

Transcript of
Washington REIT
Second Quarter 2019 Earnings Conference Call
July 26, 2019

Participants

Tejal Engman - Vice President, Investor Relations
Paul McDermott - Chairman, President & Chief Executive Officer
Stephen Riffie - Executive Vice President & Chief Financial Officer

Analysts

Bill Crow – Raymond James
John Guinee – Stifel
Blaine Heck - Wells Fargo
Daniel Ismail – Green Street Advisors
Christopher Lucas - Capital One Securities
Dave Rodgers – R.W. Baird

Presentation

Operator

Welcome to the Washington Real Estate Investment Trust second quarter 2019 earnings conference call. As a reminder, today's call is being recorded. Before turning over the call to the company's President and Chief Executive Officer, Paul McDermott, Tejal Engman, Vice President of Investor Relations will provide some introductory information. Ms. Engman, please go ahead.

Tejal Engman – Vice President of Investor Relations

Thank you and good morning everyone. Please note that our conference call today will contain financial measures, such as FFO, core FFO, NOI, Core FAD and adjusted EBITDA that are non-GAAP measures as defined in Reg G. Please refer to our most recent financial supplement and to our earnings press release, both available on the Investor page of our website, and to our periodic reports furnished or filed with the SEC, for definitions and further information regarding our use of these non-GAAP financial measures, and a reconciliation of them to our GAAP results.

Please also note that some statements during this call are forward-looking statements within the Private Securities Litigation Reform Act. Forward-looking statements in the earnings press release, along with our remarks, are made as of today, and we undertake no duty to update them as actual events unfold. Such statements involve known and unknown risks, uncertainties, and other factors that may cause actual results to differ materially. We refer to certain of these risks in our SEC filings. Please refer to pages 8 – 25 of our Form 10-K for our complete risk factor disclosure.

Participating in today's call with me will be Paul McDermott, President and Chief Executive Officer, Steve Riffie, Executive Vice President and Chief Financial Officer, Amy Hopkins, who will take over as Vice President, Investor Relations following this call and Drew Hammond, Vice President Chief Accounting Officer and Treasurer. Now, I'd like to turn the call over to Paul.

Paul McDermott – President & Chief Executive Officer

Thank you Tejal and good morning everyone. Thanks for joining us on our second quarter 2019 earnings conference call.

Introduction: We are pleased to have delivered Core FFO of \$0.47 per diluted share this quarter. Our second-quarter performance has exceeded consensus and our own expectations and has enabled us to raise the mid-point of our 2019 guidance range by \$0.01 per diluted share. Steve will explain our quarterly outperformance and the changes to our guidance in his remarks. I would like to focus on the three key drivers of our near and long term business performance. The first is the execution of our 2019 strategic capital allocation plan, which significantly grows our multifamily exposure while reducing our exposure to the riskier commercial assets in our portfolio. The second is the continued strengthening of our multifamily portfolio and WashREIT's ability to capitalize on growing regional demand for value-oriented multifamily product. And third is creating greater visibility on our NOI and FAD growth trajectories through office leasing, multifamily rent growth and the delivery of the Trove multifamily development, all of which will continue to grow WashREIT's net asset value.

Progress on 2019 Strategic Capital Allocation Plan: Beginning with our 2019 Strategic Capital Allocation Plan, we successfully executed the largest components of our plan in the second quarter. We closed on the acquisition of the Assembly multifamily portfolio, comprising 2,113 units, for \$461 million and completed the transaction in two tranches, as planned. We closed on the Northern Virginia tranche, comprising 1,685 units, on April 30, and the Maryland tranche, comprising 428 units, on June 27. We also closed on the acquisition of Cascade at Landmark Apartments in Alexandria, VA for approximately \$70 million on July 23. On the dispositions front, we closed on the sale of Quantico for gross proceeds of \$33 million on June 26 and on the sale of the five retail shopping centers for gross proceeds of \$485 million on July 23. To date, we have acquired \$531 million of multifamily assets and sold \$518 million of commercial assets, thereby completing the largest volume of asset recycling in WashREIT's recent history.

Regarding the sales of our power centers, we remain under contract to sell Frederick Crossing and Frederick County Square in Frederick, MD in the third quarter. Center at Hagerstown in Hagerstown, MD is under LOI with a separate buyer and is expected to close in the third quarter as well. Finally, we continue to expect to complete the sale of another \$125 to \$175 million of commercial assets close to year end.

Transformation through planned 2019 Strategic Capital Allocation Plan: We expect our 2019 Strategic Capital Allocation Plan to be transformative for WashREIT and are excited about scaling our multifamily portfolio to build a sustainable and stable long-term NOI growth trajectory. We have grown our multifamily unit count by approximately 56% making multifamily our largest asset class in terms of number of properties owned. We expect multifamily to contribute 46% of our overall NOI on a second-quarter proforma basis and to be our biggest NOI contributor when we add the Trove's expected stabilized NOI contribution to that pro forma.

