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COPT Defense Properties (CDP)

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the COPT Defense Properties Fourth Quarter and Full Year 2023 Results Conference Call. As a reminder, today's call is being recorded. At this time, I will turn the call over to Venkat Kommineni, COPT Defense's Vice President of Investor Relations.

Mr. Kommineni, please go ahead.

Venkat Kommineni
Vice President-Investor Relations, COPT Defense Properties

Thank you, Abigail. Good afternoon and welcome to COPT Defense's conference call to discuss fourth quarter and full year results. With me today are Steve Budorick, President and CEO; Britt Snider, Executive Vice President and COO; and Anthony Mifsud, Executive Vice President and CFO. Reconciliations of GAAP and non-GAAP financial measures that management discusses are available on our website in the results, press release and presentation and in our supplemental information package. As a reminder, forward-looking statements made during today's call are subject to risks and uncertainties which are discussed in our SEC filings. Actual events and results can differ materially from these forward-looking statements, and the company does not undertake a duty to update them.

Steve?

Stephen E. Budorick
President, Chief Executive Officer & Trustee, COPT Defense Properties

Good afternoon and thank you for joining us. Our strategy, concentrating investments in assets that support priority US National Defense missions, once again in 2023 generated exceptionally strong results, driven by strong vacancy and new development leasing, superior tenant retention, a highly pre-leased development pipeline and significant value creation from delivering fully leased new properties. All of which is supported by our prudent balance sheet management. Since 2019, we've generated compound annual FFO per share growth of 4.5% due to these attributes. Our total portfolio is 95.3% leased. Our Defense/IT Portfolio is an even higher 97.2%, which is over 800 basis points higher than the traditional office REIT average, and is on par with the industrial apartment and retail sectors.

We've been able to grow our occupancy off the strength in defense spending, in missions supported at our Defense/IT locations, and have not been impacted by trends plaguing conventional office product. We placed nearly $1.4 billion of Defense/IT developments into service since 2019, totaling 4.5 million square feet that were 99% leased at the end of 2023. On an annualized run rate basis, these developments, net of the properties we've joint ventured, generate over $80 million of contractual cash NOI, which is roughly a 30% increase to the 2019 cash NOI level, driving both FFO and NAV per share growth. We've also strengthened our balance sheet with our refinancing activities in 2020 and 2021, and then again, with our exchangeable note offering in September.

So to sum this up, our business was strong in 2019, and has only strengthened over the past four years. Our portfolio, rental rates and occupancy are well above 2019's level. We've expanded our relationships with top defense contractors in the country. We continue to demonstrate the ability to place highly leased development into service at strong initial cash yields. And we've defended and enhanced our balance sheet, all of which serves to create further shareholder value. In 2023, simply put, we had another great year. We delivered strong results with FFO per share increasing 2.5% over last year's results, exceeding our expectations by roughly 1.5 percentage points. Full year same property cash NOI increased 5.7%, which is the highest level since we started reporting the full year metric back in 2008.

We completed 2.9 million square feet of total leasing volume, which consisted of 1.7 million square feet of renewal leasing with an 80% retention rate, 747,000 square feet of development leasing exceeding our annual goal, and 452,000 square feet of vacancy leasing, again, exceeding our annual goal. Rent spreads on renewals increased 1.5% on a cash basis and 9.3% on a GAAP basis, achieving the highest levels since 2008. We placed $275 million of development projects into service that were 98% leased at year end, totaling roughly 850,000 square feet all in our Defense/IT portfolio. We committed $280 million of capital to new development starts, which are 100% pre-leased, totaling 690,000 square feet, all in our Defense/IT portfolio.

Our active development pipeline has a total cost of roughly $325 million is 91% pre-leased and totals roughly 820,000 square feet. We also raised our dividend in 2023 for the first time in over a decade. We are one of only two REITs in our sector to have raised the dividend during the year, and we maintain a rock solid AFFO payout ratio which has been at or below 70% for the past five years. Turning to the world view, the global threats to national security of the United States continue to escalate with increased conflict in both the physical and cyber domains. The war in Ukraine and the aggressive posture of Russia poses a significant risk of escalation throughout Eastern Europe.

Combat activities in Ukraine are revealing capability strengths and weaknesses in weapons systems and introducing new innovative applications that pose opportunities for and threats to our defense systems. The terrorist attack in Israel demonstrated the need for increased intelligence in the Middle East. The Israeli combat response in Gaza triggered escalated terrorist and militia attacks on US troops deployed in the region and has now advanced to US combat responses. Similarly, Houthi rebels' actions are threatening international trade routes through the Red Sea and the Suez Canal, triggering combat responses from both the United States and the United Kingdom. And meanwhile, China continues to posture an intent to invade Taiwan, and North Korea has amplified its missile testing activity and its aggressive rhetoric.

All of these situations demand elevated intelligence, surveillance, reconnaissance and technology advancements. Moreover, the Center for Strategic and International Studies published a report which revealed that cyberattacks in the United States remained elevated in 2023, with 118 major cyber events, more than double the number of attacks that occurred just six years ago. Clearly, the threat environment to our national defense continues to escalate, suggesting US defense spending has and must remain elevated to maintain parity and elevate deterrence in the physical, cyber and intelligence domains. Over the past three fiscal years, the US defense budget increased by roughly $100 billion or 15%.

