PSBQ119
Maria Hawthorne
PS Business Parks Incorporated
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Operator: Good afternoon and welcome to the PS Business Parks First Quarter 2019 Earnings Results Conference Call and Webcast. At this time, all participants have been placed in a listen-only mode and the floor will be open for your questions following the presentation. If you would like to ask a question at that time, please press * and 1 on your touchtone phone. If at any point your question has been answered, you may remove yourself from the queue by pressing the # key. If you should require operator assistance, please press * and 0.

It is now my pleasure to turn the floor over Jeff Hedges, Chief Financial Officer. Please go ahead.

Jeff Hedges: Thank you. Good morning, everyone, and thank you for joining us for the First Quarter 2019 PS Business Parks Investor Conference Call. This is Jeff Hedges, Chief Financial Officer. Here with me are Maria Hawthorne, CEO; John Petersen, COO; and Trenton Groves, CAO.

Before we begin, let me remind everyone that all statements other than statements of historical facts included in this conference call are forward-looking statements. These forward-looking statements are subject to a a number of risks and uncertainties, many of which are beyond PS Business Parks' control, which could cause actual results to differ materially from those set forth in or implied by such forward-looking statements.

All forward-looking statements speak only as of the date of this conference call. PS Business Parks undertakes no obligation to update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise.

For additional information about risks and uncertainties that could adversely affect PS Business Parks' forward-looking statements, please refer to the reports filed by the company with the Securities and Exchange Commission, including our Annual Report on Form 10-K and subsequent reports on Form 10-Q and Form 8-K.

We will also provide certain non-GAAP financial measures. Reconciliation of these non-GAAP financial measures to GAAP is included in our press release and earnings supplement which can be found on our website at psbusinessparks.com.

I will now turn the call over to Maria.

Maria Hawthorne: Thanks, Jeff. Good morning, everyone, and thank you for joining us. 2019 is off to a great start. We're happy to report Same Park NOI growth of 4.3% along with 9.2% rent growth on 1.6 million square feet of executed leases. These metrics, combined with Same Park occupancy of 94.5%, demonstrates the strength of our infill markets combined with our small customer strategy.

Market conditions for industrial properties remains among the best we have seen. Our balance sheet is well positioned for growth and investor demand for our type of real estate is intense. JP will give greater detail on the performance of our operations, and Jeff will close with some commentary on our Q1 financial results.

Current operating conditions in nearly all our markets are excellent, and Washington D.C. which has lagged in prior quarters is improving. We feel that, on average, we are likely to continue to achieve improved rental rates on new and renewed leases for our 2019 expirations. We remain focused on making multi-tenant industrial park acquisitions in our existing markets. Pricing remains high and our volume will be dependent on the quality and pricing of opportunities.

I'm pleased to tell you that in the month of April, we closed on the acquisition of Walnut Industrial Park, a park located in Los Angeles very close to some of our most established and successful assets. Walnut has long been a direct competitor. It is comprised of eight buildings, totaling 74,000 square feet with 32 customers. We purchased the park for $13.8 million and it is currently 98% leased with in-place rents approximately 20% less than what we are getting on our comparable properties. As is typical with our acquisitions, there will be some turbulence in occupancy over the next two years as we increase rents to market.

In the first quarter, we announced that we were marketing two parks for disposition as we continue to shed office parks that we do not intend to redevelop in the near-to-mid-term. The assets are located in Montgomery County, Maryland, totaling approximately 1.4 million square feet and in 2018, they generated approximately 7% of the company's total NOI.

As a quick update, I wanted to let you know that the properties are on the market, the offering memorandums are out, and they are currently being shown. We are willing to sell as a single portfolio and we are also considering multiple sales similar to what happens in Orange County last year, which resulted in giving us the best value through three separate transactions in a process that took nine months to execute.

We will keep you updated as the marketing process evolves. Now, I will turn the call over to JP.

John Petersen: Thanks, Maria. In terms of operational metrics, 2019 started where 2018 left off. User demand was robust in all our markets, lease concessions were contained, and our teams in the field delivered cash rent growth of 9.2%. A portion of our leasing volume was driven by our existing customer base with a net of 18 expansions, aggregating to almost 80,000 square feet. Notwithstanding the fact that Same Park occupancy dipped 63 basis points to 94.5% due to the known move-outs I mentioned last quarter, favorable landlord momentum reached into each of our markets driven by growing small businesses. This demand from small users helped drive strong leasing production in Q1.

