PSBQ419
Maria Hawthorne
PS Business Parks Incorporated
02/19/20
1:00 pm ET

Operator: Good afternoon and welcome to the PS Business Parks fourth quarter and full year 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 star (*) 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 pound (#) key. If you should require operator assistance please press star (*), 0.

It is now my pleasure to turn the floor over to Jeff Hedges, PSB's chief financial officer. Sir, you may begin.

Jeff Hedges: Thank you. Good morning, everyone. Thank you for joining us for the fourth 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 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 it's 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 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'll 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: Thank you, Jeff. Good morning and thank you for joining us. Today, I will start with an overview of the company's current condition and some perspective on full-year 2019 performance. JP will provide details on operations and markets, and Jeff will provide financial updates.

We had a strong finish to a great year as favorable industrial metrics continued and showed no signs of slowing. The overall annual results we reported are reflective of the strong market conditions we are experiencing. In 2019, we had the Same Park cash NOI growth of 5.5% with cash releasing growth of 8.3% on 7.4 million square feet of leases executed. Our team was busy as they completed nearly 2,000 transactions during the year. We can easily say that we are beyond peak rents in all of our industrial markets and rents continue to climb. We remain encouraged that we do not see any signs of deceleration and all of our markets are experiencing job growth and low unemployment. Confidence remains high among our customer base.

Despite the growing supply of large tenant industrial, we still see almost no new competitive supply of shallow bay multitenant buildings. This lack of new competitive supply has led in part to our decision to recently commence construction of an 83,000 square-foot industrial building on vacant land at one of our parks adjacent to DFW Airport. The building will be LEED silver-certified, have 28-foot clear height and eight suites. Additionally, we are pursuing a similar development of an 80,000 square-foot Class A industrial building at our 212 Business Park in our Seattle market. We are currently finalizing plans and expect this development to commence late this year.

2019 was also a good year for our multifamily project Highgate at the Mile, which continue to maintain occupancy around 95% while average effective rents grew 5.7% and NOI grew to $5.9 million. As a result of the Highgate’s success, we are proceeding with the second phase of development, Brentford at the Mile, which will be a 411-unit Class A luxury apartment complex. Brentford will be built on land that is currently non-income producing and construction will start in April with planned delivery beginning in Q1 of 2022.

We continued with our initiatives of selling office parks but we do not intend to redevelop, and successfully completed the sale of the three office flex parks in Montgomery County, Maryland, that we announced last year, totaling 1.4 million square feet for a combined gross sales price of $178.8 million. This was done in two separate transactions, and the final building closed last month at a gross sales price of $30 million. We were able to exchange these proceeds into the purchase of one flex park acquisition located in Santa Clara, totaling 79,000 square feet, and three industrial park acquisitions located in Los Angeles totaling 691,000 square feet for a combined total purchase price of $148.5 million. All four acquired parks are adjacent to or near existing PSB properties. All have below market in-place rents and required little capital for repositioning.

In summary, the success of 2019 will carry over into 2020. The efforts of our leaders in the field and here at the home office mean that the company is well-positioned coming into the year and conditions remain favorable to driving internal growth. The balance sheet is primed for major expansion, and we continue to work on development opportunities and sensible acquisitions targets.

Now, I’ll turn the call over to our COO, John Petersen.

John Petersen: Thanks, Maria. I will take you through fourth quarter statistics by market beginning on the West Coast. Northern California delivered outstanding metrics in Q4 and led us in leasing production 560,000 square feet and rent growth 15.9%. One highlight in Q4 was the execution of 213,000 square-foot, 10-year lease, with only six weeks of downtime to Amazon. This is one of the two large remaining Q4 expirations I mentioned on our call last quarter. Subsequent to year-end, we did take back a 460,000 square-foot building as a7 user expanded out of our park.

We have the ability to divide this Class A industrial building into three separate units and are actively marketing this space. With this desirable East Bay location, we have strong mark-to-market potential, and we will pursue a credit user that is a good fit for the park. While we do have activity, this space could be down for multiple quarters.

The economy in Southern California keeps chugging along and helped our team deliver another productive quarter. As always, our 328,000 square feet of leasing was powered by Small Business America, highlighted by the 2,200 square-foot average deal size. Occupancy in Southern California was steady at 95.4%, and Los Angeles led the way in rent growth 13.9%. As you may recall, in Q3 of last year, we acquired Hathaway Industrial Park in the Los Angeles Mid-Counties market, and that asset is performing well for us.