Multifamily is also expected to remain our strongest and most stable business segment. We are raising our same-store multifamily guidance for the second time this year and now expect our same-store multifamily portfolio to grow NOI by 4.25% to 4.75% on a year-over-year basis in 2019, after delivering 3.3% same-store NOI growth in 2018 and 3.6% in 2017. Multifamily demand for both Class B and A product remains very strong and for the first time in nearly two years, total absorption across the metro area has surpassed 10,000 units, with all three geographic areas absorbing over 3,000 units, according to Delta Associates. Multifamily occupancy remains steady in the mid-90s, allowing us to continue to push rents and optimize NOI growth through our daily pricing and asset management focus. Our multifamily leasing and recurring capital expenditures to NOI ratio rate is significantly lower than both office and retail at approximately 7% on a five-year-historical average basis, and tracking 5% year-to-date.

We are strengthening our NOI growth prospects by allocating more capital to multifamily and are reducing risks to future NOI growth and cash flows by selling our power centers. Following this sale, we expect to significantly reduce our retail NOI 'at risk', which we define as the NOI derived from in-place leases with a 50% or lower probability of renewal in 2019 and 2020. Finally, the completed and planned retail sales reduce our embedded

capital gains in the retail portfolio by approximately \$350 million and allow for more flexible and manageable capital allocation in the future.

Multifamily strategy: Moving on to multifamily, we have grown our portfolio by acquiring value-add Class B assets in submarkets with solid rent growth potential, both in suburban and urban in-fill locations. Class B multifamily in the DC Metro region is generally defined as product built between 1970 and the mid-1990s that caters to renter households earning between \$50,000 to \$80,000 per year. This demographic comprises the largest pool of market rate renters in the DC Metro region who, at a 30% monthly outlay, can afford average monthly rents between \$1,250 and \$2,000. Today, 90% of our multifamily units are Class B with average rents that range between \$1,500 in the Assembly portfolio to the upper \$1,600s for our same-store Class B assets. The average rent to household income ratio for our Class B multifamily portfolio is 26%, which creates runway for future rent growth. Urban in-fill Class B assets have unit sizes that are nearly 10% larger on average than Class A assets with some being covered land plays as they are located on large plots of land with excess surface parking that can be entitled for additional density, which creates more value for the asset.

In urban in-fill areas, Class B units provide renters with a high-quality option that is typically \$300 to \$600 cheaper to rent on a monthly basis than Class A. This spread is not only wide enough to preserve strong demand for Class B multifamily through periods of elevated Class A multifamily supply, but it also allows for value-add Class B renovations. Over the past five years, Class B net effective rent CAGR has outperformed that of Class A by approximately 70 basis points in the DC Metro region despite elevated and even record-setting levels of new Class A supply during that period. This is because the rents for new Class A supply are well beyond the reach of the Class B renter. In the 1970s and '80s the share of all apartments that were affordable to median income renters and were no more than five years old ranged between 10% to 20%. In the 1990s and 2000s, that share fell to 3.1%. In the current decade, it has slipped further to only 1.8% according to Yardi and National Multifamily Housing Council data. The bottom line is that it is no longer financially viable to build apartments for the middle market. Therefore, increases in Class A supply aren't impacting Class B multifamily fundamentals.

In the DC Metro suburbs, Class B suburban rents are 22% below Class B urban-infill rents on average, unit sizes are 15% larger and public schools generally rank better than they do in urban centers. Furthermore, DC Metro suburbs are expected to capture 73% of regional household growth over the next five years, according to ESRI data. Suburban Class B multifamily also offers an attractive alternative to home ownership. The Assembly portfolio offers average monthly rents that are approximately \$900 less than the estimated average monthly mortgage payment for a home in those suburban markets. Moreover, in the Assembly portfolio's suburbs, the average down payment requirement is approximately \$80,000, which is well in excess of average millennial savings of \$9,000. This lack of housing affordability is expected to remain an issue in the DC Metro area where the cost of home ownership is rising even faster than the cost of renting. On a three-year cumulative basis, the cost to own has risen 17%, while the cost to rent has increased 13.5%, according to Yardi data.

Multifamily acquisition: Moving on to our latest multifamily acquisition, Cascade at Landmark Apartments is a 277 unit, high-rise Class B apartment community located in the Landmark area of Alexandria, VA. We acquired Cascade at an approximately 30% discount to replacement cost and sourced the deal through our strategic relationships with key multifamily players in the DC Metro region. Cascade is a 10-minute drive from Amazon HQ2 and is also in close proximity to other major employers including the Department of Defense's Mark Center, Inova Alexandria Hospital and the Pentagon. As a result of its strong employment drivers, Alexandria's population has grown by 15.3% over the past eight years compared to 6.2% nationally, according to East Dil data, and is projected to continue to outpace national growth over the next five years. We believe there is scope to renovate approximately 60% of the units at this asset and to generate a double-digit average return on cost.

