PSBQ219
Maria Hawthorne
PS Business Parks Incorporated
07/24/19
12:00 pm ET

Operator: Good afternoon, and welcome to the PS Business Parks Second Quarter 2019 Earnings Results and Conference Call. 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 to Jeff Hedges, PSB’s Chief Financial Officer. You may begin.

Jeff Hedges: Thank you. Good morning, everyone, and thank you for joining us for the Second 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 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 today. We are pleased to report several exciting items this morning, starting with our quarterly financial results.

Q2 was another strong quarter for us as our reported Same Park NOI grew 5.2%, with cash rental rate growth of 9% on 1.7 million square feet of executed leases. Occupancy held steady at a weighted average of 94.3% for our Same Park portfolio and total portfolio retention was over 72%. These strong results again demonstrate the strength of our infill markets combined with our small customer strategy.

Now, I am extremely pleased to announce that we recently received master plan rezoning approval for The Mile in Tysons, Virginia. We're very happy with the success of Highgate, our existing 395-unit, multifamily property and with this master plan approval, we now have the ability to move forward with all future phases of redevelopments, which includes about 3 million square feet of mixed use density or, said differently, nearly 3,100 additional multifamily units. Of course, redevelopment of the park will take several years to complete, but our rezoning approval affords us complete discretion on if and when to move forward with any future phase of development.

Today, we are only pursuing the next phase of development, which will be called Brentford at The Mile, a multifamily property, which will be very similar to Highgate in size and design. What we love about Brentford and the potential next phase of development behind it is that both can be developed without disrupting any of the in-place NOI we are currently generating from our existing office properties, which are currently over 94% leased. It is too early to say exactly when construction will begin on Brentford, but we are estimating sometime in mid-2020. Of course, we will keep you informed of our plans as they evolve.

Now, for a quick update on the potential sale of the Maryland office portfolio which we announced on our previous earnings call. We are pleased with how the marketing process has progressed, and you'll note that in our GAAP financials we have reclassified a portion of the marketed portfolio to held-for-sale. These held-for-sale properties accounted for 5.9% of our total company NOI in fiscal year 2018, and 5.5% of our total company NOI in the first half of 2019. Expect another update from us on this process on our next quarterly call.

Lastly, I would like to welcome Steve Wilson and Kristy Pipes to our Board of Directors. Both Steve and Kristy bring with them extensive real estate and financial expertise, and we are extremely excited to have them advising us going forward.

With that, I turn the call over to JP.

John Petersen: Thanks Maria. As most of you already know, the industrial market is robust in each of our regions with solid demand, low overall vacancy, and historically low unemployment. The cumulative impact of all this is strong operating metrics for our portfolio in Q2. Our Washington Metro division had another good quarter, leasing 410,000 square feet, retention of almost 80%, and essentially flat rent growth. Additionally, combined Same Park occupancy in Washington Metro was 93.5%, with Northern Virginia an outstanding 94.7%, a 370 basis point improvement over Q2 2018.

What has been the key to our recent success? One, we have an experienced, talented team that has been in the market through good times and bad. Two, as we have been talking about for over a decade, our focus on small multi-tenant parks, buildings, and suites allows us to tap into a small business environment that has been growing for some time; and three, the tech sector is leading an expanding D.C. economy and we are capturing more than our fair share of this activity.

Now, for an update on our 1 million square foot, 19-building, multi-tenant Northern Virginia Industrial Portfolio we purchased in June 2018. We have completed our repositioning efforts, cleansed some of the undesirable users, and improved occupancy from 76% to over 85% as of today. We are on track to stabilize NVIP in mid-2020 near 95%, just as we expected.

Leasing activity in Northern California was also active in Q2, with our team signing 398,000 square feet of deals, generating cash rent growth of almost 17%. Occupancy dipped by 80 basis points from Q1 as we saw a handful of users over 20,000 square feet move out. We were able to lease a 130,000 square foot vacancy I mentioned last call to an existing customer that needed additional space. That occupancy commenced in late Q2. Rent growth on that lease was an excess of 30%, as we priced the space to the current market rate.

We have three other expirations over 150,000 square feet in Q4 that are currently in various stages of negotiations. We expect healthy rent growth on these deals and while we may experience some downtime on one or more of them, these buildings are in good sub-markets and we have solid interest.

Southern California had another strong quarter, signing 315,000 square feet of leases, buoyed by retention of 75%. Rent growth was nearly 10% and demand for small tenant industrial space is quite healthy. The Southern California economy, especially industrial sector, is performing at historically high levels, giving us the ability to keep our customers and push rents.