We have a known move out coming in Q2 of this year of slightly under 300,000 square feet. It's a great opportunity for us to re-lease a space at a healthy mark-to-market rent increase. In Seattle, our team grew occupancy by 240 basis points to 97.9% as we expanded one customer into a 36,000 square feet vacancy and backfilled a 20,000 square-foot space they vacated. Retention in Seattle was 14% due to us terminating one 48,000 square-foot user in Q4 to accommodate an existing customer. These expansions helped us push rent growth to 10.2%. Both situations demonstrated the importance of multi-building parks, but also having efficient business relationships with our customers.

Moving over to Washington Metro, which is buoyed by unemployment of less than 3%, improving decision-making by government contractors, and a robust technology sector, our team had another good quarter, delivering 419,000 square feet of leases. We saw a favorable trend with rent declines improving to negative 3.8% helped by strong retention of 75.6%. Same Park Virginia occupancy is 93.5%, which, as I mentioned before, is 740 basis points better than our competitive peer set. Our NVIP industrial park that we acquired in 2018, which remains in our Non-Same Park portfolio, is fully repositioned, 90% occupied, and on its way to stabilizing in the mid-90s.

The South Florida Industrial market is still benefiting from strong trade dynamics. From time to time, we may lose a customer due to uncertainty with the various trade issues, but we are able to re-tenant quickly normally through existing customer demand. We signed 276,000 square feet in 56 deals, generating robust rent growth of 10.7%. Finally, with the economic engine moving forward in Texas, we had success in virtually all our metrics. Leasing production delivered 449,000 square feet, retention up nearly 73%, rent growth of 3.5%, and occupancy grew by 190 basis points to 93.3%.

As we begin 2020, I am bullish on our customer base and the favorable dynamics in our markets, confident our teams will once again take advantage of the fundamentals. Specifically, with 25% of our portfolio expiring in 2020, 90% of which is industrial product, our teams are poised to have another strong year.

Now, I’ll turn the call over to Jeff.

Jeff Hedges: Thank you, JP. As Maria mentioned at the opening of the call, we are very pleased with our fourth quarter operating results, a great conclusion from a strong year of growth. Net income per common share for the three months ended December 31 was $1.00 per basic and diluted share. Same Park cash NOI grew by 6.6.% on the strength of 7% cash rental income growth. On the year, Same Park cash NOI was up on cash rental income growth of 5.4%. For the year, our total portfolio cash releasing growth was 8.3%, setting us up for continued strong NOI growth in 2020.

FFO for the quarter was $1.34 per share, while core FFO was $1.65 per share. We incurred an accounting charge of $11 million related to the redemption of our Series U and V preferred shares during the quarter, which has been excluded in our presentation of core FFO. This non-cash charge represents the only difference between core FFO and FFO.

I'd also like to point out that we issued our Series Z preferred shares in late October, but the related redemption of the Series U and V shares did not complete until December 30, resulting in effective double distribution for those shares for most of the quarter, creating a drag on core FFO. With redemption of the Series U and V shares completed at the end of Q4, there will not be any lingering effect from this in 2020.

Funds available for distribution, or FAD, was $194.9 million for the year, an increase of 6.9% from the prior year. In addition to cash NOI growth, the year-over-year increase in FAD was driven by lower total recurring capital expenditures, which were $36.9 million, down from $37.5 million in 2018, a decrease of 1.6%. For the Same Park portfolio, recurring capital expenditures were 12.3% measured as a percentage of NOI in 2019, generally consistent with the prior year.

Finally, I want to point out that we paid a dividend of $1.05 to common shareholders in the fourth quarter, bringing our total dividend payout in 2019 to $4.20 per common share. For the year, our FAD distribution payout ratio was approximately 75%, and we retained $48 million of free cash after distributions. Our continued ability to retain significant free cash flow from our operations coupled with our fortress balance sheet, provides us with the ability to move swiftly when accretive acquisition opportunities present themselves.

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

Operator: At this time, if you have a question or comment, please press star (*) and 1 on your touchtone phone. If at any point your question is answered, you may remove yourself by pressing the pound (#) key. We do ask that while you post your question, you pick up your handset to provide optimal sound quality. Thank you. We'll take today's first question from Manny Korchman with Citi. Please go ahead. Your line is open.

Manny Korchman: Hey, everyone. On the last call, you discussed retaining that last building in Maryland. It sounded like you're going to keep it long-term and now you've gone and sold it. Did I just misinterpret your message in the last call or did something change in driving you to sell that asset?