Since we typically experience a 12 to 18 month lag between defense budget funding and contractor demand, we expect this budget growth will continue to support strong tenant demand into 2025. Congress passed the fiscal year 2024 National Defense Authorization Act in December, which calls for a further 3.3% growth year-over-year, in line with expectations and is now awaiting appropriation. Clearly, in this threat environment, funding for priority missions tied to national security must continue. Turning to guidance, we established 2024 FFO per share guidance of $2.51 at the midpoint, which implies 3.7% year-over-year growth. In contrast, two-thirds of the Nareit-defined office REITs are expected to see FFO per share decline in 2024. The execution of our differentiated strategy has and will continue to produce differentiated results.

Now, I'd like to turn it over to our new Chief Operating Officer, Britt Snider, who joined the company in December. Britt is a highly experienced leader with nearly 20 years of real estate experience, spanning in asset management, development and investment banking. We welcome Britt to the team and we are glad to have him join us.

Britt A. Snider
Executive Vice President & Chief Operating Officer, COPT Defense Properties

Thank you so much, Steve. And first, I want to thank Steve, Anthony, and the entire Board of Trustees for their support in allowing me to take on this role as the Chief Operating Officer. It's an honor to join the company given the 30-year history of supporting this country's national security mission. I'm very excited to work with such a talented and accomplished team. Our portfolio is extremely healthy, and we continue to see robust demand in our Defense/IT markets driven by sustained strength in defense spending, fueling high renewals and mission expansions. Our portfolio continues to outperform with our total portfolio at 94.2% occupied. Our Defense/IT Portfolio, which represents 91% of our total square footage is 96.2% occupied with particular strength in The National Business Park and Redstone Gateway.

This strong demand is evidenced by the outperformance in vacancy leasing executed in 2023 along with our leasing activity ratio which provides visibility into current demand on our unleased space. Our overall portfolio leasing activity ratio, which is defined as square feet of demand divided by available square feet to lease, remains very strong at 75%, with a total prospect pipeline of 880,000 square feet. The ratio is an even higher 89% in our Defense/IT Portfolio, as we only have roughly 600,000 square feet of inventory available out of nearly 22 million square feet. Demand is especially strong in our Fort Meade/BW Corridor segment, with a prospect ratio of over 110%. Yes, this means, we actually have more prospects than we have space to lease.

And you'll recall, we set our vacancy leasing target at 400,000 square feet for 2023 because we had so little space to lease. We actually exceeded that target by executing 452,000 square feet of vacancy leasing with a weighted average lease term of over eight years. For our Defense/IT portfolio, we increased the lease rate in all but one of our sub-segments compared to year end 2022. Now, I'd like to share some key leasing stats. We signed 60 deals at an average lease size of 7,500 square feet, nearly 100,000 square feet or 23% of the vacancy leasing was with the DOD, over 200,000 square feet of vacancy leasing was with defense contractor tenants. Of these amounts, roughly 175,000 square feet or almost 40% of the total was tied to cyber activity.

An important fact surrounding the strength of our tenant relationships is that, 75% of combined vacancy and development leasing was repeat business with existing tenants. We executed over 90,000 square feet in our other segment in 2023, which exceeded our internal goal of 50,000 square feet. Of that 90,000 square feet, we signed 35,000 square feet across our three Baltimore properties and signed a 40,000 square foot lease with a law firm at 2100 L Street in D.C., which is now 83.5% leased. And the team is tracking some additional demand at 2100 L Street and we hope to share some more good news soon on that asset. We completed 2.9 million square feet of total leasing volume, which included 1.7 million square feet of renewals for the year.

Our overall retention rate was 80% with our Defense/IT portfolio, even higher at 86%. And just to note, four US government renewals that were delayed into 2024 by the continuing resolution, which had they completed, would have resulted in an 83.4% overall retention rate with the Defense/IT portfolio at 88.5%. We do expect those four renewals will be completed in the coming months. Cash rent spreads on renewal leasing were up 1.5%, while GAAP rent spreads were up 9.3%, driven by annual rent increases of 2.6%, with a weighted average lease term of 4.8 years. Measuring the starting cash rent of the tenant's expiring lease to the starting cash rent of the renewal lease, the compound annual growth rate achieved on these leases was 3.2% for the year.

Now on page 17 of our flipbook, we provide our large lease disclosure, which details our view of renewals defined as 50,000 square feet through 2025. Looking backward, over the last six quarters we've renewed 17 large leases totaling 1.7 million square feet, with a retention rate of 97%, including 15 full premises renewals and two renewals with only modest downsizes. And now, looking forward, over the next eight quarters, we have 6.2 million square feet of leases expiring, which includes 3.3 million square feet of large leases. Large leases account for nearly 60% of total annualized rental revenue expiring in the next two years. Of those large leases, nearly 75% are full building leases to the US government. And recall, in our 30-year history, we've had 100% renewal rate on full building government leases.