I will now provide market-by-market update going west to east. In Seattle, the operating environment remains tight, demand is consistent, and we delivered strong results. Rent growth was nearly 19% on the strength of 24 deals for 78,000 square feet. Occupancy dropped to 96.1% from 99% in Q4 due to three separate move-outs at the end of 2018 as they outgrew our essentially full portfolio. We have since released one of the spaces and have good tour volume on the other two. We expect to continue to see this kind of move-out activity from time to time as we simply don't have room to handle all our internal customer demand.

Our Northern California team was again able to take advantage of the landlord favorable conditions and signed 87 deals totaling 329,000 square feet, an average of 3,800 square feet per lease with rent growth of 22.1%. As expected, occupancy dipped 120 basis points to 96.6% as we took back the 130,000-square-foot industrial space in Hayward I noted last quarter. Aside from that move-out, demand is healthy and our team is focused on continuing to push rents, meet existing customer demand, and improving both the use and credit quality of our customer base.

In Southern California, the economy is healthy, demand is good, and we delivered 311,000 square feet of deals. Occupancy dropped a 110 basis points in Q1 to 95.7% due to a 53,000-square-foot industrial user filing bankruptcy. The good news is that once we get this base back, we should be able to release it quickly and generate solid rent growth. Blended rent growth in Southern California for Q1 was 10.6%.

We signed 327,000 square feet in Texas in 80 transactions with retention of 84%. In Dallas, [wooed] by a strong local economy, our small customers are looking to secure their space in a tight market, pushing retention to 91% and rent growth of 6.6%. In Austin, user activity was strong which allowed us to grow rents 5.5%.

In Washington Metro, the team completed 400,000 square feet in 117 deals, an average of 3,400 square feet. Strong retention of 79% helped improve our cash rent decline which was negative 2.8%. A portion of this demand is coming from tech users, both the private sector and government contractors. Our Q1 Same Park occupancy in Northern Virginia was 93.7%, again demonstrating we are capturing more than our fair share of user demand.

The South Florida industrial market continues to be one of our strongest operating environments. As such, our team grew rent 16% on 219,000 square feet, an average size of 4,400 square feet. We generate the best rent growth on our dock-high industrial spaces, below 5,000 square feet at our MICC Park in Miami. Users looking for small industrial space with dock and grade-level loading near Miami International Airport have very few options, allowing us to set rents 20% higher than the competition.

Looking ahead, I am confident that primarily driven by continued small business job growth, our team will be able to produce favorable metrics on the approximately 18.7% or 5.3 million square feet of our portfolio expiring in 2019. The majority over 70% of these expirations occur in our strong coastal industrial markets, which should provide ample rent growth and retention opportunities.

Now, I'll turn the call over to Jeff.

Jeff Hedges: Thank you, JP. I'm pleased to report that we kicked off 2019 with a strong first quarter. Net income for the three months ended March 31st was $0.96 per common share, while FFO was $1.67 per share, an increase of 5.2% from the same period a year ago. The increase in FFO was primarily attributable to growth in Same Park NOI, which increased 4.3% in Q1 driven by 4.3% rental income growth. Note that FFO growth also benefited from NOI generated by our NVIP portfolio which we acquired in mid-2018. Funds available for distribution or FAD was $46.2 million, an increase of 5.3% from Q1 2018. FAD growth was driven by the same factors as FFO coupled with continued discipline in our management of recurring capital expenditures.

I'd like to now spend a minute providing some commentary on a couple updates to our reporting package that we pushed through this quarter. First, we have enhanced our cash NOI disclosure to now include cash NOIs by market and product type. Cash NOI - which, as we present it, excludes straight line rent from rental revenues and stock-based compensation from operating expenses - had historically been provided on a Same Park and total portfolio basis, and our hope is that this additional disclosure will allow you to form a more granular view on the performance of our portfolio.

Second, you'll note that beginning on January 1, 2019 we are recording compensation costs related to our divisional vice presidents in general and administrative expense, as the role that these four individuals play within our organization is more aligned with corporate oversight than with direct property operations. Where appropriate, we have reclassified prior periods to conform to the current period presentation in effort to preserve comparability between periods. While the dollar amount of this reclassification is not significant, we believe that this change will be helpful going forward in comparing our property operating performance to that of other market participants, as well as comparing our corporate overhead expense to that of our corporate peers.