Multifamily NOI growth strategy: One of the most frequently asked questions on a recent non-deal-roadshow was regarding our potential to further grow our multifamily portfolio. We expect to grow our multifamily portfolio's contribution to NOI in three ways. The first is by organic growth. Year-to-date, we have grown average rents by 2.5% and renewal tradeouts by 4.1% with growth in both metrics at all of our same-store multifamily assets. New lease tradeouts have grown at all but two same-store assets on a year-to-date basis and average unit occupancy has also grown on a year-over-year basis. As a result, we have achieved revenue-led NOI growth despite deliveries of 11,000 new units in the DC Metro region over the past 12 months, according to Delta Associates.

Our rent growth is partly due to the fact that WashREIT's multifamily portfolio is relatively insulated from the competition posed by new multifamily supply, the majority of which has been concentrated in Washington, DC and is Class A with rents that are at the very top of the market. Approximately 80% of our overall units are located in Northern Virginia and 90% are Class B.

Moreover, we have unit renovation-led value-creation opportunities embedded in 50% of our total portfolio, or approximately 3,300 units. When harvested, we expect these to generate a minimum return on cost in the low double digits, with renovations at Riverside, The Wellington, 3801 Connecticut and Kenmore generating a mid-teen average return.

The second path to multifamily growth is through acquisitions. While we do not expect to complete any additional acquisitions this year, we do have a healthy pipeline of multifamily deals that we continue to underwrite. Under this management team, WashREIT has already acquired 4,322 new multifamily units in our region and has established an execution track record as well as the key strategic relationships that offer access to future value-add opportunities.

Finally, our third path to growing the multifamily portfolio is through development. While the Trove is the only development project that is currently under construction onsite at The Wellington, we have additional Class B assets that are covered land plays. We own and control the land at these assets and have approved entitlements to add on-site density. Riverside Apartments, for example, is located on 28 acres of land and is now entitled to add another 767 new units onsite. While we continue to evaluate the current economics of ground-up development, we would note that the financing environment for multifamily development in the DC Metro region remains favorable and provides us the opportunity to unlock embedded development value at a desirable return and fee structure for a relatively small capital investment.

Office: Turning now to the factors that will create greater visibility into our future NOI and FAD growth, we expect Watergate 600 to be the biggest positive office NOI growth contributor in 2020, on a year-over-year basis. We expect rent to commence on the top two floors of that asset by the first quarter of 2020. Other large 2019 lease expirations at 1227 25th Street, 1220 19th Street and Arlington Tower are expected to rent commence during the second half of 2020 and to be weighted toward the back-end of the year. For these three assets, we currently have a leasing pipeline of prospects totaling approximately 386,000 SF, which is approximately 2.5x the 155,000 SF of current and upcoming availability at these three properties.

Space+ update: As some of the available space at these three assets will be a part of Space+, our flexible office space offering, let me provide a brief update on the Space+ program overall. We continue to see growth in demand for high quality, flexible office space in our region, particularly among technology companies. We finished the first half of 2019 with approximately 54,000 SF of delivered Space+ spaces, which are located in 21 spaces across seven buildings. The delivered square footage is currently approximately 75% leased. In the first half of 2019, the Space+ program experienced an average of 97 days or 3.2 months of downtime until new lease commencement. We have another 107,000 SF across 25 spaces in the Space+ program, with approximately 75% expected to be delivered by year end.

Turning to our 2020 office lease expirations, the World Bank lease, which expires on December 31, 2020, makes up 210,000 SF or nearly 50% of the 430,000 SF of office leases expiring next year. The World Bank has accepted our term sheet and we are now under LOI and in negotiations.

Other NOI growth drivers: The Trove multifamily development is another key NOI growth driver in 2020 and beyond. Phase I of the Trove comprises 203 units and starts to deliver at the end of this year. We expect the Trove to contribute approximately \$800,000 of NOI in full year 2020 and over \$6 million in 2021. Finally, we expect continued strength in our same-store and our non-same-store multifamily portfolios through continued base rent growth that will be further augmented by value-add unit renovations across the multifamily portfolio.

As we strengthen WashREIT's portfolio and long-term NOI growth, our region is also strengthening its long-term growth profile. Amazon is expected to create approximately 2,400 new jobs on average, per year, for the next 15 years with a multiplier effect from indirect and induced job growth that could potentially be in the tens of thousands, according to NKF data. Approximately 60% of our overall multifamily units are within a 35-minute public transit commute to HQ2, which is likely to positively impact our overall Northern Virginia multifamily and office portfolios. Our portfolio is well positioned to capitalize on the other tech and professional and business service companies that are attracted to the DC Metro region due to Amazon's presence. Furthermore, we expect DC Metro real estate fundamentals to benefit from the domestic in-migration that is likely to result from the billions of dollars that the Commonwealth of Virginia, Virginia Tech and George Mason University are collectively investing to build and grow the tech talent in our region. With that, I would like to turn the call over to Steve to discuss our financial and operational performance in the second quarter and our updated 2019 guidance.

Steve Riffie – Senior Vice President & Chief Financial Officer

Thanks Paul. Good morning everyone.

GAAP measures: Net income attributable to controlling interests was \$1 million dollars, or \$0.01 cent per diluted share.