Maria Hawthorne: Hey, Manny. Yes, I'll take that, and good morning. No. You were right. We had intended to keep it, because when we went out with the portfolio early last year or earlier last year, the pricing for that building, which had a long-term GSA user in it, didn't come in where we wanted it to. Then late in the year, we got an unsolicited LOI for a number that met our pricing expectations and so we closed very quickly on it.

Manny Korchman: Got it. Thanks. And then, Maria, in your press release, you talked about a terrific 2020. I was wondering if you could - and I realize you don't give guidance, but I was wondering if you could help us put some type of guiderails or bookends or whatever you want to call them, on how you're defining terrific. I don't know if that's in terms of same-store growth, in terms of acquisition opportunities, in terms of cash flow growth. Just give us something to latch on to.

Maria Hawthorne: Sure. I think just internally with the portfolio that we have, as JP mentioned, 90% of our expirations are industrial, and those metrics just are still strong, so there is that. Secondly, we've gone through our disposition. So, any acquisitions that we have will be additive. Thirdly, Jeff and Trenton did a great job last year in taking our in-place preferred from 5.4% down to 5.1%. So I think that whatever way you look at it, it should be a great year. I mean all metrics are pointing north for us.

Manny Korchman: Thank you.

Maria Hawthorne: Sure. Thanks, Manny.

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

Craig Mailman: Hey, everyone. Recognizing that you guys do not give guidance, I was just curious if you could help bridge 4Q to 1Q with the impact of no move-outs, associated downtime, the LTIP, and give us some context around some of the moving parts.

Jeff Hedges: Hey, Craig. This is Jeff. First, I'll quickly just address the LTIP. As you pointed out, and as I'm sure everyone saw, we did announce that our Compensation Committee and the Board recently did approve a new equity plan. We're still working through the accounting for that, but that will result in incremental stock-based compensation expense in 2020, beginning in Q1. We don't have precise numbers to give you at this time, but we can say we expect the incremental impact of that for the year 2020 to be roughly in the neighborhood of $200 million in G&A.

Maria Hawthorne: Two hundred?

Jeff Hedges: I'm sorry. [Laughter] Thank you. $2 million. Thank you very much. $2 million to G&A and then another roughly $0.5 million would run through cost of operations. That's on the LTIP piece. Then I'll turn it over to JP, who can talk a little bit about the impact of the large move-outs.

John Petersen: Yes. Craig, as I mentioned, we do have a big vacancy that hit us in the first quarter of '20. We have activity on it, and it's in Northern California, in Hayward, so one of the best markets in the country. I like our chances there of marking that to market. We're going to be patient as we always are. As I mentioned, too, in my prepared remarks, we were able to execute really well on a 200,000 square-foot lease, also in the Bay Area, to Amazon, which – I'm not suggesting we will do that on this big space, but there is a lot of activity in the Bay Area on industrial; and we like our chances there.

We like our chances in the Mid-Counties exploration we have on the Hathaway acquisition that we did last year. Where we have vacancy for these large move-outs, we really like the market dynamics, we really like activity we're seeing, and it affords us two things. One, mark-to-market, and we have the ability, because of the activity, we could be selective in the users we take. It's those expirations and that one vacancy is in a great spot, and great building. We're excited to capture that, but we're going to be patient, too. Does that help?

Craig Mailman: Yes. It helps us to see if we could put some number around some of the vacancy. The Amazon lease you said, how much downtime is that? Six months?

Maria Hawthorne: Six weeks.

Jeff Hedges: Six weeks.

John Petersen: Six week.

Craig Mailman: Oh, six weeks. Sorry. All right. So that should get…

Maria Hawthorne: Yes. Basic occupancy - Craig, basic occupancy in mid-November. That's the reason we took a slight dip in the fourth quarter. The 460,000-foot space went dark in mid-January. That's the one that JP is referencing. That one will impact, obviously, Northern California because that's 460,000 feet on a 7.3 million square-foot portfolio.

Craig Mailman: Right. From a rent perspective, is that 460,000 at $6.00, $7.00 rent?

Jeff Hedges: We'll see, but let's just say…

Craig Mailman: That is what's vacated? What was the impact of the vacate?

Maria Hawthorne: The vacated. That would be about right.

Jeff Hedges: Yes, probably. Probably in that range, yes.

Craig Mailman: Okay. And then Amazon, what do those rents escalate to on the new lease?

Jeff Hedges: I can't tell you exactly, but let's say we marked it to market, and that's reflective in our stats that we announced for Q4.

Craig Mailman: Got you. So we could use that 16%, 17% mark-to-market as a guide?

Jeff Hedges: Yes. That deal is baked into those numbers.