Turning now to Highgate at The Mile. We are pleased with the first quarter results of over $1.4 million of net operating income, up from $1.3 million in Q4. Recall that we began the year at stabilized occupancy levels and the strategy for the first half of 2019 is to bring rents in line with market rates as some of our early tenants turn for the first time. As a result, we expect to see Highgate's NOI continue to increase as we progress deeper into the year.

Finally, I'll wrap up by pointing out that we paid a dividend of a $1.05 to common shareholders in the first quarter and our board recently declared a dividend of a $1.05 to be paid to shareholders in the second quarter payable on June 27th to shareholders of record on June 12th.

Our balance sheet at March 31st remains largely consistent from how we began the year, and I'll note that we funded the recent Walnut Industrial Park acquisition with cash on hand leaving our corporate credit facility untapped and ready for use, if and when we identify additional accretive acquisition opportunities.

With that, we'll now open the call for questions. Operator?

Operator: The floor is now open for questions. At this time, if you have a question or comment, please press * and 1 on your touchtone phone. If at any point your question is answered, you may remove yourself from the queue by pressing the # key. We do ask that while you pose your question, you pick up your handset to provide optimal sound quality. Thank you.

We'll take our first question from Manny Korchman with Citi. Please go ahead. Your line is open.

Jill Sawyer: Hey, guys. It's Jill Sawyer here with Manny. Can you talk about some of the embedded mark-to-market you have on the lease role and some of the higher growth markets like California or South Florida?

John Petersen: Yes. Sure, Jill. We've, as you all know, had good track record over the last several quarters with rent growth in Northern California in the high teens, low 20s quarter-after-quarter and as we continue to take leases to market, we see that continuing. It could fluctuate quarter-to-quarter depending on what roles but with mostly our West Coast expirations, we're happy to get that space coming to us because markets are strong, market rent growth is strong, and we're able to mark-to-market quite nicely. Will it always be over 20%? I don't think so, but we're anticipating strong conditions in '19.

Jill Sawyer: Okay, and now your industrial retention rate was lower than some of the peers this quarter, how do you go about weighing the balance between pushing rents versus keeping tenants or your willingness to lose them?

John Petersen: Yes, it's a great question and the good news is especially in our coastal markets including Florida, we have the upper hand. In Seattle, I noted we lost some occupancy. Tenants just outgrew our park. They needed more space, we didn't have it. In Northern California, we lost a big space, as I mentioned last quarter. They also outgrew our portfolio. But more often than not, it's advantageous to us to renew a customer than to let a customer go. All things being equal because we'll have less transaction costs, lower broker fees, etcetera, but it is a balance. We're also trying, as I noted earlier, to ensure that we have good long-term credit and good tenant uses going forward, so we have the ability to be more selective now and so you will see from time to time that we let a tenant go, if we don't like to use their lines of credit and it gives us - we do have options on most of our expirations in our coastal industrial markets.

Jill Sawyer: Great. Thanks, JP.

John Petersen: Sure. Thanks.

Operator: We'll take our next question from Brendan Finn with Wells Fargo. Please go ahead.

Brendan Finn: Hey, guys. Good morning out there. I guess can you guys comment on the acquisition environment in the event of a sale of the Maryland assets, and I guess where you guys are looking, if you're looking for core-type assets or maybe value-add assets?

Maria Hawthorne: Yes, Brendan. Q1 was a little bit slow. The reports were it was down. We didn't see a lot of assets, and then what there was did sell at record highs within their markets, so it's intensely competitive. There was even competition on the small asset in Signal Hill because that's a market that's very, very desirable at the intersection of the 405, the 91, and the 110. Our goal will be to do what we did last year but we'll have to double it so if you think about when we sold our Orange County and the asset in Texas, it was almost a dollar-for-dollar trade with the NVIP portfolio and portfolios like that tend to come out after first quarter. Believe me, we're talking with investment brokers in our markets and we are looking to repeat our success from last year.

Brendan Finn: Got you. Thanks, Maria. Then I guess JP, you mentioned the industrial tenant filing for bankruptcy. When do you plan to get that space back? Then, I guess are there any other tenants that are on your watchlist that you guys are concerned about?

John Petersen: No. There are no major tenants that we're concerned about. We can't get the space back soon enough, obviously. Based on where it's located in Los Angeles, it's a great industrial park and it might take a couple of months to go through the bankruptcy process and recapture the space, but that's not preventing us from marketing it and things like that. It's a good opportunity for us to mark-to-market.

Brendan Finn: Got you. Thanks, guys.

John Petersen: Yes. Thanks, Brendan.

Operator: We'll take our next question from Craig Mailman from KeyBanc Capital Markets. Please go ahead.