2Q 2019 Core FFO performance: Second-quarter Core FFO exceeded our expectations and consensus by \$0.02 cents per diluted share. Approximately \$0.01 of this quarter's outperformance is timing related and will likely be offset in the third and fourth quarters. The second \$0.01 of outperformance is largely due to higher settlements of prior-year reimbursements. We have therefore raised the mid-point of our 2019 Core FFO guidance range by \$0.01 per fully diluted share. We expect to deliver broadly equal Core FFO per diluted share in the third and fourth quarters of 2019 in order to achieve the \$1.71 mid-point of our updated 2019 Core FFO guidance range.

On a year-over-year basis, Core FFO per share was \$0.01 lower primarily due to the sale of 2445 M Street in June 2018 and increased interest expense, partially offset by the acquisition of the Assembly portfolio. The increase in interest expense was due to the short-term bridge loan we used to temporarily finance the multifamily acquisition in the second quarter of 2019. We have already paid down \$350 million of this loan, \$100 million on our line and approximately \$10 million of a mortgage associated with a retail asset we just sold, following the completion of the sale of the five shopping centers on July 23, and we plan to pay off the balance of the term loan when the 1031 exchange transactions are completed.

On a sequential basis, Core FFO was \$0.03 higher primarily due to the acquisition of the Assembly portfolio in the second quarter as well as higher settlements of prior-year reimbursements.

2Q 2019 Same-Store NOI overall and office performance: Same-store NOI declined 0.6% year-over-year on a GAAP basis and was flat on a cash basis largely due to a 6.4% decline in same-store office NOI. As expected and widely messaged, the expiration of the lease for the top floors of Watergate 600 was the single largest driver

for the year-over-year decline in second-quarter office NOI. We continue to assume a -5.25% to a -4.5% decline in office same-store NOI for full-year 2019. We expect the year-over-year same-store office NOI decline in the third quarter to be comparable to the second quarter, with the year-over-year decline in the fourth quarter being steeper and at the nadir for the year due to the expected move out of a 41,000 SF tenant, Ankura Consulting Group, on September 1, 2019.

2Q 2019 same-store NOI multifamily performance: Same-store multifamily NOI grew 6.4% year-over-year as we grew rents at all 13 of our same-store multifamily assets while also growing average occupancy by 60 basis points on a year-over-year basis. Moreover, the multifamily portfolio achieved strong renewal tradeouts of 4.2% and solid new lease tradeouts of 3.5% in the second quarter. As referenced earlier, multifamily utility expenses in the second quarter were lower than we expected and the quarter also benefited from lower tax assessments that were previously forecasted to benefit the third quarter. We are raising our multifamily same-store NOI growth assumptions for the second time this year and now assume 4.25% to 4.75% year-over-year same-store NOI growth in 2019. We expect the year-over-year same-store multifamily NOI growth rate in the third quarter to be lower than in the first, second and fourth quarters of the year because of a tougher prior year comparison driven by \$300,000 of favorable tax appeal settlements recognized in the third quarter of 2018.

Finally, our residual retail centers, which we report as 'other', grew same-store NOI by 9% and cash NOI by 8% year-over-year. High-rental-value lease commencements at Spring Valley Village as well as higher recoveries of previously reserved bad debts contributed to the year-over-year NOI growth and were only partially offset by a 20 basis point decline in average occupancy. The 30 basis point decline in sequential ending occupancy was due to a few small leases, the majority of which have already been backfilled. As there are fewer retail centers remaining, small changes in occupancy have a magnified impact on a year-over-year basis and sequential basis statistically. That said, we have good leasing momentum at Spring Valley Village and also look forward to stabilizing Concord, Randolph and 800 South Washington Street.

2Q 2019 office leasing and future expirations: Moving on to office leasing, we signed approximately 32,000 SF of new office leases and 52,000 SF of office renewals in the second quarter. We proactively signed a renewal with the largest tenant at Monument II in Herndon, VA, a 47,000 SF, blue-chip defense contractor. We achieved a rental rate that was in line with the market and additional term of 11 years with expiration now scheduled for 2032. While GAAP renewal rents were up 130 basis points, cash rents spreads were negative as the prior lease had significantly escalated and led to the nearly 20% cash roll down in the second quarter. It also resulted in renewal TIs per foot per year of term of approximately \$7 as the space needed a refresh after 10 years of occupancy.

As we have messaged since November last year, we are dealing with a larger than usual volume of lease expirations in 2019. While we expect some large vacates in the second half of the year, the weighted average mark to market for the remaining 179,000 SF of 2019 office lease expirations is slightly positive. In 2020, we currently expect a high probability of renewing approximately 320,000 SF of the approximately \$430,000 SF of expiring office leases.

Q2 2019 other leasing: Moving onto retail leasing for all of our retail centers, including those sold in July, we signed approximately 69,000 SF of new retail leases and 115,000 SF of retail renewals in the second quarter. We achieved positive 14.5% GAAP and 10.4% cash rent spreads on new leases and positive 15.2% GAAP and 6.8% cash rent spreads on renewals.

