers. We will be using our mezzanine loan structure and will be the contractor of the project. At this time, we do not intend on purchasing this project and bringing it on balance sheet. In addition to substantial income from construction fees and mezzanine interest, our involvement allows us to manage the entire construction process and ensure timely completion of the 250-million-dollar Interlock project.

Now turning to our balance sheet.

Over the past quarter, we continued to take actions to enhance the flexibility of our balance sheet and work on loan maturities. We are making several moves to position the balance sheet for the new projects and future growth.

This past quarter, we raised 10.6 million dollars through our ATM program at an average price of $15.66 per share. We raised more than anticipated as we took advantage of the stock trading at or near all-time highs. Year to date we have raised 60.6 million dollars at an average share price of $14.33.

We anticipate receiving approximately 17 million dollars in November from the sale of our Annapolis Junction at-cost purchase option for 5 million dollars along with an approximate 12-million-dollar loan payment.

And lastly, we expect to continue our activity in the ATM program, assuming favorable market conditions. If not, we will pursue other sources of capital, including dispositions.

With the lengthy construction schedules of all these development projects, we have considerable time to access the necessary capital to maintain a strong balance sheet.

We've addressed all of the 2018 loan maturities. This past month, we closed on the last remaining loan of 2018, Lightfoot Marketplace. The new loan is for a 5-year term at a rate of LIBOR plus 175 basis points. We entered in a swap lock to fix LIBOR of the initial loan proceeds of 10.5 million at 3 percent for the five-year term.

At the end of the quarter, we had total outstanding debt of 661 million dollars including 102 million dollars outstanding under the 150-million-dollar revolving credit facility.

We continue to evaluate our exposure to higher interest rates and look for opportune times to hedge our interest rate exposure. At quarter end, 97 percent of our debt was either fixed or hedged. This quarter, we entered into a 53-million-dollar swap lock on the JHU Village loan and purchased a 2 year, 50 million dollar interest rate cap at 2.5 percent. Subsequent to quarter end, we entered into a 10.5 million swap lock on the Lightfoot marketplace loan.

Today we updated our 2018 full-year Normalized FFO guidance to a dollar to a dollar three per share, which is unchanged from the guidance in our October 4th press release. This includes the expected sale of the distribution center by the TRS. The distribution center is a construction project that evolved from our cross-selling platform. We intend to sell this asset before it is placed in service and include the profit in Normalized FFO. We included this expected gain from this sale in both the Construction Company gross profit and Normalized FFO guidance. This transaction will have an impact on Debt to EBITDA in 2018 as our balance sheet will carry the debt with no corresponding EBITDA. Because of the short-term nature of this project and associated debt, we did not issue any equity for this project.

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

First, starting with our assumptions:

- A gain of 2.9 to 3.3 million dollars from the sale of the distribution center in the fourth quarter.
- Additional activity in the ATM program, assuming favorable market conditions
- Interest expense is calculated based on the Forward LIBOR Curve which forecasts rates rising to 2.46 percent by year end.

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

- Total NOI in the 78.7 to 79.2 million-dollar range,
- Third party Construction Company gross profit in the 5.9 to 6.4 million-dollar range, which includes the expected profit from the sale of the distribution center.
- General and administrative expenses in the 10.8 to 11 million-dollar range.
- Interest income from our mezzanine financing program in the 10.1 to 10.5 million-dollar range. This includes 500,000 dollars from the amortization of the Annapolis Junction purchase option gain. As of quarter-end, the aggregate loan balance of these mezzanine loans was 99 million dollars.
- Interest expense in the 19.0 to 19.2 million-dollar range.

- And, 64.8 million weighted average shares outstanding.

Now I'll turn the call back to Lou.

Louis S. Haddad
President, Chief Executive Officer & Director

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 the week not in the best interest of the company. We are happy to take your questions on this issue or any other topic this morning. Operator we would like to begin the question and answer session.

QUESTION AND ANSWER SECTION

Operator:

Thank you. Ladies and gentlemen, if you have a question at this time, please press star, one on your telephone keypad. If your question has been answered and you wish to withdraw it, you may do so by pressing star, two. If you're using a speakerphone today, please pick up your handset before entering your request. Once again, that is star, one to register questions.