Craig Mailman: Okay. Then just separately, you guys do have a fair bit of development going on now with the second multifamily asset. I'm guessing somewhere between $130 million and $140 million to finish, to do that plus the two smaller industrial developments. Does that sound about right?

Jeff Hedges: That's right. Craig, I would say that not all – obviously, that's going to stretch out over the entire development timeline. So, certainly, not all of that would be incurred in 2020.

Craig Mailman: Right. No, no. I'm just getting at – it seems like you guys had about $63 million of cash at year-end. You're throwing off $4 million to $8 million a year. Do you even need to tap preferred through the line to fund this? Is this going to be funded with cash on hand or how should we think about that?

Jeff Hedges: Yes. I think it's a good observation. We are in a strong cash position. Of course, we have the line at our disposal should there be a need. But absent any large acquisition opportunity, we likely would not need to raise any additional capital, or perhaps even go out on the line in 2020 to fund the development activity that we've announced.

Craig Mailman: All right. Thank you.

Maria Hawthorne: Thanks, Craig.

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

Eric Frankel: Thank you. Just a couple of questions here. First, just given the amount of lease roll that you highlighted for 2020, I understand that you guys don't give any sort of guidance, but given the move-outs that already occurred in Northern California, would you expect that your average occupancy would actually decline next year versus 2019 – or this year rather versus 2019, just based on the amount of lease roll that you guys have to chug through?

Jeff Hedges: Yes. That lease roll, Eric, first of all is normal for us. We can't get to wait to get at it because in almost all cases there's mark-to-market opportunities in those expirations, and our retention being plus or minus 70%, and if we don't retain, we have the ability and strong markets to backfill that pretty quickly. So, we welcome the lease roll. And then to your point on the occupancy, yes, there is – if we don't lease that space this year, the big space in North Cal, we could see a decline in the occupancy vis-à-vis '19. So, that's right. Your observation is right.

Eric Frankel: Okay. Just remind me. Did you not have two other vacancies that were covering – you had three vacancies coming due in Northern California in Q4? I guess, obviously, one was tackled with Amazon, but maybe you can let us know what happened to the other two.

Jeff Hedges: Yes. We renewed the other one. Yes.

Eric Frankel: Okay.

Jeff Hedges: We took care of the two of the three in this, though the big one – I mean they doubled in size. Unfortunately, for us, we couldn't keep that deal.

Eric Frankel: Got you. Okay, the $450 million was part of that – okay, part of those three. Okay, understood.

Jeff Hedges: You got it. Yes.

Eric Frankel: Then I think you referenced in your opening remarks just about your acquisition development pipeline. Do I have that right that you're actually looking at development opportunities now or something of that ilk?

Maria Hawthorne: Well, Eric, land prices are skyrocketing. We don't really go out and we're not building a development pipeline by going out and buying land in developing. The two industrial developments are literally just like extra parking spaces that we have at both of these parks, Freeport and Dallas, and then 212 in Seattle. Then, of course, what we're talking about with the multifamily, that's The Mile acquisition, where we got 700,000 square feet of office, and then we got the right. This is a big strategic initiative to take that office and convert it to about 3.1 million square-foot of density, 92% of which can be residential.

The next two developments at The Mile are both in locations where they are current – we wouldn't have to take any of our office, NOI offline. Right now, that low-hanging fruit on the development front for us.

Eric Frankel: Okay. That's what you're referring to. But any thoughts in this given that you guys are – you're so confident in managing your smaller tenant properties and pursuing, there may be some developers that maybe aren't as adept at managing small tenant properties that you buy, vacant assets that were recently developed, and maybe not in Southern California, but maybe in Dallas or South Florida or somewhere else where you guys can get some sort of yield premium for buying some vacancy.

Maria Hawthorne: You know what, Eric, right now, occupancy is pretty high everywhere so it's hard to find those value-add, and if you think about the acquisitions we did last year, both in Northern and Southern California, they were all very highly occupied. Anywhere from 20% to 35% in below-market in-place rents. That's where we're going to be able to improve the NOI on those.

Prices are just going up in industrial. One of the things I haven't appreciated lately is when I heard some of our big tenant peer industrial companies are now appreciative multi-tenant small base sites. So, anyway. We do have institutional competition when we go for these small tenant acquisitions now that we didn't used to have.

Eric Frankel: Okay. Thank you for the clarification.

Maria Hawthorne: Sure. Thanks, Eric.

Operator: As a reminder, it is star (*) and 1 for questions today. We'll go next to Anthony Paolone with JP Morgan. Please go ahead.