FY 2019 guidance: Now turning to guidance, we have raised the mid-point of our 2019 Core FFO guidance by \$0.01 per fully diluted share to a range of \$1.69 to \$1.73 from our previous range of \$1.68 to \$1.72 per share. The increase is primarily due to the aforementioned higher second quarter results. As I have already detailed our same-store NOI growth assumptions by asset class, I will now focus on the remaining guidance assumptions.

We continue to expect to sell an additional \$125 to \$175 million of commercial assets that are yet-to-be finally identified. Our 2019 Core FFO guidance does not assume we will complete any additional acquisitions this year. We expect development expenses to range from \$47.5 to \$52.5 million.

We now expect the annual impact of the adoption of the new lease accounting standard ASC 842 to range from \$1.25 to \$1.75 million in 2019. We continue to expect G and A to range from \$20.25 to \$21.25 million. We expect interest expense to range from approximately \$55 to \$55.5 million from a prior range of \$54.25 to \$54.75 million due to the updated assumed timing and execution of acquisitions and dispositions. Capitalized interest is expected to range from \$2.75 to \$3.25 million. As a reminder, the increase in interest expense relative to the guidance we provided in February this year is due to a higher debt balance during the year related to the short-term bridge loan we used to temporarily finance the multifamily acquisitions. Next year, we would expect interest expense to decrease year-over-year due to the bridge loan being paid off in 2019 and lower debt and line of credit balances throughout the year as a result of the asset sales we expect to complete in 2019.

We expect non-same-store NOI and income from discontinued operations to range from \$56.5 to \$57.75 million from a prior range of \$54.75 to \$56.25 million due to a slight improvement in the expected contribution from the Assembly portfolio, the timing of acquisitions and dispositions and our second quarter outperformance. The non-same-store range includes \$34 to \$34.75 million from the office and multifamily properties the Company intends to hold. To recap the impact of the transactions, the increase in the NOI assumed from non-same-store and discontinued operations due to the updated assumed timing and execution of the acquisitions and dispositions has largely been offset by the assumed increase in interest expense.

Balance Sheet: As always, our focus remains on maintaining our balance sheet strength. Although our net debt to adjusted EBITDA was temporarily high at 8.6x in the second quarter, we are already significantly lower on that metric. We expect to end the third quarter toward the higher end of our target range of 6x to 6.5x and to end the year in the high fives, assuming the completion of the \$125 to \$175 million of commercial asset sales by year end. We expect our 2019 Core FAD payout ratio to be in the low 80% range and expect to be able to continue to cover and maintain our dividend even after including the impact of our capital allocation, which is expected to enhance the stability of our cash flows and our long-term FAD growth. And with that, I will now turn the call back over to Paul.

Paul McDermott – President & Chief Executive Officer

Thank you, Steve. We have achieved several milestones in the first half of this year beginning with signing a 51,000 SF long-term lease at Watergate 600 in the first quarter and acquiring almost 2,400 multifamily units and selling Quantico and a large portion of our retail portfolio thereafter. As we work to execute the remainder of our 2019 Strategic Capital Allocation Plan, we expect that the planned sales of our power centers in the third quarter, increased office leasing momentum and the assumed commercial asset sales by year end will generate additional positive catalysts that further de-risk the portfolio and create visibility on our quarterly NOI inflection point as well as our longer term NOI and FAD growth.

While recycling assets at the scale at which we have described inevitably results in an earnings reset, we are pleased to have significantly grown multifamily, our strongest and most stable asset class, which also commands among the highest public market earnings multiples, from less than a third to nearly half of our overall NOI. We have simultaneously shrunk retail and office from over 70% to just over half of NOI on a second quarter pro-forma basis. Not only are we de-risking our portfolio, improving the stability and strength of our cash flows and FAD, and solving for some of the large embedded tax gains in our commercial portfolio, but we are also cementing our position as one the largest value-add multifamily REIT's in the DC Metro region.

And finally, as many of you know today is Tejal's last day with WashREIT. On behalf of our board, management team and everyone associated with this company over the last five years we want to thank her for her tremendous efforts in investor relations. She has done a remarkable job in creating a role basically from scratch to where it is today. Tejal we wish you all the best in your future endeavors. I would also like to welcome our new Vice President of Investor Relations Amy Hopkins. Amy joins us from investor relations at Booz Allen following several years of working in senior research analyst roles at institutions including Duff & Phelps, Compass Point and FBR Capital Markets. Amy will be your investor relations contact going forward.

With that, let me now open the call to answer your questions.

Operator

At this time, we'll be conducting a question-and-answer session. [Operator Instructions]

Our first question comes from the line of Blaine Heck from Wells Fargo. Please proceed with your question.

Q: Thanks. Good morning. Just big picture, Paul, when you think about the ideal portfolio for Washington REIT, what's it look like? Is it close to 60/40 multifamily to office? Or do you think you guys are going to continue to migrate even more towards the multifamily side? And if that's the case, how do you think about managing the dilution and possible dividend implications?