Our first question is coming from John Guinee of Stifel. Please go ahead.

John Guinee:

Great, thank you. Two questions. One is what do you anticipate your mezz loan balance to run in 2019, and second, can you talk a little bit more in depth about the cap ex associated with your retail leasing for 3Q18?

Louis Haddad:

Sure, thanks John. Good morning.

John Guinee:

Morning.

Louis Haddad:

With this past quarter's re-leasing, that represented about 37,000 square feet, and it was not a significant amount of cap ex involved in those. Those are primarily small shops. I don't think—we're not anticipating a whole lot in terms of rollover in the retail for the rest of the year. We do have some more significant rollovers next year that are going to require some pretty substantial tenant improvement investments, and that's primarily at Columbus Center, the two shopping centers here adjacent to Town Center, as well as some re-leasing in Town Center. But so far, it's been pretty light.

Michael O'Hara:

John, good morning. On the mezzanine program, we're expecting it to top out, I'm going to say in the $140 million range, but it's all going to depend on timing. Next year, like in the first quarter, we're expecting the Decatur Whole Foods Center loan to be paid off - I believe that opens next month, and also it's going to be around the timing of the ultimate payoff of the Annapolis Junction loan.

John Guinee:

Great. Just a little follow-up here, what it looks like is you're getting pretty healthy GAAP and cash spreads on your new leases - I'm assuming these are net rents but correct me - without spending much at all for TIs and leasing commissions, but you've got to come in to the tune of about $6 per square foot per year for new leases. Any idea as to what the expiring rents might be on the new leases you're signing versus the renewals?

Louis Haddad:

John, are you speaking…

John Guinee:

Retail.

Louis Haddad:

Retail, okay.

John Guinee:

Yes. Said another way is renewing your tenants seems like pretty good economics, but when you deal with a new lease, it seems like pretty challenging economics. You don't provide the old cash rents so you're not providing the mark to market, so we're looking for a little more detail on when you have to replace a tenant.

Michael O'Hara:

Yes John, on that, the first is on a renewal, one thing that depends on how the renewal comes about, and we don't have a leasing commission on a lot of our renewals. The other thing is as we've talked about, we have tenants who are doing well who don't need a lot of TI, especially in the—you know, they're happy with the space, you don't have to re-do anything. With new tenants, a lot of time it's the TI to get them up and going, which you've already paid for in the renewals.

John Guinee:

Any idea on the prior cash contractual rent on the new leases, i.e. is it a rent roll-up or a rent roll-down on your new leases, not your renewals?

Michael O'Hara:

Oh, on the new rate?

Louis Haddad:

Yes, it's typically higher, John. We haven't seen much compression, and I think the only exception to that would be in some of the nooks and crannies in Town Center, where we're after specific tenants basically to add to the mix. That would be about the only time that we would see rents contract, and that happens fairly regularly here at Town Center as we try to keep the mix as fresh as possible and add new offerings.

John Guinee:

Then the last question, Lou, you provided 2019 guidance of a very strong year. Can you elaborate?

Louis Haddad:

Well, as I said, we'll be providing guidance on the next conference call, but John, you've followed us for a while, as has several people on the phone. We've been saying for a year and a half that pointing to 2019 as the show-me year for this current pipeline that we are in the process of delivering, and that's—we plan on doing just that and all systems are go. You heard the updates on the deliveries and on the lease-up schedules, so I think the math is going to be pretty compelling and we're really looking forward to that call.

There are still a few pieces to put in place, a few leases to sign, and as I suggested, Mike and I really have a tough couple of weeks coming up with finalizing a couple of projects and loans, but we're looking forward to a very strong 2019 and I think even stronger 2020.

John Guinee:

Great, thank you.

Operator:

Thank you. Our next question is coming from Dave Rodgers of Baird. Please go ahead.