In Texas, our team signed 264,000 square feet in 56 deals. Combined rent growth in Austin and Dallas was 8.6%, with Dallas a solid 10.3%. Small users led our leasing volume with an average deal size of 4,700 square feet. Occupancy in Texas increased 290 basis points on the strength of these small users and a customer retention of almost 77%.

In South Florida, we have yet to see any material signs of the trade wars and demand is active, especially for suites under 10,000 square feet. We signed 228,000 square feet, 4,000 square foot average deal size. Retention was low for us at 34% as we saw three users over 15,000 square feet move out in the quarter. We have backfilled one of those spaces and have activity, including existing customers on the other two. Based on strong market demand, rent growth was over 10% in Q2.

Finally, Seattle completed 26 leases for 73,000 square feet. Occupancy in Seattle is 95.1%, as we had two spaces over 20,000 square feet vacate in

Q2. Subsequently, we released one which has already taken occupancy with strong rent growth in the mid-teens. For the quarter, rent growth was over 15% as the Seattle industrial market remains one of the hottest in the country.

As we look ahead to the balance of 2019, we remain optimistic that the economic engine in our markets will drive user demand and with vacancies at or near historic lows, our teams will put together positive metrics. I look forward to the opportunity we have with our three larger expirations in Northern California to push rents, improve users, and upgrade credit quality.

Other than that, with 13% or 3.6 million square feet of our portfolio expiring in 2019, our teams will continue to execute by pushing rents, lowering transaction cost, and maintaining occupancy in the mid to high 90s.

Now, over to Jeff.

Jeff Hedges: Thank you, JP. I'm pleased to report that we rounded out the first half of 2019 with a strong second quarter. Net income for the three months ended June 30th was $1.04 per basic and diluted common share, and for the first half of 2019 was $2.00 per basic and diluted common share. FFO was $1.75 per share for the quarter and for the six months ended June 30th was $3.42 per share, an increase of 7.8% from a year ago. Meanwhile, funds available for distribution or FAD increased 8.5% during the first half of the year. The increases in both FFO and FAD were primarily attributable to growth in Same Park NOI which increased 4.8% in the first half of 2019 compared to the prior year. On a cash basis, which excludes the effect of non-cash rent, NOI increased 5.5% for the six months ended June 30th, driven by 4.8% cash rental income growth.

There are a couple of items I would like to point out related to our Same Park operating results. First, in connection with their classification as held-for sale for GAAP purposes, the Maryland disposition of properties have been excluded from our Same Park financial results for the three and six months ended June 30th, as well as in the comparative periods for 2018.

Second, I would like to point out that we did benefit from above average lease buyout income in Q2, which was approximately $780,000.00 during the second quarter. After normalizing for leased buyout income, our Same Park NOI growth for the six months ended in June 30th would have been 4.2% or 4.9% on a cash basis.

Turning now to an update on The Mile, we are pleased to report that Highgate continues to perform well and NOI for the first half of 2019 came in at $2.9 million, which was in line with our expectations. We expect continued NOI improvement in the second half of 2019 as we churn through the remainder of first generation leases.

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

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

Operator: The floor is now open for questions. At this time, if you have a question or a 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.

Our first question is coming from Craig Mailman with KeyBanc Capital Markets. Please go ahead.

Craig Mailman: Hi, everyone. Just, Maria, a couple of follow-ups here on the Maryland portfolio. Could you just give us a sense of where you are in the process at all? Just what's being excluded from the held-for-sale portfolio of the assets you want to sell?

Maria Hawthorne: Morning, Craig. Yes, that's a good question and what we did when we marketed was we marketed the 1.4 million square feet as the total portfolio, but we also marketed it in pieces as six separate portfolios that could be purchased. What happened is that when pricing came in and if you remember, we said that we would evaluate when and if and what to sell, we determined that there was one piece which is a 114,000-square foot building with a single user. It's a government user with six years left on the term and we decided to keep that. Then the other piece of the portfolio we decided to keep was just a small lot with a land lease. It's a ground lease with a bank on it and there's a lot of term left on that. We excluded those two points and we're confident that the balance of the portfolio, 1.3 million square feet, will sell.

Craig Mailman: Okay, and I think you guys had said last quarter or when it first came out, it's I guess with the 160,000 gone, it was like $16 million or $17 million of NOI. Is that still kind of the bogey here? I know you gave the percentages. I'm just trying to get the nominal value.

Maria Hawthorne: You want to take that?

Jeff Hedges: Yes. Hi, Craig. This is Jeff. We don't have any specific NOI number to guide you on related to just the portion that is being classified as held-for-sale, other than the percentage of NOI that Maria mentioned in her opening remarks.

