November 8, 2022

Armada Hoffler Properties, Inc. (AHH)

Q3 2022 Earnings Call

Operator

Good morning, and welcome to Armada Hoffler Properties Inc. Third Quarter 2022 Conference Call.

[Operator Instructions]

Please note this event is being recorded. I would now like to turn the conference over to Chelsea Forrest. Please go ahead.

Chelsea Forrest

Good morning, and thank you for joining Armada Hoffler's Third 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 third quarter earnings along with our quarterly supplemental package were distributed this morning. A replay of the call will be available shortly after the conclusion of the call through December 8, 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, November 8,2022, 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 the documents we have filed with or furnished to the SEC.

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

I'll now turn the call over to Lou.

Lou Haddad

Thanks, Chelsea. Since becoming public 9 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 benefits of these attributes become even more apparent in unsettled times. Although our business model might require a bit more analysis to fully grasp than the typical REIT, our results remain very clear and compelling.

Our third quarter earnings release is a further illustration of our inherent advantages versus our peers. After raising our guidance fora third consecutive quarter, our new midpoint of $1.19 per share represents an 11% increase over full year 2021 earnings, which has supported the 18% increase in the dividend this year. Although we are not ready to release guidance for next year, our expectation is for earnings and dividends to continue to rise in 2023.

This is wholly consistent with the data included in our initial guidance presentation from earlier this year, where we projected that NOI would increase by 45% over 2021 levels over the next few years as our developments stabilize. With 2 multifamily development deliveries this year, a large mixed-use development expected to enter service next year and the expected 2024 deliveries of the T. Rowe Price global headquarters and 300 more luxury apartment units, we are right on track with that forecast.

The rapid lease-up of our development deliveries and stellar performance in third-party construction are important factors in our steadily increasing results. However, the largest source of the upward trajectory has been the continued high occupancy and rent growth in our stabilized properties. These increases are primarily due to the sustained upward trend in virtually every leasing metric across our diversified portfolio, over already with robust levels.

Continued increases in same-store NOI, commercial re-leasing spreads and high single-digit apartment trade-outs have become the norm for 2022. We believe that this is a result of our continued emphasis on A+ properties in each of our asset classes. When you have prime properties amongst limited peer competition, you have the ability to sustain premium rents through essentially any macroeconomic background.

Taking advantage of a flight to quality has always been central to our strategy. We believe the type of assets we own, be they office, retail or multifamily, will outperform the competitive set through almost any business cycle. What we've seen over the last 4decades remains true today. High-quality facilities in mixed-use environments located in desirable submarkets stand the test of time. 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.

To that end, I'll reference our 2 most recent press releases. First, you'll recall that last quarter, we reported that we expected another high credit lease to replace the soon-to-be vacated Johns Hopkins space at Thames Street Wharf at Harbor Point. Yesterday, we announced that Morgan Stanley has leased the entire 46,000 square feet. Perhaps more importantly, they've extended the term on their initial 195,000 square feet to 2035. With the recent addition of Morgan Stanley's Wealth Management Group and 35,000 square feet in our adjacent Wills Wharf building, Morgan Stanley will have a presence of over 275,000 square feet at Harbor Point, well into the next decade at a minimum.

This commitment combined with the long-term leases of the corporate headquarters of Constellation Energy Group, T. Rowe Price's global headquarters, Transamerica, RBC, EY and many others, should validate to all our years' old belief that Harbor Point is atop destination for Class A companies between D.C. and Philadelphia. These trophy office buildings complemented by what will ultimately be nearly 1,000 luxury apartments and some specialty retail, all surrounding a 5-acre waterfront park, make Harbor Point the premier destination for the top demographic in each of its asset classes.