Dave Rodgers:

Good morning, guys. Lou, wanted to start off with the Nashville, Charleston and Charlotte projects - I think that's what you had mentioned in terms of Class A CBD office opportunities, correct me if I was wrong there. Two things around that. One would be, would you anticipate those being similar type mezz investments and what would be the peak—you said 140 is the peak, but what would be your kind of max that you'd be comfortable with in mezz? Then maybe a second broader question to that, just in terms of that pipeline, you said maybe nothing to be added to the pipeline after that. Is that just that things may be starting to quiet down, or that just takes you guys to capacity where you just don't feel comfortable adding anything else?

Louis Haddad:

Yes, it's—I'll start with that second question first. It's the latter. An easy way to get in trouble in this business is to get way out over your skis. The opportunities are accelerating, we're not seeing any slowdown in that; however, we've practiced discipline here for nearly 40 years and we really don't want to get further out than where either our balance sheet or our personnel will take us. We've got really strong development partners in the locations that we are discussing to round out the pipeline, but that's really the limit of our comfort level until we deliver some of the projects that we're talking about. We have three or deliveries in 2019 that I really want to see done successfully and executed well before we start shopping again.

Of course, you never say never. Something really compelling could come along, but the three projects that you mentioned, they would be a mix of projects that would be done on balance sheet as well as on the mezz side. We're comfortable where the mezz program is now. As Mike suggested, there's a lot that's going to get paid off or paid down here in the not too distant future, and remember these are large lengthy projects, so you have an awful lot of runway before these things ramp into any kind of significant dollars.

Dave Rodgers:

Okay, that's helpful. One of the other comments that you had made was about recycling out of an older center to help fund this. Can you start to give us an idea of maybe how much assets you're willing to sell and does that bottom portion of the portfolio get a little bit bigger as the development pipeline gets a little bit bigger, and how do you think about asset sales relative to what you've been doing?

Louis Haddad:

Sure. Actually, there's not much down there at the bottom. You've heard us talk about in years past how we may cycle out of the three Food Lions that we have. We also have a BI-LO center. Those projects are doing really well, those assets. Food Lion is actually gaining market share in our area, and so not sure that's going to happen; however, as you know, we do like to regularly go through that portfolio and recycle. That's why this Nexton opportunity that came up was perfect for us. We love lifestyle centers. We love Charleston, and there certainly will be something in our portfolio that we will be desirable—less desirable of, but I don't think you're looking at a change in strategy, Dave. It's going to be one-off at best in terms of dispositions.

Dave Rodgers:

Great, thanks guys.

Operator:

Thank you. Our next question is coming from Rob Stevenson of Janney Montgomery Scott. Please go ahead.

Rob Stevenson:

Good morning, guys. Lou, why do mezz on Interlock if you don't want to buy it or don't have a purchase option? What's the incentive for you guys to do mezz without a path to ownership?

Louis Haddad:

Essentially, it's a money making opportunity. We have an opportunity to take substantial interest above our cost of capital and still control things with our construction company, so we're looking at it as basically an income stream that's very healthy. It's not too dissimilar to the two Whole Foods that we're involved in right now, where those are going to trade far below our cost of capital. We expect Interlock will do the same thing, so we'd be more desirous of taking current profits as opposed to bringing something on balance sheet that is below our cost of capital.

Michael O'Hara:

The other thing on that, Rob, is on the first part that we talked about last time on the mixed use of office and retail, we do get participation and cash flow and a capital transaction on that over and above our mezz, so we will have some participation on that. As we've talked about before in these mezz projects, we love these projects and the reason we're involved, if these people defaulted, we'd love to own them for what we'd be in for them.

Rob Stevenson:

Okay. Then if I'm doing the math right on the supplemental, it looked like during the quarter about 56% of your AVR came from retail, and then if I take a look at the development pipeline, you've got the two Charleston multifamily projects that will come online next year and assuming that you guys will buy in the Point Street Apartments purchase option, but there's still a lot of retail coming behind that as well and any of this office looks like it's a 2020 or 2021 or beyond delivery. How comfortable are you in seeing retail ratchet up to north of 60% of AVR for some period of time here before other asset types come in to dilute it back down?