We expect a retention rate of over 95% on the 2024 and 2025 large leases, and we remain highly confident our overall tenant retention will remain strong in the near and medium term. Now, turning to development. One key aspect of our development strategy is to always maintain some level of inventory at locations where we see strong demand. And when nearing fully leased, we'll commence a new project to create inventory. The National Business Park is 99.4% leased and 99.3% occupied across that 4.3 million square foot park. 30 of the 34 buildings are 100% leased, with only 25,000 square feet of unleased space at year end. Accordingly, we commenced development of NBP 400 in the first quarter of 2024 to add approximately 140,000 square feet of capacity.

Similarly, Redstone Gateway is 98.7% leased and 97.5% occupied across that 2.3 million square foot park. 19 of the 22 properties are 100% leased, with less than 30,000 square feet of unleased space at year end in the operating portfolio. Accordingly, we are in the planning phase of RG 8500 to add approximately 150,000 square feet of office capacity. And we're planning RG 9700, a 50,000 square foot high-bay building to meet increasing demand for that particular product type. Our active developments totaled roughly $325 million in investment, are 91% pre-leased and total 117,000 square feet. During 2023, we executed 747,000 square feet of development leasing, which was towards the high end of guidance and includes three data center shell leases totaling 643,000 square feet and over 100,000 square feet at Redstone Gateway.

Our development leasing pipeline, which we define as opportunities we consider 50% likely or better to win within two years or less, currently stands at 500,000 square feet, due to the leasing success in the fourth quarter. And beyond that, we're tracking over 1 million square feet of potential future development opportunities, which should allow us to maintain a solid development pipeline in the near and medium term. Before I conclude my remarks, I want to note that last month, Steve and I, along with senior leadership in our Asset Management and Operations groups, attended the ribbon cutting of our 300 Secured Gateway development located in the secure campus of Redstone Gateway, which is 100% leased to the Huntsville Center of the US Army Corps of Engineers.

We commenced development of the $67 million project in the third quarter of 2021 and delivered the building to the Army Corps in the third quarter of 2023. The 206,000 square foot state-of-the-art facility will serve as a prototype for future Army Corps locations, and is an example of the value add solutions we provide to the US government. Colonel Sebastian Joly, Commander of the US Army Engineering and Support Center in Huntsville, stated, and I quote. "This facility allows us to consolidate 16 different leases into one. Finally, all co-located and meeting all force protection requirements and safety requirements for the very first time." We are very grateful and honored to be able to support the vital missions conducted out of the Redstone Arsenal and all of our strategic defense holdings that contribute to our collective national security.

With that, I'll turn it over to Anthony.

Anthony Mifsud

Executive Vice President & Chief Financial Officer, COPT Defense Properties

Thank you, Britt. We reported 2023 FFO per share as adjusted for comparability of $2.42, which was $0.04 above the midpoint of our original guidance. The year benefited from early lease commencements on several operating and development leases, favorable renewal outcomes, lower net operating expenses, primarily seasonal and utility costs, and higher net development fees. We reported fourth quarter FFO per share as adjusted for comparability of $0.62, which was $0.01 above the midpoint of our guidance. The quarter benefited from higher development fees and slightly lower net operating expenses. In 2023, we reported same property cash NOI growth of 5.7%.

The increase is driven primarily by rent commencement of vacancy leasing executed in 2022, embedded escalations in virtually all of our leases, lower than expected free rent concessions and rent commencement on development leases placed into service in 2021. Same property occupancy ended the year at 93.4%, which is flat sequentially from last quarter, and up 140 basis points year-over-year, driven largely by the following segments. The Fort Meade/BW Corridor increased 370 basis points year-over-year to 96.2%. 60% of the increase was due to lease commencements at the National Business Park, primarily by the government. Redstone Gateway increased 940 basis points year-over-year to 97.4%, as Lockheed Martin took occupancy of over 120,000 square feet at 1200 Redstone Gateway.

Our balance sheet is well positioned to navigate the current stress in the capital markets. We have no significant debt maturities until March 2026. Our unencumbered portfolio represents 95% of total NOI from real estate operations. At the end of the year, we had over 85% of the capacity on our line of credit available and over $165 million of cash on hand. We currently have no variable rate debt exposure. In February 2023, we entered into interest rate swaps that fixed SOFR at 3.75% for three years on our $125 million term loan, and $75 million of the line of credit. The swap rate is over 150 basis points lower than the current one month term SOFR and provides significant protection in this prolonged elevated rate environment.

We expect 100% of our debt will be at fixed rates late into 2024 as we look to fund the equity component of our development investment from cash from operations after the dividend, and fund the debt component from our existing cash balance and subsequently from our line of credit. With respect to guidance, we are establishing 2024 FFO per share at a range of $2.47 to $2.55, implying 3.7% growth over 2023's results. The midpoint of this guidance takes into account the following positive contributions; $0.25 from increases in GAAP NOI, including $0.09 from cash NOI from developments placed into service. This is partially offset by $0.11 from higher interest expense based on higher projected debt balance and a slight decline in capitalized interest, and $0.05 primarily from lower development fees, higher G&A and other GAAP adjustments.