The story at the Town Center of Virginia Beach is much the same. With occupancy across retail, office and multifamily in the high 90s, our asset management team began working on the few potential vacancies expected to occur over the next couple of years. Although the existing Hampton University space is leased through 2023, we negotiated a buyout and signed a new lease for 18,000square feet with Old Dominion University to locate their School of Data Science and Cyber at Town Center. This adds a new source of patrons to the wide variety of apartment residences and entertainment retail in the complex. These assets collectively continue to be the top destination in the entire 1.8-million-person MSA.

As I said repeatedly, the competition for space in our trophy office properties is very robust. We realized that the demand for – 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 retail portfolio tells much the same story. As most of you know, retail is the largest component of our asset base and grocery-anchored shopping centers make up the majority of that sector's NOI. With occupancy at an all-time high, robust re-leasing spreads and same-store NOI growth, we anticipate very little turnover and increasing revenues for the foreseeable future.

Some of you have inquired about the status of our 2 Regal Cinema properties. Please remember that both of these properties sit on what we consider to be prime multifamily acreage, one adjacent to Town Center, the other in the heart of Downtown Harrisonburg. That said, Regal continues to operate the theaters and is not interested in relinquishing either property at this time, nor do we have any interest in renegotiating rental rates. We will keep you posted of any new developments on either of these properties.

The multifamily sector continues to perform at a very high level with sustained high occupancy and apartment trade-outs and same-store NOI in the high single digits. Most exciting in this area is the delivery of our Chronicle Mill apartments in the Charlotte area market. Although delivery of the first units occurred only last month, the property is already nearly 70% leased as of yesterday.

Although the pace of apartment leasing traditionally slows over the winter season, we expect the properties to still stabilize during the first quarter of 2023. In our last report, we told you that our Gainesville development in the greater Atlanta area was the fastest multifamily lease-up in our history at just under 7 months. Chronicle Mill may well eclipse that record.

On the construction front, we continue to realize record profits and expect this division to produce its best year ever in 2022. And with over $525 million in third-party contract backlog, we expect this trend

to continue through the entirety of 2023. While third-party construction profits continue to grow, the percentage of earnings attributable to fee income will continue to diminish relative to portfolio NOI.

With respect to the Interlock project in West Midtown Atlanta, we are now projecting our loan to be outstanding well into next year given the current unsettled capital markets. As I mentioned earlier, this property is over 90% leased and cash flowing handsomely with our priority position, which requires all net income to be applied to our loan balance, we are happy to remain patient until the environment is more favorable for our partners to transact at a meaningful profit.

Alternatively, should the opportunity ever arise to acquire this trophy property at a significant discount, we remain favorably disposed to that option. Earlier in this year, we told you that in light of the continued undervaluation in our share price, we have decided to sell a few noncore assets to fund the remaining equity required for our active development pipeline.

Those transactions achieved a blended 4.1% cap rate and yielded gross proceeds of $177 million. 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 this year and beyond. The low-cost funds from the dispositions largely satisfy the remaining equity needs for our developments. Collectively, the projected return on cost of the new assets in development 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.

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 on to 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 virtually100% fixed or hedged has been a trademark of Armada Hoffler for many years.

As Matt will detail later in the call, we expect our net interest expense to be largely unaffected by rising rates through 2023. This is due to the fixed rate long-term debt on many properties as well as the protection afforded by our hedging instruments, which effectively kept the expense on our floating rate loans until the latter half of 2024.

This action, along with strong top line growth and strategic debt pay-downs, go a long way to assuring the upward trajectory of our earnings continues. Across all operations in our business model, our team continues to produce at an extremely high level. We have come to expect nothing less than these great people and we look forward to continued success in 2023 and beyond.

And now I'll turn the call over to Matt.

Matthew Barnes-Smith

Good morning, and thank you, Lou. It is a pleasure to be here this morning to once again report on another strong quarter of performance.

For the third quarter of 2022, we reported FFO of $0.26 per diluted share and normalized FFO of $0.29 per diluted share, in line with our expectations. For another consecutive quarter, we produced a robust set of operating metrics across our portfolio, resulting in an increase to our guidance range now with normalized FFO at $1.18 to $1.20 per diluted share. This represents an 11% increase over2021 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.