Michael O'Hara:

Rob, on the retail on the development side, there's not a lot of retail. We've got the Market at Mill Creek, which is a $23 million project, not a large one, and then just the retail piece here at Town Center. Outside of that on the office side, we've got the Brooks Crossing office coming online, which is obviously 100% office, and then we also have Greenside, Harding Place and Charlotte on the multifamily coming next year.

Louis Haddad:

Yes, we think that percentage is topped out, Rob; but to answer your question, whether it grows by a couple percentage or starts to go down significantly, like we believe it will, as I said earlier, we're very comfortable with that retail portfolio. It continues to perform, sales are strong, our grocers are strong. With 97% occupancy and re-leasing spreads as high as they are, we're very comfortable with what we own, and we intend on adding to it. We don't—I don't think it's going to add materially because we're not involved in large scale retail projects, but it is going to—we are going to add to that portfolio.

Rob Stevenson:

Okay, and then last one from me, when you sit here—in terms of the projects that you have underway and the stuff that you're looking to tee up over the next month or so, how should we be thinking about the general contracting company going forward? I mean, does that get bolstered by the continued expansion of mezz, something similar to what you're doing in Interlock? Does it retreat, does it maintain the current size going forward? How fast should we be thinking about the size and scope of the contractor business going forward?

Louis Haddad:

Sure, good question. Our company works best between $200 million and $300 million worth of work in any given year. I think we're going to hit that target, it's going to be in that range in 2019. What we don't know yet is the mix of third party versus in-house, and that mainly is going to revolve around a couple of big engagements that are coming up on both sides and there still being a chance that they don't come to pass. However, I think you can expect the construction company to be in the range that it was last year. This year was a little bit less in volume, kind of artificially lower based on the distribution center and the fact that that's all being recognized as gain on sale, as opposed to the fee income. But we're going to be in that same range that Mike has guided you to, we believe, for next year.

Rob Stevenson:

Okay, thanks guys.

Operator:

Thank you. Our next question is coming from Jim Lykins of DA Davidson. Please go ahead.

Jim Lykins:

Morning guys. Just a couple things from me. First of all, for Nexton Square, can you provide the rate on the mezz loan, and also when will that begin to impact FFO? Is that in 2018 guidance?

Michael O'Hara:

Jim, what—oh, Nexton? Okay. Yes, that's going to—we currently have a bridge loan that's at 10%. We're anticipating going into the full loan here and closing on that here in the next two weeks, and that's going to start at 15%, and then when they hit certain performance thresholds, it will drop to 10%.

Jim Lykins:

Okay. Also, for the acquisition in Columbia, can we get the cap rate for that one?

Louis Haddad:

It's in the high sixes, Jim.

Michael O'Hara:

Yes - 6.75.

Jim Lykins:

Okay, thanks guys.

Operator:

Thank you. Our next question is coming from Craig Kucera of B. Riley FBR. Please go ahead.

Craig Kucera:

Hey, good morning. I'd like to follow up on Nexton Square. You have an option to purchase below market. Can you walk us through how that agreement is constructed? Is that based on appraisal at the time of completion, or just some additional color how we should think about the spread of what you're buying versus what you think it's going to be worth, or anticipated worth.

Louis Haddad:

Yes, we've negotiated a purchase option based on a cap rate times an NOI that will be in place at the time and a spread between what we believe to be market and what that option is at is around 50 basis points. But mind you, in the interim we'll be collecting significant development and construction management fees as well as $2 million to $3 million worth of interest income, so inclusive of all that profit that will come our way, we still will be purchasing the project below market.

Craig Kucera:

Got it. Going to Lexington Square, appreciate that about 10% of the purchase price was paid in OP units, but can you tell us what the pricing was, or the number of units issued in that transaction?

Louis Haddad:

Fourteen-something, weren't they, Mike?

Michael O'Hara:

Yes, they were in the mid-14s.

Craig Kucera:

Got it.

Louis Haddad:

Those have been in place for quite a while.

Craig Kucera:

Right. Going to the construction business, I know earlier in the year you had anticipated that backlog was going to pick up, I think a little earlier than its sort of come together, and it sounds like you're quite busy here in the fourth quarter. Is that just really a function of just other things taking precedence, or did you have any potential deals that fell out of that pipeline? Just some additional color on maybe why that maybe slipped a quarter or so, or even two quarters from what we thought earlier in the year.