Same property cash NOI guidance is projected to increase 6% at the midpoint. Of note, more than half of the growth comes from the strength of our portfolio operations. If we were to keep the 2023 pool intact, we forecast roughly 3.5% same property cash NOI, growth driven by average portfolio rent escalations of 2.5% and lease commencements primarily at our Fort Meade/BW Corridor and Redstone Gateway segments. The remaining 2.5% of same property NOI growth is due to cash commencements on development leases placed into service in 2022, which are now part of the 2024 same property pool. We expect same property occupancy to end the year between 93% to 94%. We do expect occupancy to dip in the first quarter driven by several non-renewals, with 30,000 square feet occurring in the other segment, and then remain relatively stable throughout the remainder of the year.

Similar to last year, we are targeting 400,000 square feet of vacancy leasing, which we consider an aggressive goal since we are so highly leased. We expect tenant retention in the 75% to 85% range, cash rent spreads on renewals to be flat at the midpoint, with average escalations of roughly 2.5%. We expect to commit $200 to $240 million of investment capital for the full year and expect our development spend on active and future projects will range from $240 million to $280 million. We plan to place three projects totaling nearly $150 million into service, which are 81% leased and totaled 400,000 square feet. We've historically framed development in terms of leased square feet. However, beginning in 2024, we will instead guide to committed capital to investment as we feel this is a more suitable disclosure when evaluating the future NOI contributions from our invested capital.

The cost to construct a Defense/IT property has increased approximately 25% when comparing the three-year average of our starts between 2017 and 2019 to those commenced between 2021 and 2023, driven by inflation in both material and labor costs. Importantly, we earn both our return and NOI on invested capital, not square feet. Despite the increases in costs, we have been able to increase our initial cash yield on developments on Defense/IT projects modestly to approximately 8.25%. Since we have leased all of the land we owned for data center shell developments, we assume no additional capital is committed to shells in 2024. As illustrated on slide 10 of our flipbook, the $200 million to $240 million of expected investment in 2024 into Defense/IT Office projects is the second highest annual level since 2019.

In closing, the building blocks of our guidance illustrate why we are well positioned to continue to generate increasing NOI, FFO and cash from operations which we expect to allocate towards accretive investment opportunities.

With that, I'll turn the call back to Steve.

Stephen E. Budorick

President, Chief Executive Officer & Trustee, COPT Defense Properties

Thank you. I'll close by summarizing our key messages. We delivered another strong year in 2023 with FFO per share of $0.04 above our original guidance. Our Defense/IT segment is 97.2% leased, the highest rate achieved since we started reporting the segment in 2015. Full year same property cash NOI increased 5.7%, which is the highest level since we started reporting the full year metric in 2008. We exceeded our vacancy leasing target by executing 452,000 square feet. Our $325 million of active developments which are 91% pre-leased, provide a solid trajectory for NOI growth over the next few years. Our liquidity is very strong and we continue to expect to self-fund the equity component of our expected development investment going forward.

We established 2024 FFO per share guidance of $2.51 at the midpoint, which implies 3.7% year-over-year growth. Between 2019 and 2023, we generated compound annual FFO per share growth of 4.5%. Looking forward, we continue to expect compound annual FFO per share growth of roughly 4% between 2023 and 2026 from the midpoint of our original 2023 guidance. In a time where global threats are increasing, data security and facility security are becoming more important every day, fueling demand for specialized real estate solutions, we are uniquely positioned to capture that demand and we expect our strong performance to continue.

Operator, please open the call for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you, Mr. Budorick. [Operator Instructions] Our first question comes from the line of Camille Bonnel with Bank of America. Your line is open.

Camille Bonnel
Analyst, BofA Securities, Inc. Q

Hi, everyone. Steve, can you remind us how the 3.3% national defense budget that passed in December compares to the initial projection? And then, is there anything on the horizon either from elections or potential major agency relocations that you're closely watching this year?

Stephen E. Budorick
President, Chief Executive Officer & Trustee, COPT Defense Properties A

Sure. So with regard to the budget increase, it's exactly where it was expected to be in the 3% to 3.5% range. Do recall the last three years, that budget ramped up by $100 billion, so 3.3% is a big number and an extra $100 billion, and a lot of money to fund defense priorities. With regard to the election, it'll be a fascinating outcome. I just want to remind everybody that since 2016 after the restorative increase to the defense budget, we have had going on 7 years of solid bipartisan support for increases in defense spending. And it's the one part of our government that operates in a strongly cooperative, bipartisan way. And I expect, irrespective of this outcome of this election, that support will continue.

Camille Bonnel
Analyst, BofA Securities, Inc. Q

And in terms of like major agency relocations, are there any that you've been hearing about tracking in your markets?

Stephen E. Budorick
President, Chief Executive Officer & Trustee, COPT Defense Properties A

The only one that comes up from time to time is the prolonged discussions about the relocation of the FBI out of their headquarters building in downtown D.C. to a more protected location that would either be in Virginia or

Maryland. It's kind of gone quiet in the world of current events over the last six months, and I think it's so heavily disputed, it will be years off before it's finalized.

Camille Bonnel
Analyst, BofA Securities, Inc.