Starting with our operational metrics. I'm pleased to report the stabilized operating property occupancy once again came in above97% at 97.1% this quarter. The combination of our strong asset management team's lease-up efforts, coupled with high-quality trophy assets located in strategically select submarkets, continues to produce winning results.

The standout segment this quarter is our retail portfolio at 98% occupied. Portfolio-wide same-store NOI was up 3% for the quarter on a GAAP basis and 2.7% on a cash basis with our multifamily segment posting 6.5% and 7% growth in GAAP and cash same-store NOI, respectively.

Our commercial re-leasing spreads continue to remain strong with the retail segment at 10.7% and the office segment at 3.3% on a GAAP basis. Leasing activity continues to outperform expectations across all our property types. Lou discussed our fantastic news with respect to Morgan Stanley at our Thames Street Wharf property.

Inclusive of this significant lease, our asset management team has executed nearly 1 million square feet of renewals and new leases since the beginning of the year. To put this into perspective, at historically high occupancy levels, we are continuing to maximize our market exposure and surpass all of the leasing objectives we set for ourselves at the beginning of the year.

In the multifamily segment, we are seeing new lease trade-out metrics at nearly 9%. High re-leasing 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 a high NOI growth statistics.

Last quarter, I spoke about how our operational performance needs to be supported with sound fiscal management. And I'm pleased to report that we have started to implement and execute our fiscal strategy with great success. Working with our diverse lender base, we closed on our credit facility recast in August, increasing both our term loan and revolving credit facility by approximately $100million each. Purposely going to market 18 months early to ensure that we secure the most optimized terms, we were able to maintain our favorable pricing whilst extending the revolver and the term portions of the facility out to 2027 and 2028, respectively.

The additional flexibility and liquidity allows us to both be mindful of the current environment and also take a meaningful step in our transition to an unsecured balance sheet.

For the third quarter of 2022, our stabilized portfolio debt-to-EBITDA leverage reduced to 4.9x. This reduction is a result of the continued implementation of our overarching financing plan to deploy capital

in the most optimized way. In August, as stated earlier this year, we paid off our last 2022 maturity, adding the Hilltop Marketplace to our unencumbered asset pool. You will all recall that this is a third asset this year we have paid off at maturity.

As noted earlier and at length last quarter, our long-range financing strategy is to surgically over time move to a more unsecured balance sheet. Continuing on this part, we are currently working with our preferred lenders to advance another unsecured term loan of $125 million with an accordion feature rising to $200 million. We expect this 51-month unsecured loan to close at the end of November and be utilized to convert our secured construction debt on the Wills Wharf asset and secure construction debt on our Chronicle Mill asset to unsecured funds and leaner pricing.

We will also look to transfer a couple of our higher interest rates, smaller properties to this term loan, therefore, further reducing our cost of debt.

For the third quarter, our weighted average cost of debt was 2.9%, illustrating the success in maintaining that our debt is 100%fixed or hedged and reducing the risk of uncertainty in this rising interest rate economic cycle. Assuming the full yield curve stays reasonably consistent with the current projection, our expectation is that our weighted average cost of debt will be below 4% for 2023.

We are also looking to close our final refinancing of the year later this month with a $30 million loan to the Gainesville apartments priced significantly below the construction [note]. As indicated on last quarter's earnings call, we have now not only taken care of all of our 2022 debt maturities but with the recast of the primary credit facility and the closing of our new unsecured term loan, we have also taken care of all of our expirations through the end of 2023.

This coupled with ensuring that we are able to self-fund our development pipeline sets the organization up with a sound financial infrastructure to perform well through the potential market downturn with enhanced flexibility and liquidity for when opportunistic acquisitions or developments present themselves.

As you all heard, for the third straight quarter, operational excellence continues to be an Armada Hoffler key competency and our better-than-expected performance is anticipated to continue throughout the remainder of the fiscal year. This is reflected by the increase in our guidance range.