Craig Mailman: Hey, good afternoon. Maria, could you maybe just - I know it may be early in the marketing process, but any takeaways you're seeing from kind of depth of demand for the potential asset sales and pricing expectations? I know [you have] a good cap rate, but just maybe versus your initial what the brokers are kind of guiding you guys to?

Maria Hawthorne: Okay. Sure, Craig. We are seeing good activity. There has been over 70 requests for signatures to the NDA so when those get signed, that gives people access to the rent role. We are in very heavy tour mode last week and this week and next week. We'll probably do an initial call for offers. It's hard for me to say right now whether it will go as a full portfolio or if we will split it up because we do have interest both on the full portfolio, but as well as interests from people who are interested in bits and pieces. It's hard for me to give guidance right now on where that pricing will go, but I will say that the office market for Suburban Maryland is not what it was for Orange County last year so we're anticipating for the office pieces, cap rates that are in the 9% to 9.5% range.

Just as a reminder, one of the parks that we're selling have the big 156,000-square-foot user, we'll be vacating this year and for the remaining nine months of the year, depending on when we sell that office or that asset in Maryland, that will negatively impact our NOI by about $2.7 million compared to what it contributed last year.

Craig Mailman: Right, and that kind of leads into my next question. Are you guys seeing any different - I guess how much demand is there for that piece of portfolio versus kind of the better [well leased]? I guess what kind of appetite is there for vacancy in that market?

Maria Hawthorne: Well, actually the property that that big customer is leaving is actually a flex property that is directly adjacent to a brand new hospital that's opening next quarter, so there's actually a lot of interest in that asset and it's being seen as a value-add opportunity.

Craig Mailman: Okay. All right. Then, Jeff, I know we've talked about in the past. It has been a while since you guys put an LTIP in. I know you don't give guidance, but is there any indication from the board that that could be in the future and kind of bump up G&A here as we go forward?

Jeff Hedges: Yes, so we don't have anything to officially report here today. That conversation is being at the board level. The board recognizes that it has been a while since our last LTIP expired, and so we do expect that something will be in place at some point in the future, but we don't have any guidance to give you here today as to the timing of that. Unfortunately, I just am not able to disclose any more than that at this point in time.

Craig Mailman: No, that's fair. I guess just as a benchmark, what type of drag have you guys historically seen when some of those plans were put in place? Is it sort of around $4 million annual kind of drag, that kind of a good place for it?

Jeff Hedges: Yes. There are some nodding heads in the room here, Craig. I think you're in ballpark. Again, I have to be careful here because that is dependent on a number of different variables. There are several factors that could influence the gap impact in terms of what the increase of G&A would be, but I think ballpark you're in the right area.

Craig Mailman: Just one last one for JP. You guys had some good success here on moderating the rent role downs in Northern Virginia in the last couple of quarters. Has this been a mixed issue where maybe some of your industrial rents are rolling, and so you have a better mix versus more office or is this kind of sustainable?

John Petersen: Great question, Craig. It's a little bit of both. If you look at - we are able to see rent growth our industrial portfolio in Northern Virginia and we recognize that. Our industrial flex portfolio is in the mid-90s and in that environment, we have the ability to push rents, not as much as we would like in other, say, we have in the West Coast. But that's also offset by improving demand, low unemployment on the office sector in Northern Virginia. Then, as I mentioned in my prepared comments, our portfolio in

Northern Virginia is almost 94% leased, and we're coaching our teams. "Okay, when you're in the mid-90s, you have to try harder to maintain rents, at least maintain your last outgoing rent." It is still a struggle. Market vacancy is still in the high teens, low 20s so we're fighting that battle, but our portfolio especially in Tysons and that area, we're in 93%, 94%, pushing 95% at times. In that environment, there's good demand and we can at least maintain rents.

Now, sometimes we have a longer term lease that's coming up. A bunch of annual increases, it's harder there but, yes, our team has done a great job in Northern Virginia trying to minimize rent declines. Does that help?

Craig Mailman: Right. Thank you. Yes.

Operator: We'll take our next question from Eric Frankel with Green Street Advisors. Please go ahead.

Eric Frankel: Thank you. Just to clarify the potential Maryland sale, Maria, when you say the expected pricing amounts to a 9% to 9.5% cap rate, does that include this 156,000-square-foot tenant vacating or does that include -[does that presume] that that gets leased up and have to stabilize deals?