Q

That's helpful. And all the disclosure you've provided has been very helpful in understanding the building blocks that support your three-year CAGR of 4%. Just given the high expected retention levels, could you comment on how that outlook is on an AFFO basis?

Stephen E. Budorick
President, Chief Executive Officer & Trustee, COPT Defense Properties

A

Well, Anthony, I'll flip it to you.

Anthony Mifsud
Executive Vice President & Chief Financial Officer, COPT Defense Properties

A

From an AFFO standpoint, as I think we've talked about on some recent calls, we had some elevated leasing capital in 2022 and 2023. And the third and fourth quarter are back to sort of back to our regular levels. So we expect AFFO over that three-year period to grow slightly more than what we've been talking about with respect to FFO, because of the relative capital that we have to invest in renewal and new leasing compared to some of our peers.

Camille Bonnel
Analyst, BofA Securities, Inc.

Q

Okay. Great. And welcome, Britt. Just lastly, could you provide some color on the known moveouts that were highlighted in the press release last night? What are some reasons your tenants are not renewing and how much are tenants downsizing? Thank you.

Britt A. Snider
Executive Vice President & Chief Operating Officer, COPT Defense Properties

A

Yeah. Absolutely. I mean, it's something we're seeing, I guess, outside of the Defense/IT world, and primarily in our non-Defense/IT tenants. And with law firms, for example, one of them was a law firm that is consolidating. And there's some strategic consolidations of a few smaller IT, Defense-related contractors, but that is definitely the exception, most of them are growing.

Stephen E. Budorick
President, Chief Executive Officer & Trustee, COPT Defense Properties

A

We routinely get some non-renewal from small and mid-sized contractors due to the M&A activity. So they tend to innovate, create a new concept or product they can sell. They grow to a certain level, and then they typically sell to one of the larger contractors. Sometimes that results in some contraction as they get consolidated into bigger tenants.

Britt A. Snider
Executive Vice President & Chief Operating Officer, COPT Defense Properties

A

And this is Britt. One other thing I'll note is that, when we do have non-defense and IT tenants, leaving our Defense/IT Portfolio, they're typically backfilled with Defense/IT with incredibly strong credit and strong businesses. So we actually see that as a positive.

Camille Bonnel
Analyst, BofA Securities, Inc.

Q

Thank you.

Operator: One moment for our next question. Our next question comes from Blaine Heck with Wells Fargo. Your line is open.

Blaine Heck
Analyst, Wells Fargo Securities LLC

Q

Great. Thanks. Good afternoon. Steve, how do you feel about pricing power in general? You guys achieved 1.5% rent spreads in 2023, but you're guiding to flat for 2024. I'm just wondering how much of that is conservatism and a return to more historical averages versus maybe something in the market telling you it could be a little tougher to push rents this year, or even specific leases or extension options that might keep that metric lower this year.

Stephen E. Budorick
President, Chief Executive Officer & Trustee, COPT Defense Properties

A

So one thing that affects that overall metric is the mix of leases and where they're at. We did a significant amount of leasing over the last year in the BW Corridor, where pricing power is as strong as anywhere. We expect some good traction in Northern Virginia, which is a little more competitive. And then, generally you'll notice we guide pretty conservatively because we never want to over promise. So I'd say, little bit mix and probably 50%-60%, just conservative viewpoint in our guidance.

Blaine Heck
Analyst, Wells Fargo Securities LLC

Q

Got it. Really helpful. Can you talk about the 500,000 square feet of development leasing pipeline you have at this point? And how much of that is in advanced stages or close to becoming executed deals? Just trying to get a feel for kind of the cadence of commencements in 2024. And then also, how much is NBP versus Huntsville?

Stephen E. Budorick
President, Chief Executive Officer & Trustee, COPT Defense Properties

A

So I think, it's 2 to 1 Huntsville to NBP, roughly. Commencements, I think, you'll see June through November with peak volume of execution. As Britt mentioned, we have another 1 million plus square feet of projects that we're entertaining with customers. But as I pointed out on prior calls, in this world of an elevated cost of capital, it really affects the decision-making of all companies, even defense contractors. And what we see is, they're being very methodical to make the business cases for the facilities they need. So the pace of progress is a little slow, but the visibility is very clear. We're very excited about what we can get done this year.

Anthony Mifsud
Executive Vice President & Chief Financial Officer, COPT Defense Properties

A

Hey, Blaine, just to clarify and make sure that you understand the distinction. The 500,000 square feet that Britt mentioned is new leasing activity that we're looking at that has a possibility of being executed in 2024. In terms of commencements, the vast majority of that leasing is already executed, and the commencements that we expect in 2024 are the development projects that are under construction right now and significantly well leased.

Blaine Heck
Analyst, Wells Fargo Securities LLC
Q

Right. Okay. I think we're on the same page there. Okay. Helpful color. And then, Steve, appreciate your comments on having defense support no matter what happens in the election. But have you seen any pause in leasing activity in past election year just as your tenants kind of take some time to figure out the ultimate implications of either kind of more of the same or a new President in office?