The strength and speed of lease-up in our Gainesville and Chronicle Mill multifamily assets coupled with our high occupancy, continued expense management, strong re-leasing spreads and better-than-expected performance in our third-party construction pipeline are the main drivers of this projected increase. For the specific assumptions affecting our guidance range, please turn to Page5 of our supplemental package, which is available on our website.

Our results and the execution of our financial strategy 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 foundation for future value creation that will be harvested in the years to come.

Operator, we are now ready for the question-and-answer session.

Q&A Session

[Operator Instructions]

The first question comes from Dave Rodgers with Baird.

Dave Rogers

Lou, I just wanted to ask from a high-level perspective, you're obviously not seeing it in your results to this point. But as you have discussions with customers and tenants across the board, are you seeing any or do you anticipate seeing any impacts from the tighter credit markets overall just from an operational standpoint?

Lou Haddad

David, we're not seeing much there at this point. More what's on people's minds is getting more employees, both on the office side and in particular on the restaurant side. That seems to be the order of the day. Right now, people are able to move prices in accordance with their input costs. And we're just not seeing any signs of that letting up.

Dave Rogers

Okay. That's helpful. I appreciate that. Then maybe shifting to the investment sales market. I know you've got -- it looks like an acquisition set up for the fourth quarter. But maybe more broadly, especially in apartments and retail, can you talk about the investment sales activity that you're seeing broadly in the market and what you might be seeing in terms of pricing and cap rates over the course of the year?

Lou Haddad

Sure. Well, as you might expect, the velocity of sales has slowed meaningfully. We're seeing some deterioration in cap rates, which frankly is welcome. It puts us more in play for being able to afford the types of properties that we'd like to acquire. I think as rates continue to rise, you'll see particularly on the retail side, cap rates starting to move materially. They've already moved fairly materially on multifamily.

As I said earlier, we sold the Annapolis Junction property at a 4.1% cap rate on trailing 12-month NOI. I doubt we could achieve that today. And with our multifamily partners, what we're hearing is 6 months ago, we were looking at sub-4 cap rates and now they're lucky to get sub-5. So I think things are normalizing in that side of the business.

Dave Rogers

Okay. And in the retail side, you said you anticipated them to move more aggressively maybe in the future. You haven't seen as much of that to date?

Lou Haddad

I haven't seen much yet but I'm sure we will. Again, we've kind of -- we've seen this movie before a few times over the decades. The-- as you know, we're strongest in grocery-anchored shopping centers. Those are dominated by the long-term lease on the grocer and those are historically very flat.

And so you already -- you have an underpinning there of a not rapidly increasing NOI. And so when rates go like they're going, naturally cap rates have to widen. And I think the opportunity is going to be there to pick up some really high-quality properties at a cap rate that's 100 to 150 basis points higher than what it was just at the beginning of the year.

Dave Rogers

Great. Last one for me. On the Interlock, it sounds like you've got good cash flow coverage on your loan. Is there a construction loan that would be senior to you or any type of capital event before the sale that from a timing perspective that you're watching, or we should be watching?

Lou Haddad

Yes, we're watching -- there is a construction loan. It's got a couple of years of extension that the sponsor can achieve by achieving a debt service coverage that's commensurate with the loan. So, our loan follows that construction loan. So, assuming they meet that coverage middle of next year, they could stay another year.

I don't believe that is their intent. They would really like to transact in 2023. We certainly agreed with their decision not to fully market the facility right now. As you know, it's just not a great time for people to deploy a lot of capital.

Operator

Our next question comes from Rob Stevenson with Janney.

Rob Stevenson

Lou, a follow up on Dave's question. Can you tell me when pricing was determined on the $26 million retail center acquisition? Was that before the big upward move in cap rates or after? And how you evaluate it, buying this asset versus potentially buying back your stock at $10, $11 and paying off some debt?