Maria Hawthorne: It does include the underwriting assumes that that tenant is vacating. Because it's flex, we don't expect that one to necessarily be at the 9% to 9.5%. However, there is a lot of office in that portfolio, and so that the office portion will drive the total sale to that overall cap rate, Eric.

The only thing is that I would be very hesitant to assume that all of this will sell either second or third quarter because if the pricing doesn't come in to our expectation, we could do what we did in Orange County and Texas where we take a step back and then break the portfolio apart because it does break very nicely into six separate pieces.

Eric Frankel: I see, and per what you're describing in the last call where you may not see the short or near medium term opportunity for redevelopment, is it being marketed that way? Just trying to understand kind of where - how to look at these assets.

Maria Hawthorne: Yes. No, these assets, we don't see as redevelopment opportunities for us. However, there's about a 1.5 million square feet in Eastern Montgomery County that we're selling that is in an opportunity zone, and the one asset that does have the big vacancy that is adjacent to the hospital, there are other medical office users that are looking at that as potential redevelopment opportunities. We're not going to redevelop into office, so that's why we're just shedding this portfolio at this time. There may, in the future, be some other portfolio, pure office play portfolios that we will be announcing like maybe next year but right now, the only office that we would be keeping would be what we consider redevelopment plays, for instance, Tysons at The Mile. We have a beautiful asset portfolio that's currently about 95% leased in San Mateo. That would be a longer term redevelopment opportunity, but it's in San Mateo in a great location. For instance, you would not see us putting that up for sale. Does that…?

Eric Frankel: Yes, that's helpful. It sounds like potentially more assets in Maryland and Virginia might be taken out of your portfolio at some point. Is that fair to say?

Maria Hawthorne: Yes. If you think about it, the only office that we have left on the West Coast really, other than maybe a tiny little building within a bigger park, yes, there is. It is the asset in San Mateo, and then really the office that's left is Northern Virginia and Maryland.

Eric Frankel: Okay, thanks.

Maria Hawthorne: Okay?

Eric Frankel: Then maybe this is for Jeff, I suppose, just on the Highgate project. I know you're describing that you want [unintelligible] and offer some lease and concessions so maybe that skewed the rent figures a little bit, but could you maybe provide what you think a stabilized yield is going to be on that project and how that's going to affect your underwriting for future phases going forward?

Maria Hawthorne: Hey, you know what, Eric? Let me take that one and just give a little bit of context around Highgate. Unlike our commercial where we give weighted average occupancy, for the apartment we stated what occupancy was on December 31st and I think you noticed we dropped about 100 basis points to March 31st. First off, that was because we had our first significant rollover of customers. Then you'll also see that the average rate per unit dropped a few dollars. One of the reasons for that was because we finally leased up all of our workforce dwelling units, so that had a heavier impact than normal on first quarter.

The good news though is that between now and 2021, there's only 900 more units delivering in all of Tysons and they are all high-rises. As a result of the delivery in the market tailing off, we're finally beginning to see some rent growth opportunity in Tysons, and we currently are offering zero-free rent and zero incentives at Highgate.

Hence, Jeff's comment that each quarter we do expect NOI to increase at Highgate as we're rolling off of some lower rents that we had in place last year that we gave some massive concessions and we had some lower rents just so that we could get the occupancy going, so now we want to maintain around 95% occupancy and then we're going to push rents as hard as we can.

Eric Frankel: Okay, thanks. I appreciate that. That's all I've got. Thank you.

Maria Hawthorne: Okay.

Operator: We'll take our next question from Anthony Paolone with J.P. Morgan. Please go ahead.

Patrice: Hi, guys. This is actually Patrice on for Tony. Just a quick one as most of my questions have been answered. Are you guys disclosing the cap rate for the Signal Hill acquisition?

Maria Hawthorne: Yes. Patrice, we don't disclose the cap rate, but I can tell you given that in-place rents we are at least 20% below current market and the location, so the price per pound was very, very high. It does have a very low in-going cap rate and we'll be improving it over the next two years because 76% of the rent role does roll in the next 18 months.

You might see us as we're pushing rents to what our current Signal Hill assets are giving us. You might see, like I said, some turbulence with occupancy, as you know, as we get the full park to market and improve our returns.

Patrice: Great. Thanks, Maria.

Maria Hawthorne: Sure.

Operator: It appears we have no further questions. I'll return the floor to Jeff Hedges for any additional or closing remarks.

Jeff Hedges: All right. Well, thank you, everybody. It was a pleasure talking with you today and we look forward to seeing many of you at NAREIT. Have a good afternoon.

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