Stephen E. Budorick
President, Chief Executive Officer & Trustee, COPT Defense Properties
A

We really didn't see that in either of the prior two elections. Our demand was pretty solid throughout. So, no, the business case for leasing and development is driven by defense needs and funding that's usually already occurred beforehand. And with the mission-critical nature of the tenants we support, it's really not tied to changes in philosophy on the edges with the President position.

Blaine Heck
Analyst, Wells Fargo Securities LLC
Q

Great. Thank you.

Operator: One moment for our next question. Our next question comes from Michael Griffin with Citi. Your line is open.

Michael A. Griffin
Analyst, Citigroup Global Markets, Inc.
Q

Great. Thanks. Maybe going back to the defense spending bit for a second. Steve you noted the passage of the NDAA in December, but I think the Defense department is still running on a continuing resolution. I'd just be curious, your thoughts on if these continuing resolution continue to be the case and whether or not that would impact kind of demand or space needs for some of your tenants?

Stephen E. Budorick
President, Chief Executive Officer & Trustee, COPT Defense Properties
A

Yeah. Well, let me phrase it this way. In the 12 years that I've worked at this company, in only one year did we not have a continuing resolution. The continuing resolution is really the norm, and the issue is, does it get wrapped-up early or does it become protracted. The longest protracted continuing resolution was in 2017 which extended to about May 25, primarily because the new President wanted to top up the defense spending and slow down the passage. I would think, by March we should be – Congress would get around to the point where they're going to appropriate the funds, but it could go longer. Ultimately, it doesn't affect the outcomes that are going to come our way. It will cram a lot of activity in the second half of the year. So it could manifest itself in some lower progress in the first or second quarter, which we'll catch up for.

Michael A. Griffin
Analyst, Citigroup Global Markets, Inc.
Q

Got you. That's helpful. And then maybe just on the development pipeline and future opportunities. You talked about a current pipeline being highly preleased. It seems like demand is really outstripping supply in some of your key markets. Is there any appetite to start to execute on future development opportunities or are construction costs still prohibitive to make that happen?

Stephen E. Budorick
President, Chief Executive Officer & Trustee, COPT Defense Properties

A

Well, Britt pointed out that we just kicked off, call it a not pre-leased or spec building at the NBP, and that'll deliver about 138,000 square feet early next year, because we need the inventory. We're about 40% leased on an inventory building in Redstone Gateway, RG 8100, got very clear visibility into the full lease up of that asset. So we're actually moving dirt and preparing to kick off RG 8500, which will be a 150,000 square foot building to create inventory. And then we've had increased demand for our high-bay product at Redstone Gateway. So we're going to kick off a 50,000 square foot high-bay support facility for some of our existing tenants, also this quarter. So when we have demand and a lack of inventory, we will build to the demand.

Michael A. Griffin
Analyst, Citigroup Global Markets, Inc.

Q

Great. That's it from me. Thanks for the time.

Stephen E. Budorick
President, Chief Executive Officer & Trustee, COPT Defense Properties

A

Thanks, Michael.

Operator: One moment from our next question. Our next question comes from Tom Catherwood with BTIG. Your line is open.

Thomas Catherwood
Analyst, BTIG LLC

Q

Thank you. And good afternoon, everybody. Steve, I know there's no acquisitions in guidance, but you've talked in the past about maintaining liquidity for potential investment opportunities. Are you seeing any early movement in the transaction markets, and kind of given your focus on specific submarkets and tenants, what criteria would you be keen on if you were to pursue a deal?

Stephen E. Budorick
President, Chief Executive Officer & Trustee, COPT Defense Properties

A

So that's a great question. To pursue a deal, it has to be an asset with current or expected occupancy that serves the missions that we typically serve, geographically would have to be very closely located to the assets we own currently. And then the return that we have to get on that asset would have to be competitive with our development yields. And so that creates pretty small set of opportunities. We're always diligent to look at opportunities that come up. We haven't found many that meet that criteria.

Thomas Catherwood
Analyst, BTIG LLC

Q

Got you. I appreciate that. And then maybe sticking with your commentary about the inventory building at NBP, given that the park was 99.4% leased, and that inventory building doesn't deliver for the 18 months, 24 months, whatever may be, what are tenants doing when they need expansion space? And is that demand having any impact on your other Howard County business parks?

Stephen E. Budorick
President, Chief Executive Officer & Trustee, COPT Defense Properties

A

We've been able to push quite a bit of demand that would have otherwise gone to the NBP into our portfolio in Columbia Gateway. And we've got the prospect ratio that's about 160% for our vacancy in that park. So it's very positive for us long term because we're adding quite a bit of SCIF facilities in Columbia Gateway that typically would have favored the NBP.

Thomas Catherwood
Analyst, BTIG LLC

Q

Got it. And then, last one from me. Britt, first off, congratulations on your first call. And second off, you had mentioned a handful of lease renewals that were delayed because of the continuing resolution. How does the mechanics of that work? Did the leases expire and the tenants are now month-to-month, or is there still term left on the lease? How does that kind of all come together?

Britt A. Snider
Executive Vice President & Chief Operating Officer, COPT Defense Properties

A

Yeah. No, It just gets put into – if it approaches expiration then it just goes into holdover. But I mean, we feel great like I said, about those leases, it's going to happen in 2024. It just some things are out of our control. But yeah, they would stay in the space. There's no – obviously, we have no intention of moving them out or asking to move, they are long term partners of ours.