Lou Haddad

Sure. That acquisition was locked in after cap rates have moved somewhat. We've got a cap rate in the high 7s on that acquisition. And when -- we're not quite ready to announce it but you'll see it makes perfect sense for the grocery-anchored that we like to see as well as the proximity to other assets in the area.

That -- we're typically -- we're not going to be a buyer of our stock. This is a growing concern that has all the opportunities in the world to add to NOI. So the short-term boost that you might get through shrinking the company is not in keeping with our long-term strategy.

So we're always going to look for accretive acquisitions as well as development. And with Matt having the balance sheet in its shape ever, having all the liquidity we need to fully fund what we have going on. We're going to sit back and wait and watch as opportunities come our way. It's going to be a wonderful time to be a buyer as well as a developer once a little bit more pain is present in the market.

Rob Stevenson

Okay. And then with the Annapolis Junction sale, where are you today in terms of the retail office, multifamily NOI breakdown? And where does that go when the current development pipeline stabilizes now?

Lou Haddad

It's still pretty consistent with our original guidance from February. If you want to pull that out, we can send it to you. But you're going to round out around 40% retail and 35% or so office and whatever the remainder, 25% in multifamily, the big ticket there being T. Rowe Price coming online.

Rob Stevenson

Okay. And then did Regal miss any payments with the parent's bankruptcy filing? And do they owe you any deferred rent still?

Lou Haddad

They still owe us deferred rent from the pandemic, which they have been paying steadily down. And our expectation is that they will continue. I don't believe there was ever a missed payment. There was a pause when they were getting approval from the bankruptcy court. But we're -- I don't believe we've missed any payments and they continue to make good on their lease.

And we'll see what happens in the future. As we said for the last 1.5 years, we're somewhat anxious to get those properties back because it's a great time to launch multifamily projects in those 2 markets. At the same time, they have leases and they're willing to honor them. So we'll sit tight.

Rob Stevenson

Okay. And then last one for me. Matt, the guidance range for fourth quarter is implied \$0.31 to \$0.33 versus \$0.29 in the third quarter that you did. You listed a few things that were driving that. What are the 1 or 2 biggest things that are going to be responsible for that \$0.02 to \$0.04 sequential jump, especially given the sale of Annapolis Junction?

Matthew Barnes-Smith

Yes. Rob, the 2 bigger ones are the interest income from the Interlock asset not being sold this year. So, we continue to clip that as through the end of the year. Also, the acquisition of the Pembroke grocery-anchored retail asset that closed last Friday was another slight tick up there.

Lou Haddad

It's also going to be a stronger construction quarter for the fourth quarter. Yes. One other thing, Rob, remember, we've delivered 2 multifamily properties this year. And there's not a full year of having that income in. And so, the trend is going to continue to be upwards and then, of course, next year be a full year.

Operator

Next question comes from Camille Bonnel with Bank of America.

Camille Bonnel

Only one question for me. You mentioned expense management being a key focus going forward. Just looking at your same-store NOI, it seems like much of the cost growth was driven by higher real estate taxes particularly within your multifamily portfolio. Were there any regions driving this increase? And how should we be thinking about this heading into 2022?

Matthew Barnes-Smith

Yes, certainly. So there was a reassessment of real estate taxes in the Baltimore area. So some of that is due to timing. Some of that is due to -- as those assets in the Harbor Point development come online. We are working with the local authorities. Our asset management team is doing a great job to kind of make sure those assessments are coming in on track and they are built in – the additional increases are built into our guidance going forward. But we often see those developments come online, an increase in those real estate taxes when those assets are reassessed.

Operator

This concludes our question-and-answer session. I would like to turn the conference back over to Lou Haddad for any closing remarks.

Lou Haddad

Thanks very much. I appreciate everybody tuning in this morning. Our expectation is to have more news out between now and the end of the year. And we look forward to a very successful 2023 as well. Thanks for your attention, and we'll talk to you soon. Take care.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.