Paul McDermott - President and CEO

Thanks Blaine. Well, I don't have a precise number in mind. What we've said pretty consistently for the last couple of years is we wanted to try to overweight in multifamily. We are seeing considerably more multifamily value creation opportunities than we are in the office space and so we are going to continue down that path.

I think right now we've gone through and you looked at most of the executions that we've done, we managed to sell our assets and take care of the other thing that we need to keep in mind that is the embedded tax gains, but we also have organic growth that's built into our portfolio. So, we are heading on the right path, and we're going to continue to try to service more value-add, multifamily opportunities as the office market continues to recover in D.C.

Q: That's helpful. On the dispositions later this year, first off, I just want to confirm the cap rate range you put out in the press release a month ago still stands at 6.5% to 7% range. And then, do you guys have any more visibility on the mix between office and retail that you are targeting in that bucket?

Steve Riffie - EVP and CFO

We're not updating that now, so we're good with that as a placeholder. We haven't finally identified the assets that we'll sell, so we're good with that as a place for cap rate. What we have said is it's a range of 125 to 175 million. We've certainly had some price discovery on some additional retail assets as a result of a process, but the majority of it, probably 90%, would be office. So, we'll update that more as those assets are officially identified.

Q: All right. That's helpful. Lastly, congrats on getting the World Bank deal under LOI. I'm sure you can't give specifics, but I was hoping you could give some color around the economics or at least whether the spread is expected to be positive, negative or neutral and maybe some color on the concession package?

Paul McDermott - President and CEO

Blaine, as we've been pretty consistent in the past, and I think you asked that question last call about the retail economics, we can't get into those while we're in negotiations. We're in negotiations with the World Bank right now. We're moving in a positive direction and we will be prepared to comment on the deal once it's executed.

Operator

Our next question comes from line of Bill Crow from Raymond James. Please proceed with your question.

Q: Thanks. Good morning. Couple of follow-ups from Blaine's question. As you think about that ideal portfolio, what are the odds that you're in more markets two or three years from now in Mid-Atlantic, whether that's Baltimore, Philly or some of the regional markets there?

Paul McDermott - President and CEO

Bill, right now, we have enough to keep us busy, between our acquisition pipeline and development pipeline, but we will always consider new opportunities to create value for our shareholders, so we'll keep an open mind to that.

Q: All right. The other part of Blaine's question on the dividend that I'm not sure actually got answered and I think that was an issue last quarter, I just want to make sure that you talk about the ability to grow cash flow internally, and I think that starts the second half of next year. Are you confident that dividend can be maintained at this level?

Steve Riffie - EVP and CFO

Yes. I don't think it was an issue - someone asked about it last quarter. We're still targeting for the balance of this year to be in the low 80s from a FAD payout ratio and even while we were going through sort of the gradual reset as the leases commence, we cover all the time in 2020.

When you look beyond that, you think about the relative recurring leasing capital and the less downtime in a more multifamily weighted portfolio versus commercial portfolio, we see this as a very long-term strong FAD growth opportunity and that's how we allocated our capital. So, we'll have a capital allocation decision to make in 2021 and beyond because our FAD should be stronger than it's traditionally been.

Q: That's helpful. I just want to make sure it was clear. My other question is just given the changes to the portfolio. Paul, have you effected changes internally at the corporate level to strengthen the multifamily side? Tom departed a quarter or so ago. Or do you still have some work to do to realign the focus internally?

Paul McDermott - President and CEO

Well, a lot of that depends on the acquisition side, clearly, we have the appropriate sized team in place and we'll continue to stay that course. On the development side, we have an opportunity to augment the staff. That's going to depend on how aggressive the development pipeline can be, and that's going to come down to the math.

We have an excellent multifamily team in place right now. They're doing an outstanding job on the Trove, and we are getting through design development and the appropriate processes on Riverside, if we were to take on more opportunities on the development front, we would have to supplement the staff accordingly.

Operator

Our next question comes from the line of Dave Rodgers from Baird. Please proceed with your question.

Q: Paul, and Steve just to follow up on that development comment, you talk about doing new development on some of the residential sites that you've acquired. Maybe talk about the ability to build to that Class B price point that seems to be a difficult thing to do and how you'd manage that.

The second component is when you look at the other multifamily REITs that are big developers, I think they're levered at four times plus or minus; you guys are still over six. So, how do you get down into that range in order to be comfortable and comparable to your new peer set?

Paul McDermott - President and CEO

Well, let's start with the development. If you look at what we have, we have probably three or four covered land plays that we're exploring. We're very price sensitive. We're not trying to build to the high Class A or the lower Class B. We talked a couple of calls ago about what our basis would be going forward.

For us, on the development front, if you look at our current portfolio, we're targeting incomes from \$50,000 to \$80,000. We would still like to maintain that affordability gap post stick A. I don't feel like you can build Class B today for the middle market, you have to build a value conscious Class A product and that's what we're doing.