Craig Mailman: Then just timing on this, I know you guys are pretty sensitive to tax planning. What do you think timing would be on the assets that could sell, and are you guys even anywhere close to LOIs or under contract on any other stuff?

Maria Hawthorne: Yes. Okay, so we're in negotiations. We did qualify to moving these to being held for disposition. We're hopeful that it will happen this year. Then the other thing I would like to say is that we have also identified enough of an acquisition pipeline, Craig, that we feel confident that we will be able to do an exchange so that we won't be doing a special dividend which we were uncertain about earlier in the year.

Craig Mailman: Okay, and on what you're rolling it into, is that more industrial or more flex office? I'm just trying to get a sense of what you think the dilution could be if these are in that 8% to 9% range? Where do you guys think you can redeploy?

Maria Hawthorne: Okay, so right now, we're looking to redeploy in a core plus market on the West Coast, so that's going to be at a cap rate far lower than 8% or 9%.

Craig Mailman: Fair, and then just one last one for me. I know you guys are going to be pretty deliberate on how you build out the rest of The Mile but in terms of how we should anticipate you guys funding the Brentford here starting next year, you guys have typically used preferreds in the past. Is it going to be more construction financing and unsecured? How do you guys see the balance sheet management changing, if at all, as you build this out?

Jeff Hedges: Yes, Craig. It's a little too early to give any real guidance on that point, other than to say we have sufficient capacity under our credit facility, so we have that at our disposal for construction financing if we choose to use it, but there are a number of variables in play, including other potential acquisition opportunities or other things that could impact our cash management between now and when we actually start construction on the project. I would not expect to see any true secured construction financing just given that we have sufficient capacity, again either on our corporate credit facility or through other means available to us to fund that project.

Craig Mailman: Great. Thank you.

Operator: Our next question will come from Blaine Heck with Wells Fargo. Please go ahead.

Blaine Heck: Thanks. Just a follow-up on that. When you think about your cost of capital, clearly you guys have a better cost of equity than I think you ever have. Does that have any effect on your investment strategy or underwriting, and would you guys consider equity as an attractive source of funds if there were a large opportunity to come along?

Maria Hawthorne: Yes, Blaine. That's a really good point. We are trading at multiples that are extremely attractive and our cost of capital is certainly the lowest that we have seen in our history since we went public in 1998. Given the strength of the markets, the way the industrial markets are going, it is changing how we are looking at potential acquisitions, and we plan to utilize the strength of our balance sheet right now as we go forward with development and future acquisitions.

Blaine Heck: Okay, and then I guess generally and separate from the 1031 you're talking about in conjunction with the Maryland industrial sales, are there any markets that you're currently targeting that you'd like to be in and that you're not in currently?

Maria Hawthorne: Right now, all of the markets that we're in are very deep so like if you think about the Los Angeles market which is nearly 1 billion square feet, we can go much deeper within our markets and where we actually have successful operating platforms, but we do look at new markets and to go into a new market, I think as we've said before, we do like to enter a market with concentration of hopefully about 1.5 million square feet which allows us to put our own leasing and management team in place, which is how we like to operate our facilities. We wouldn't exclude going into new markets but right now, current potential acquisitions are within existing markets.

Blaine Heck: Okay, that's helpful. Lastly, for Jeff, your NOI margin was stronger this quarter than it has been recently. While I think some of that is due to reclassifying the salary, the G&A instead of OpEx, were there any other operating expenses that you expected to incur this quarter that may have gotten pushed out or any other nuances?

Jeff Hedges: Yes. The short answer is it was a pretty normal quarter for us. Now, obviously, given the nature of our business, there are a number of things that could influence the timing of certain operating expense items, including utilities and repairs and maintenance. There are no large items to note. There potentially could be a little, depending on weather patterns, storm-related damage, things like that. It's always possible that Q3, Q4 could have additional R&M spend, but we're not forecasting anything necessarily in that area.

One item I do want to clear up though on what you said regarding the reclassification of the salaries, we have restated that in the period shown, so

I just want to make sure if you're looking on a comparative basis based on what we have produced last quarter and this quarter in our earnings supplement, we have normalized that for all periods shown.

Blaine Heck: Got it. That's helpful. Thanks.

Operator: Our next question will come from Eric Frankel with Green Street Advisors. Please go ahead.

Eric Frankel: Thank you. Just to clarify on the Maryland assets that have been reclassified as held-for-sale, what is the occupancy of those assets? I understand that a large tenant left, but I just want to make sure I understand that better.

Maria Hawthorne: You know what, Eric?

John Petersen: Eric, we'll have to get back to you on the specific occupancy, where it is right now, because as we've been marketing it, we continue to lease space and customers move in and out. To answer your question, where it is right now, we don't know and we'll have to get back to you on that.

