PSBQ320
John Petersen
PS Business Parks Incorporated
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Operator: Good afternoon and welcome to the PS Business Parks Third Quarter 2020 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's 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, and thank you for joining us for the third quarter 2020 PS Business Parks investor conference call. This is Jeff Hedges, chief financial officer. With me today is our interim chief executive officer and COO, John Petersen; and our chief accounting officer, Trenton Groves.

Before we begin, let me remind everyone that all statements, other than statements of historical fact 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 JP.

John Petersen: Thanks, Jeff. Good morning. Thank you for joining us today and we hope each of you and your families are doing well and staying healthy. I'd like to start the call by thanking our team for delivering strong results in Q3 and their continued hard work and dedication through these challenging times.

We've successfully maneuvered through the ongoing pandemic with nearly 2 million square feet of leasing, cash rent growth of 5.2%, and also, improved rent collections back to pre-pandemic levels in our non-California markets. Year-to-date, the team has executed over 300,000 square feet more leasing production than we did in the first nine months of 2019 at a transaction cost per square foot rate that is nearly 20% lower than the prior year.

Further, expansion of our existing customer base remained robust during the third quarter and year-to-date, we have had nearly 200,000 square feet of net expansions from approximately 125 customers. While the path of the pandemic is uncertain, it is clear that our core small business customers are resilient, active, and in a vast majority of cases, they have figured out how to successfully operate their businesses in this environment.

I would like to discuss a couple of important highlights since our last earnings call. First, I am very pleased to report that yesterday, we closed on Pickett Industrial Park in Alexandria, Virginia in an off-market transaction. Pickett is a 246,000 square foot, three-building, multi-tenant park currently 100% occupied with an average tenant size of 41,000 square feet. The park is located inside the capital beltway and complements our seven existing parks in that submarket giving us 2.1 million square feet and a strong market share in an industrial submarket that is currently 96% leased.

Although Pickett was 100% occupied at acquisition, our plan is to reposition this asset over the next couple of years by subdividing two buildings and in doing so, reducing the average unit size to 11,000 square feet, which will enable us to accelerate leasing and drive rents higher for last-mile users inside the beltway.

Competition for industrial assets is highly competitive as everyone knows. However, this acquisition is an indication that even in this crowded environment, we can still source value-add industrial parks that fit our strategic objectives at attractive yields.

Second, I am pleased to announce that we recently completed a long-term lease for the 288,000 square foot vacancy at our Hathaway Industrial Park in Santa Fe Springs, California. This leads which is to a credit customer came with cash rent growth of over 36%. Subsequent to quarter end, we leased an additional 40,000 square feet to the same customer in the same park. Both leases have commenced although the 42,000 square foot lease is not included in our Q3 production figures, but will be included in Q4.

Regarding our other large vacancy in Northern California, our team continues to pursue a strong-credit tenant to fit well within this park. Our expectation is to identify the right user or users for this space in the next few quarters.

As we look ahead through 2021, our expirations return to normal levels with no single expiration exceeding 100,000 square feet. Our scheduled expirations in 2021 are 5.5 million square feet, roughly 1 million square feet less than in 2020.

Turning now to rent growth. Cash rent spreads in Q3 average 5.2%. Industrial cash rent growth remains favorable at 9.3% while flex was essentially flat and office rents declined by 3.6% as demand for office space remains muted.

Before I turn the call over to Jeff, I want to briefly mention that our 80,000 square foot, multitenant industrial development in Dallas is on track for completion next month and we are starting to see good interest in the building. In Seattle, we continue to pursue permits for a similar 80,000 square foot, multitenant industrial building and we are targeting delivery in Q4 of 2021.

Finally, as we announced last quarter, we have commenced construction on our 411-unit multifamily development, Brentford at the Mile in Tysons, Virginia with delivery expected in 2022. As we have stated previously, these developments represent an exciting opportunity for us to expand in our existing markets.

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

Jeff Hedges: Thank you, JP. I'll begin with an overview of our financial results for the third quarter. Net income for the three months ended September 30th was $50.9 million or $1.11 per share. FFO was $54.2 million while core FFO was $56.3 million or $1.61 per share. During the quarter, we incurred $1.7 million of accelerated amortization of stock-based compensation expense associated with the retirement of our former president and CEO, Maria Hawthorne.