We can afford to do that because we have a lower land basis, both at The Wellington and at Riverside and we're doing stick instead of high-rise concrete. When we talk about these new opportunities for development, that's the type of product we're talking about, and then it's down to whether it's below grade structured or above grade structured.

Steve Riffie - EVP and CFO

I'm sorry I didn't quite pick it all up, was part two just looking at our leverage level and our ability to fund development? Is that what you were getting at?

Q: Yes, they were two separate questions rolled under one, that was one and then the second is when you look that multifamily peer set being much more lower levered as where you guys sit today, do you feel like you need to get down to that leverage level in order to, get the multiple of being a residential redeveloper or developer, etc.?

Steve Riffie - EVP and CFO

Well, most of the multifamily REITs s you're looking at are large caps that have been out there for quite some time. We're still in transition, but we're already going to enter next year with some optionality by selling more and we'll be at the low-end of our normal target levels.

We're comfortable with what we think potential sources of capital are and, as we're still transforming the company, staying in our targeted six to six-and-a-half ratio for now. When you think about the risk of the cash flows to the company, we went from 28% to 45% multifamily as a percentage of our NOI, and our retail, which has been 22% is looking like around 6% going forward until we make further decisions. That's a significant change in the risk profile of the company and the risk of its cash flows, and we're hoping that will be recognized by the market.

Q: As you look at Space+ versus the residential redevelopment, which gives you the better return today, and I know you do them for different reasons but tell us what difference in the returns are and how did Space+ impact the leasing metrics this quarter?

Paul McDermott - President and CEO

Well, they're two separate distinct products. Space+ right now, we're continuing to get that 8% to 10% market premium, and in the office space we like that. Our average duration is about 48 months on leases that we do, and in terms of comparing that to multifamily development, I've seen a 150 basis point to 200 basis point compression on development right now, and people in D.C. right now, are developing realistically from a 5.1% to 5.25%, and that's obviously not something that we're going to pursue at this time.

We need to see little more stability in the math in terms of construction, labor and material costs. Space+ right now, is 5% to 8% of our commercial portfolio, Our observation on Space+ is that some of our leases that we have in there can graduate into long-term viable leases for the general office portfolio, and so we are trying to incubate some of the Space+ tenants to become more permanent tenants in the office portfolio.

Space+ has been up and running for 12 to 18 months, we were happy with the program, we have the organic growth that's in there, but I don't think it's something that's going to take over, on a relative basis, a large component of our office portfolio if you were to compare that to some of the development projects we're contemplating either at Riverside or some of the other opportunities we have. They're different value propositions with different returns on cost.

Operator

Our next question comes from the line of John Guinee from Stifel. Please proceed with your question.

Q: Great. Thank you. Nice quarter. Steve, it looks to me, quick math, is you're guiding towards about \$0.80 FFO for the second half of the year, which feels a little bit like maybe \$0.42, \$0.38 in the third quarter and fourth quarter. Does it bottom at \$0.38 and what's a good start for early 2020?

Steve Riffie – EVP and CFO

John, we said in the prepared remarks, we expect it to be even between the third and fourth quarters. We don't normally give quarterly guidance, but we are basically implying if you use your math of \$0.80 left for the year, \$0.40 and \$0.40.

In terms of not giving 2020 guidance, but just thinking about the lease up pattern, we've been very transparent since the 8-K last November, of the major lease expirations in the year, we've progressed 72% to being leased or under LOI. When we think about the lease commencements, the big lease commencement will be early 2020, which will be the EIG lease at the top floors of Watergate 600.

The first quarter is probably the low point, and that Watergate lease alone should then begin to show some progress as you go forward on a quarterly basis. The progress on the other leases that we are signing, one of which we don't even get the space back until September 1st of this year. Those kick-in in our models throughout 2020.

We're not giving guidance for 2020, but just the pattern, the bottom should be around the first quarter, you should see progress as those spaces lease up. Our Trove development is expected to breakeven around midyear, next year and contribute for the year about \$800,000 of NOI, but it's significantly higher the following year in 2021, so the Trove starts to kick-in as well in terms of the pattern of growth. That's about as far as we can do in terms of years out until we're ready to give full guidance.

Q: Great. Paul, any kind of big picture in D.C, the lease economics continue to be just brutal. Is there any submarket or any assets that are bucking the trend and you feel a little bit better about it than kind of the turnkey TI world we seem to be in?

Paul McDermott - President and CEO

If I was going to evaluate the overall market, the D.C. Class B segment is marginally improving. When I say that, we're seeing pickups on the concession packages and on parking, free rent and TIs. D.C. commodity Class A, I'm not seeing improvement there. It is the turnkey package that you highlighted. D.C. trophy properties, while we're not playing in that space, we see that their deals are getting better. If I turned over to Northern Virginia, we're definitely seeing pickups along the Silverline and Rosslyn, both kind of the Class B plus A space, we're seeing slight pickups.

You've seen some of the moves in The Borough. I was just told that the remaining space at the Borough has now gone up to \$62.50 a foot. So, we're definitely seeing improvement in that market. But again, any improvement we see is pre any new supply coming on, especially in Tysons.