Eric Frankel: I see, but did you backfill that planned vacancy?

John Petersen: No, we did not backfill that larger vacancy that I think you're referring to.

Eric Frankel: Yes. Okay. That's helpful. I think in terms of…

Maria Hawthorne: Eric?

Eric Frankel: Yes?

Maria Hawthorne: Eric, that was - the big one was a 156,000 square feet. The customer there did downsize and keep 15,000, but the balance of it is currently vacant, which we chose to do because the property is in an opportunity zone, and so we marketed it so that if someone wanted to take advantage of that, they could.

Eric Frankel: Right, and that vacancy is not part of your 8% to 9% cap valuation estimate that you speculated last quarter?

Maria Hawthorne: Yes, it is.

Eric Frankel: Oh, it is. Okay, got you. As in the lack of - even with that vacancy, you would still value everything, including that space at a 9% cap or whatever?

Maria Hawthorne: Yes.

Eric Frankel: All right. Okay. Maybe I'll clarify after the call just that math. Obviously, it already seems like fundamentals in the rest of your portfolio are doing quite well. Have you seen a move in values or cap rates for what you're looking at? Is there a reason why you're more optimistic now that you're going to be able to find opportunities to redeploy the sale proceeds?

Maria Hawthorne: We're just looking at the market, looking at what is happening in our areas, and we're just being a little bit more aggressive, given the valuation of our stock and where we would be able to deploy some long-term unsecured debt. That is giving us flexibility that we didn't necessarily have in the past.

Eric Frankel: Okay. That's all I've got. Thank you.

Maria Hawthorne: Thanks, Eric.

Operator: Once again, if you have a question, you may press * and 1 on your touchtone phone.

We'll go next to Emmanuel Korchman with Citi. Please go ahead.

Emmanuel Korchman: Hey, everyone. Just switching to the Brentford development, when you're looking at your build cost assumptions there, how different are they going to be than Highgate was?

Maria Hawthorne: Manny, that's a good question. We are finalizing the budget and the interior design is not yet complete, but when we locked in pricing in 2015 when we built Highgate, construction costs have gone up, so that's where you'll see we are seeing an increase in price. The good news is that rents in Tysons have definitely increased over the last year, as we're seeing as we renew and move in new residents to Highgate, so we're anticipating similar returns so far, similar returns to what we're getting at Highgate.

Emmanuel Korchman: The fit and finish and quality will be equal to Highgate or is this going to be a competitive product or is it going to be higher or lower on the scale?

Maria Hawthorne: It'll be equal. Finishes will be equal to Highgate but we are making some different tweaks and it's based on recommendations from our development partners who have expertise in this area. For instance, we look at what's being delivered to the market and they have to do with unit mix and some will be larger, some will be smaller based on our success with Highgate, as well as what's being delivered to the market because we don't want to add too much direct competition.

Emmanuel Korchman: Right, and then I think earlier in the year, we had spoken about other office asset sales beyond Maryland. Can you give us an update as to where those stand in the marketing process?

Maria Hawthorne: Okay, so right now, we are not looking nor am I ready to announce any additional office sales. What we have in Northern - and if you think about it, we really only have one office park, 340,000 feet in San Mateo, which are the highest rents we're currently getting in our entire portfolio and the park is about 97% leased. That, we won't sell. It's an amazing piece of land. Then our Northern Virginia assets, as JP said, the office is extremely well leased, and we're selling the bulk of the Maryland office portfolio. At this point, we're happy with what we own, but it is something that we will evaluate as we proceed but we won't be announcing anything else this year.

Emmanuel Korchman: I thought back in the COO Chairman's letters earlier in the year that you guys pretty plainly put out there that you'll be selling all of the suburban office. Has something changed or did I just misread or misremembered that?

Maria Hawthorne: No. Manny, we put it out there that we will sell office that we don't have plans to redevelop but we didn't put a timeline on it, and that's what I'm saying that for this year we're not going to announce anything further, but that's not to say that in the future there won't be other parks that we announce. Just so you know, all of the office parks that we would sell are now in Maryland and Virginia because outside of the D.C. market, there's only one other office asset, and that's San Mateo which is not on the table for sale. That would be a future redevelopment opportunity.

Emmanuel Korchman: Thanks, Maria.

Maria Hawthorne: Sure. Thanks, Manny.

Operator: There are no further questions at this time, so I'll turn it back to Jeff Hedges for any additional or closing remarks.

Jeff Hedges: All right. Thank you, everyone. We look forward to speaking with you all soon. Have a great rest of your day.

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