Separately, we incurred $300,000 of non-capitalizable demolition costs associated with our new multifamily development, Brentford at the Mile. These two non-recurring charges were added back in our presentation of core FFO and were also excluded from our calculation of FAD, which was $48.3 million for the quarter. Net operating income attributable to our same-park portfolio was $67.5 million, decreasing three-tenths of a percent from the prior year while same-park cash NOI was $66.2 million, a 1.1% decrease from the prior year.

As you'll see in our press release and 10-Q, AR write-offs decreased significantly from Q2 and were in line with the prior year. The 1.1% decrease in same-park cash NOI is primarily attributable to lower year-over-year occupancy, as well as $600,000.00 of net-deferred and abated invaded rent which, consistent with the prior quarter, we have excluded in our calculation of same-park cash NOI.

I'd like to take a moment to provide a little more color on rent deferrals, which were $1.7 million in Q3. The volume of rent relief requests continues to subside and in the month of October, we have granted effectively no additional deferrals and currently have opened rent relief requests from only 1% of customers. Additionally, repayment of deferrals ramped up in the third quarter and we collected over 98% of our payments billed. Year-to-date, we have agreed to defer $5.5 million of rent. We billed and collected $1.3 million through September 30th and have an additional $1.9 million scheduled to be repaid in Q4. The majority of the remaining $2.3 million is scheduled to be repaid in the first half of 2021.

Regarding rent collections in general, we continue to post higher collection rates each month; and as JP mentioned, we have returned to pre-pandemic AR levels in all of our markets outside of California. As you have heard from us and from many of our peers, rent collection in Californian markets continues to be more challenging than other markets due to the ongoing state and local ordinances.

Turning now to the balance sheet. We ended the quarter with roughly $118 million of unrestricted cash, some of which was used for acquisition of Pickett Industrial Park, which we acquired in an all-cash transaction. Our credit facility remains undrawn and we have no debt outstanding. We intend to utilize cash on hand and retain cash to fund our current and planned development projects and will utilize our credit facility as necessary as acquisition opportunities present themselves.

Lastly, I'll point out that we paid a dividend of a $1.05 to common shareholders in the third quarter and our Board recently declared a dividend of $1.05 to be paid in the fourth quarter on December 30th to shareholders of record on December 15th.

With that I'll open the call for questions. Operator?

Operator: 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 can remove yourself by pressing the # key. We do ask that while you pose your question, you pick up your headset to provide optimal sound quality. Thank you.

We'll take today's first question from Manny Korchman with Citi. Please go ahead.

Chris McCurry: Hi, it's Chris McCurry in for Manny. Quick question here. Following the announced acquisition at Pickett Industrial Park, how are you thinking about the transaction markets today? Did your expectations for pricing on this asset change at all resulting from COVID?

John Petersen: Sure, Chris. As I mentioned briefly, the acquisition market remains highly competitive for industrial properties in all of our existing markets. I'm really pleased with the way our team executed on this; and as I mentioned, it was an off-market deal and we've been tracking this deal for some time, but we're able to jump in and put this into our portfolio with some discount to pre-COVID pricing and I think the execution, the timing was really good for us. So, really pleased with how we're able to pull this off. Like I said, when we started to engage with the seller, the timing was good and our ability to do a quick close or proven ability as an investor in this market I think allowed us to pull this off in an off-market way and what we believe is a discount to pre-COVID pricing. Does that answer your question, Chris?

Chris McCurry: Yes. That's helpful color. Just one quick follow-up here. As it relates to California, with slower reopenings, the threat of lockdowns, legislation in the works what are your thoughts on the broader California market in general today?

John Petersen: Sure. Well that's where we're headquartered, as you well know, and look, things in California have been slow to reopen and if you look at our customers in California, really the way that they've demonstrated a resiliency to operate in this market - I'm putting aside restaurants and those kind of consumer-focused businesses retailers and such - I'm pleased with what's going on in California in terms of our core customer base and they've proven, for the most part, that they can get through this and I think California, we're not out of it yet as I mentioned, but our core customers have done well. Again, retail and restaurants and those kinds of things are struggling because those, for the most part, have not reopened in California. We don't know when that's going to end, but our core industrial customers in California are doing fine.