Anthony Paolone: Thank you. In the fourth quarter, I was wondering if you can talk about the same-store growth. I think your weighted average occupancy was down year-over-year, but the same-store NOI growth was pretty high. I'm just wondering if there was anything there. Maybe just walk through what drove that.

Maria Hawthorne: Yes. Hey, Tony. I think what you're seeing is that while there was a slight decline, we've been, quarter after quarter, throwing up really good rental rate increases from the expiring rents to new rents, whether it's on incoming customers or renewing customers. I think what you're seeing is that improved rent growth, because usually that takes anywhere from one to three quarters to take effect. And then, also is the deceleration of the rent; decreases in Washington Metro are also helping because that's kind of been an anchor on us, dragging along a little bit. The Washington, DC market, as JP mentioned in his comments, is really improving. We're actually very hopeful this year that we'll see those negative rent growth numbers go positive.

Anthony Paolone: Okay. If I think about it in the aggregate, if you're leasing say 20% of the portfolio each year at a 5% to 10% increase in rents, and then you have some contractual bumps on the remaining portfolio, it would seem like that ties with the 4% or so type change for NOI growth. It just struck me that you're up in the sixes in the fourth quarter even with occupancy down. So, I'm just wondering, if this continues into 2020 same-store NOI growth is going to similarly look in this north of 5% range or no?

Maria Hawthorne: Tony, given the big vacancy in Northern California, I mean that – like I said, that is impacting the entire company's occupancy, I would be a little bit cautious, particularly, first and second quarter.

Anthony Paolone: Okay. Then just on the deal pipeline, you mentioned how competitive it is. If we look at where your stock trades, somewhere in the low to mid-fours maybe implied cap rate, could you even clear that kind of a return with what you're seeing out there on the acquisition front, or is it even south of that?

Maria Hawthorne: We are definitely buying assets that wouldn't stabilize or returning well above that number. Everything that we bought we feel will be accretive to FFO and FAD.

Anthony Paolone: Okay. When you look at your pipeline today and what's in the market, can you find yields that are in the fours or higher, or is the market just that skinny?

Maria Hawthorne: Well, it's a competitive market. There are still deals to be found. We're looking for both off-market deals as well as those that are marketed. The San Tomas deal in Santa Clara, that was actually an off-market deal. It was just that it's located just up the street from our office there in Santa Clara.

Jeff Hedges: Tony, this is Jeff. I'll just add. The competition we're up against, everybody is benefiting from favorable cost of capital dynamics right now. Competition is intense in a lot of the acquisition opportunities that we're looking at. As Maria said, certainly, where we are getting aggressive and going after acquisition opportunities, those opportunities that stabilize well above our required return threshold.

Anthony Paolone: Okay. Thanks, guys. You covered everything else I had.

Maria Hawthorne: Okay. Thanks, Tony.

Operator: We also have a follow-up question from Eric Frankel. Please go ahead.

Eric Frankel: Thank you. Maybe I just want to follow up on what Tony was getting to in your fourth quarter results. Can you, maybe, better explain how you got to your mid-6% same-store NOI growth this quarter just given the cash releasing spreads, where they were and contractual releasing bumps are at where they are and your average occupancy went down? Was there some sort of free rent burn off or some big rent increase from a lease that was signed a couple of quarters ago that boosted your numbers? It looks like some of that might be in Northern California, but I think maybe we can use some clarification.

Jeff Hedges: Yes. Hey, Eric. This is Jeff. There are a number of things, as you know, that will factor into this, and you cited a couple of them. The 8.3% cash releasing spreads that we reported for the FY '19, for the year, that is going to, obviously, take time to take effect in the cash rental income numbers that we report, both because that is an 8.3% over the year. Also, you're right. In certain cases, there are pre-rent periods and other things.

What you're seeing in Q4 is the combination of what had transpired in the several quarters prior to that. We're benefiting not only, of course, from the Q4 releasing spreads, but the releasing spreads from several quarters prior to that. It's hard to, on this call, triangulate for you all of the various pieces, but certainly there's a lot of that is going to factor in to get to that 6.9%.

Eric Frankel: Right. But was there a big rent bump within the leases or leases signed from the past couple of quarters that maybe even wasn't factored into that 8.3% of cash releasing spreads estimate or figure?

Jeff Hedges: In general, our contractual annual rent increases have remained pretty consistent over the year.

Eric Frankel: Okay. Thank you.

Operator: Speakers, 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 everyone, and we look forward to speaking with you all again in a few weeks. Have a great afternoon.

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