Louis Haddad:

Sure, and thanks for the question. Nothing has fallen out. Our expectation is that we're going to be—it's going to be a very robust backlog going into the first of the year, but what we're seeing the results of, and I would imagine you guys have heard this on a number of conference calls, it's very difficult to find labor, it's very difficult to confirm pricing. Schedules have elongated, and so the business is—we're proceeding very cautiously before we execute contracts.

The great thing about being in the development business, either working for other developers or working for ourselves, is that you have the time to set your cost pro formas before having to commit to tenants, and that's kind of where we are. Our construction company has been working the same projects that we had anticipated being under contract by now. They've been working them for several months but finalized hopefully in the next month or two. But, it's really a function of what's going on in the marketplace.

Craig Kucera:

Got it. Wanted to circle back to one of your retail tenants that has four leases - Bed Bath kind of had a tough quarter, they announced earlier this month. Can you give us some color on how you feel those stores are performing and any update on discussions you've had with them?

Louis Haddad:

Yes, that's interesting. We have a few people kind of in that same category, Bed Bath being one of them. Their business is still very healthy and in particular our centers are doing great. We understand that the center that we have here next to Town Center is one of their best performing stores in the state. We're watching that very closely from a couple of standpoints. One is Bed Bath is not a very strong rent payer - those are fairly below market deals, so it wouldn't be the worst thing in the world if we got some space back; but perhaps more importantly, we're looking for them to update their concept. They've got a tremendous amount of goodwill, a great name, and if they can just get going in a direction, we think they can probably turn it around. They may need to shrink their stores, but we're very much engaged in watching that process.

We've got the same—a similar situation with Barnes & Noble, who is in a couple of our centers. Again, they're working—they're a little bit further along, working a new concept that seems exciting and seems like it's going to be well received, and we're going to work with them here at Town Center and help them pull it off. But that environment is changing quickly, as everybody knows. We are—like I said, we're very happy with our retail portfolio. That doesn't mean that we're not vigilant and worried about various things that are happening in the marketplace, particularly in soft goods. There is a lot of winners and losers out there and you've got to be careful, but when you operate lifestyle centers, you're going to have tenants that come in and out of favor. That's why we get paid, is to stay on top of those sorts of things.

Craig Kucera:

Got it. One more from me. There seems to be rising concerns about global growth just due to higher interest rates and maybe another round of tariffs. It doesn't sound like you guys are seeing anything on the ground, but after going through a number of cycles, I guess what are the triggers, Lou, that you look at to sort of say, hey, we need to maybe start pulling back on development? I know you outlined you have three new potential—three new markets with new projects, but what are you looking for to say maybe hey, let's pull back and slow things down and just finish what we have?

Louis Haddad:

Sure. I'd tell you, for us the precursor is always a slowdown with our tenants. We've got a lot of architects, engineers, money managers, insurance companies and the like, and as you might imagine, all those people are on the front end of expansion in the economy. It gives us a good gauge of what's going on out there. That has been a great bellwether for us.

The second piece of that is remember we're not a large—on a relative basis, we're not a large company, and so we really can have a rifle approach to where we want to play and where we don't. When you do the types of public-private ventures, or ventures with well heeled tenants that we do, you're really not looking at a macroeconomic situation, you're looking at specific markets and more specifically even a specific sub-market where you can do a really good deal in really just about any kind of environment. The macroeconomics are important for our overall tenant expansions and our construction company and the like, but in terms of development opportunities short of something like the Great Recession, the opportunities in the good markets are there. Like I said before, we feel really strongly about Charlotte and Charleston and Nashville, Atlanta and the like.

Craig Kucera:

Okay, great. Thank you.

Louis Haddad:

All right. Okay, thank you ladies and gentlemen. We appreciate your interest in our Company. We look forward to updating you on our activities and results in the coming quarters, and we look forward to 2019 guidance. Take care.

Operator:

Ladies and gentlemen, thank you for your participation. This concludes today's teleconference. You may disconnect your lines at this time and have a wonderful day.