Operator

Our next question comes from the line of Daniel Ismail from Green Street Advisors. Please proceed with your question.

Q: Maybe just sticking to D.C. office. With transfer taxes and property taxes on the rise, I'm curious, does this alter any interest in long-term ownership in that region, both for office or multifamily? And then, do you currently have an estimate of the potential impact of those tax increases?

Paul McDermott - President and CEO

Right now, our desire is to continue to overweight in multifamily. The taxes, what the D.C. government has just layered on is kind of another pain point for D.C. office. What we try to demonstrate to the market is we're continuing to look at opportunities to monetize components of our commercial portfolio. I believe it will have a dampening effect, and I have talked to the top three investment sales brokers here that the D.C. investment sales market has its own challenges right now, but this was just kind of another layer of difficulty to put on to it.

We look at our portfolio right now in D.C., and when you're talking about whether or not we'd hold or monetize it, the core capital is really what's dried up in Washington. We still see a lot of value-add in our D.C. Class B. We think that there is leasing upside, and we think that there's an ability to get paid for it. The D.C. tax increase will obviously play into that, but it's not going to completely eradicate it.

But I like the value-add space. That's what is still continuing to move. Our observation will be that the biggest disconnect we're seeing in pricing right now is on vacant space, how owners are pricing it and how potential buyers are pricing it or should I say significantly discounting it.

We haven't seen the amount of trades that we would expect to have seen in the first two quarters of this year. Even if you look at the last two deals that were done in D.C., they were both done by co-working companies trying to establish a bigger beachhead here in Washington.

Q: Just last one on development. Curious to hear your updated thoughts on keeping the entirety of developments on balance sheet versus potentially JV-ing any interest there?

Paul McDermott - President and CEO

We've been approached by a number of different institutions about joint venturing some of our multifamily opportunities. We are definitely looking at those and processing them. For us, cost of capital is paramount. We need to see some stabilization—if you look at the last two to three years, construction costs have probably increased between 5% and 6%.

So for us, the math has to work for WashREIT before we start going soliciting other partners. In terms of capital uses, we would certainly consider JVs if both the cost of capital and the structure makes sense for WashREIT and its shareholders.

Operator

Our next question comes from the line of Chris Lucas from Capital One Securities. Please proceed with your question.

Q: Hi, good morning everybody. Paul, on the Landmark transaction, could you walk us through the investment thesis there as you've been pretty clear in the past about some of the boxes you need to check for allocating capital to multifamily. Just curious as to how Landmark stacks up.

Paul McDermott - President and CEO

As you know, we look for urban infill as well as suburban properties that we feel have an affordability gap. When we look in this respect, if we look at our comparable set there, we see rents ranging from a low of, let's call it, mid-\$1,500s to a high of over \$2,100. We're in the \$1,700 to \$1,750 range. We see renovation potential here. We saw an affordability gap in excess of \$350, which is one of our litmus tests, and we wanted to see if the project inside the market can bear additional renovations. We can grow rents through very light renovations, at least \$100 a door, and that the capital spend that we would be looking at would not be of the magnitude of Wellington or Riverside. The thesis is to continue to get in there, work on the management of the property, work on some of the optics and do some light renovations for probably over 60% of the property and capitalize on the rent growth there.

If you look at the market itself, if you look at Alexandria over the last eight years, it's grown over 15% compared to a national average of just over 6%. We like where that market is going. It's a 10-minute drive from HQ2. We also have other centers that we're going to be running a shuttle on this asset combined with the Assembly at Alexandria.

There's also the Metro bus out front from the Yoakum Pkwy and Cascade at Landmark that runs between there and the Pentagon. We're going to be able to capture both value-conscious military and civilian personnel. Again, another value-add, affordable thesis that we're going to be able to incorporate at this asset.

Q: On the eight asset retail portfolio sale, you had previously guided to a 6.2% cap rate on that NOI for the aggregate. Is that still a good number overall given the slight change in the sort of dynamics of the power center sales?

Steve Riffie - EVP and CFO

Yes. Obviously, we will update everything in a more final way once we close, and we're still working on the rest of the sales, but a lot is closed. So, we're still expecting to be in the low 6s, and we'll refine it as we get a little further along.

Q: Steve, for you, there were a couple of little changes on the guidance assumptions. One that caught my attention was on the projected development expenditures. Is there anything specific there, or is this just a cumulative delay in some spendings?

Steve Riffie - EVP and CFO

There's some utility delays that we had at the Trove. While we're going through and trying to get the math to work on Riverside, we actually expect to spend a little less from now to the end of the year on Riverside than we had originally projected.

Operator

We have reached the end of the question-and-answer session, and I'd like to turn the floor back over to management for any closing comments.

Paul McDermott - President and CEO

Thank you. Again, I would like to thank everyone for your time today and we hope that you enjoy the remainder of your summer. We look forward to seeing many of you on our upcoming non-deal roadshows in the very near future. Good afternoon, everyone.