Stephen E. Budorick
President, Chief Executive Officer & Trustee, COPT Defense Properties

A

And to be clear, we use a different term, it's standstill, not holdover. Holdover implies that we could put penalties on them and kind of jack up rent. There's just a provisions in the lease to allow them keep paying what they were paying. We true up when they get a lease.

Thomas Catherwood
Analyst, BTIG LLC

Q

And it's perfect Steve, that was what I was worried about was that there would be some sort of a roll down if they were on a holdover lease. So it would be just some – no change in rent while you're coming through the continuing resolution.

Stephen E. Budorick
President, Chief Executive Officer & Trustee, COPT Defense Properties

A

Yeah. Standstill. Correct.

Thomas Catherwood
Analyst, BTIG LLC

Q

Got it. All right. That's it from me. Thanks, everybody.

Operator: One moment for our next question. Our next question comes from Richard Anderson with Wedbush Securities. Your line is open.

Richard Anderson
Analyst, Wedbush Securities, Inc.

Q

Thanks. Good afternoon. So on slide 17, what about the other 2.9 million square feet that isn't 50,000 square feet or greater? What's the status of those situations?

Stephen E. Budorick
President, Chief Executive Officer & Trustee, COPT Defense Properties
A

So if you look at our overall guidance, it's impossible for me to go lease by lease. It's very comparable, maybe there'll be some non-renewal, but we're guiding to a midpoint of 80%, and we're very comfortable, we're going to deliver that.

Richard Anderson
Analyst, Wedbush Securities, Inc.
Q

Okay. You mentioned the statistic, 89% demand to space available in your Defense/IT segment. I guess that's a good number. I think, you'd like it to be above 100%. Is there a line of sight into how that number might change over the passage of time, based on what you're seeing today? And am I asking for too much for it to be over 100%?

Stephen E. Budorick
President, Chief Executive Officer & Trustee, COPT Defense Properties
A

Yeah. Over 100% is pretty rare. We actually have a graph, we track that statistic. And anything over 70% is pretty strong, 60% is not unusual in a submarket. But remember, that's spot demand for your inventory. So it changes with every ebb and flow of a deal. But 70% and up is very strong. Over 100% is great, and we are over 100% in the BW Corridor, which includes Columbia Gateway.

Richard Anderson
Analyst, Wedbush Securities, Inc.
Q

Right. 6% same store NOI growth for this coming year at the midpoint, a little bit less than 4% FFO growth. Anthony said maybe a little bit more AFFO growth. But still the common theory is, if you get X internal growth, you should get X plus Y at the bottom line. It's not the case here with you and actually your FFO growth is actually lower. Is that just a condition of the fact that you're big time developer and you never kind of really see 6% equal 8% FFO growth or 4% equals 6% FFO growth? I'm just curious if that's just sort of a function of the way CDP operates?

Anthony Mifsud
Executive Vice President & Chief Financial Officer, COPT Defense Properties
A

No. I think it's a function of no one – none of us are immune from the change in interest rates. And the full year impact of the exchangeable note offering that we did in September of last year is in 2024's math, and that 5.25% is higher than our debt portfolio interest rate that we had prior to that transaction. So some of that, both internal and external growth, EBITDA growth is being absorbed by an increase in interest expense.

Richard Anderson
Analyst, Wedbush Securities, Inc.
Q

And I guess, I would have thought that interest rates last year versus this year, almost a wash if not an opportunity. But I hear your point, you have more stuff to deal with. So interest expense goes up. But in theory, you should see what I described. If holding all else constant, that shouldn't be a reason why you shouldn't get more FFO growth than you get same store growth. Is that fair statement in long term?

Anthony Mifsud
Executive Vice President & Chief Financial Officer, COPT Defense Properties
A

Yeah. All capital costs being equal, that's a fair statement.

Richard Anderson
Analyst, Wedbush Securities, Inc.
Q

Okay. Last question...

Stephen E. Budorick
President, Chief Executive Officer & Trustee, COPT Defense Properties
A

When interest rates down, there's some pretty interesting growth that could come back.

Richard Anderson
Analyst, Wedbush Securities, Inc.
Q

Well, you better.

Stephen E. Budorick
President, Chief Executive Officer & Trustee, COPT Defense Properties
A

Stay tuned.

Richard Anderson
Analyst, Wedbush Securities, Inc.
Q

And then the last question is, I'm just thinking, you mentioned cyber and how important it is to your business. I wonder about AI these days and whether that is being weaponized, certainly it is. Is that like a demand driver for cyber demand as well? And how do you see AI impacting your business either positively or negatively, whether it's a demand or a competitive threat to CDP? I'm just riffing a little bit, but I'm curious, if you have any thoughts on that.

Stephen E. Budorick
President, Chief Executive Officer & Trustee, COPT Defense Properties
A

Well, the answers got to be highly speculative. So if we understand the speculative, eventually the AI technology is going to reach some level of competency where it will have to be evaluated for use in the DOD environment. And I don't think we've seen, we have no evidence that we've seen any increased activity in contracts related to AI as of current. So could be potentially upside, but it's a little early to tell.

Richard Anderson
Analyst, Wedbush Securities, Inc.
Q

Okay. Fair enough. Thanks very much.

Operator: One moment for our next question. Our next question comes from Dylan Burzinski with Green Street. Your line is open.

Dylan Robert Burzinski
Analyst, Green Street Advisors LLC
Q

Good afternoon guys. Thanks for taking the question. I guess, just going back to some of the comments on cash releasing spread guidance being potentially conservative in 2024. But I guess, just as we think about the business over the next five years, given portfolio occupancy is at historically high levels, and given your comments on being able to push higher yields on costs in new Defense/IT development. So I guess, at what point does that give you guys the ability to continue to push rents in the operating portfolio? I mean, is the 0 to 2, or is it called the flat mark to market sort of a low baseline as we think about the business over the next five years?

Stephen E. Budorick
President, Chief Executive Officer & Trustee, COPT Defense Properties
A

Well, do recall, one of the interesting dynamics of our business is, we have embedded growth in our leases. That's why we give you the compound annual growth rate from the original lease to the renewal lease because we capture growth in all of our leases. And the mark-to-market is really on the renewal are we a little below the market growth in rent or are we a little above? And the zero guidance says, the internal growth, we expect is about what the market is grown, and if we beat it we were able to push up a little higher or not. But it's not a measure of no growth, it's a measure of deviation of the mark-to-market growth from the embedded growth.

Dylan Robert Burzinski
Analyst, Green Street Advisors LLC
Q

Right. So I guess, the question really is like, over the next few years you continue to expect that market rent growth will keep pace with call it the 2.5% annual escalators. Is that fair to say then?

Stephen E. Budorick
President, Chief Executive Officer & Trustee, COPT Defense Properties
A

Yeah. And remember, the 2.5% escalators generates a higher growth than 2.5% because 2.5% on a gross rent with a expense stop which allows us to pass through increases of expenses. So the average of 2.5% on the gross rents produces 3.2% to 3.45% compound growth over the term, depending on the length.

Dylan Robert Burzinski
Analyst, Green Street Advisors LLC
Q

Great. I appreciate the comments, Steve. Thanks.

Operator: [Operator Instructions] Our next question comes from Steve Sakwa with Evercore ISI. Your line is open.

Steve Sakwa
Analyst, Evercore ISI Group LLC
Q

Great. Thanks. Good afternoon. Steve, I think in your prepared remarks, you guys talked about the lease up of 2100 L Street, which I know is kind of in the non-core, non-Defense/IT bucket. Where does that sit in terms of potential disposition candidates in 2024?

Stephen E. Budorick
President, Chief Executive Officer & Trustee, COPT Defense Properties
A

That'll be market dependent. So Britt alluded to some more news that could be positive in the leasing front. And I think, if we're able to achieve what he alluded to, the occupancy will be positioned well for a disposition. And then, it's a question of what does the capital market look like to bring that asset to market. Currently, our belief is, there's very little demand for investment in even a trophy asset like this. There's a lot of uncertainty around interest rates and what the fed's going to do. The cuts that were expected have been delayed, I think that creates a difficult backdrop for investors to move ahead. But I will say, we will maintain a very nimble position. And when the market supports an efficient sale, we intend to sell it.

Steve Sakwa
Analyst, Evercore ISI Group LLC

Q

Great. And then on the data center shells, you basically said you've got no land, I think, and no starts penciled in. Just how are you thinking about that business at this point with kind of the major customer you have? Are you looking for additional sites outside of the Northern Virginia kind of core market that you had, or you sort of kind of that whole business is on hold? And how do you think about the retention of that business long term if it doesn't grow from here?

Stephen E. Budorick
President, Chief Executive Officer & Trustee, COPT Defense Properties

A

So we are working actively to find additional opportunities to develop. Our market is further impaired by a lack of clarity of power availability. And so until there's clarity on power, and then from that demand we just have to be an observer of the conditions, looking for opportunities and moving forward when conditions will allow us to do a lease.

Steve Sakwa
Analyst, Evercore ISI Group LLC

Q

Well, maybe asked a little differently, are you kind of locked into the one submarket or one area where you develop with them or could that sort of expand geographically within the broader Virginia market?

Stephen E. Budorick
President, Chief Executive Officer & Trustee, COPT Defense Properties

A

I think we could expand. I can't tell you that we're actively working on expansion. We have yet to see the demand spill into the collar counties that have more affordable land and quite a bit of it, primarily because the power is still the constraint on the market.

Steve Sakwa
Analyst, Evercore ISI Group LLC

Q

Great. That's it from me. Thanks.

Operator: That concludes the question-and-answer session. I will now turn the call back to Mr. Budorick for closing remarks.

Stephen E. Budorick
President, Chief Executive Officer & Trustee, COPT Defense Properties

Thank you all for joining the call today and the great questions. We're in our offices. So please coordinate through Venkat if you'd like a follow up call. Thank you.

Operator: Thank you for your participation in the COPT Defense Properties fourth quarter and full year 2023 results conference call. This concludes the presentation. You may now disconnect. Good day.