Chris McCurry: Right. Thank you.

Operator: The next question comes from Craig Mailman with KeyBanc Capital Markets. Please go ahead.

Arty Cameron: Hi everyone. This is Arty Cameron on for Craig. Can you guys please provide an update on the CEO and CIO search?

John Petersen: Yes. So, I have no update to offer now and the process continues on both the CEO and the CIO search and as soon as we have something to announce, we certainly will, but there's no update at this time.

Arty Cameron: Okay, thank you. Then moving to market fundamentals, does it feel like we're kind of past the bottom and we should anticipate kind of less erosion to same-store should the macro recovery continue its pace given kind of where rent spreads have come quarter-over-quarter and kind of the way collections are pacing? In conversations with tenants and just kind of looking at the demand dynamics, does it feel like we're kind of past the bottom?

John Petersen: Yes. I'd say it feels like we're past the bottom and I think if you look across our markets, as Jeff pointed out, our collections are pre-COVID levels outside of California and business for the most part in our markets is - I certainly wouldn't say it's back to normal, but like I said before, I believe that our customers have figured out a way to operate to deliver their products, to manufacture their products, to meet the demands of their own customers in this pandemic.

Now, look, we've never been through a pandemic. The world has never come out of a pandemic so I can't tell you what it's going to look like in a few months, especially with cases rising. But what I can say is when we talk to our customers, and as I mentioned before, we're having customers actually expand in the pandemic and I view that as a good sign.

So yes, I think we're past the bottom as we head into the fourth quarter here and into ‘21, but it doesn't mean the road won't be bumpy from time to time as well. So, does that help?

Arty Cameron: Yes, but just kind of more from like - you guys kind of typically prioritize occupancy over rents when conditions get like this. Do you think that this is kind of the end of - or maybe as this is kind of where rent roll downs may subside and rent spreads would continue to kind of accelerate as we continue here? Or do you see it kind of maintaining its pace of being kind of flattish to maybe down?

John Petersen: Yes, if you look at where our rents were down, it was primarily in the office, in our office portfolio and there's not - which is primarily in our Washington Metro division. Industrial and flex were up to flat and so I see that trend continuing. There is going to be pressure on office. We have a small percentage of office. There will be pressure there, I think, to attract new deals for sure and even on renewals, but as we look forward to the remaining 2020 and into 2021, I think our industrial and flex are poised to do well. Office is going to be a challenge though.

Arty Cameron: Got it, thank you. Then one last one if I could, what's the appetite for acquisitions here? Do you guys see activity kind of picking up into next year? Given like where the stock is trading with REITs issuing debt and preferred at kind of record lows, how should we think about financing those deals, if so?

John Petersen: Well, let me talk - we definitely have an appetite to grow the business right now. We have the balance sheet, which Jeff will touch on a second, to go do that and execute and the Pickett deal was a great example of our ability to do that fairly quickly.

Having said that, the competition for industrial assets in our core markets is very intense right now. We're not the only ones that can go buy deals, but I think we're able to go source deals strategically, and in many cases off market, that will allow us to put some capital to work. What we'd like to see is more deals come to market. Right now, there's not a lot of deals in the market. We'd like to see more of those come to market. So we're working very hard to extract some deals and we hope more come to market in 2021, but we have the balance sheet that Jeff will touch on to go do that.

Jeff Hedges: Yes, just to pick up on that, I mean you're right in pointing out that the recent comps that we've seen in the preferred market and then also with debt placements, those sources of capital remain attractive. So, we'll look to all sources of capital including utilizing our credit facility, which has

$250 million of untapped capacity to move quickly when additional acquisition opportunities present themselves.

Arty Cameron: Got it. Appreciate the color. Thank you.

John Petersen: Sure.

Operator: As a reminder, it is * and 1 in your touchtone phone for questions. We'll go next to Eric Frankel with Green Street. Please go ahead.

Eric Frankel: Thank you. Just touching upon your now smaller office footprint given kind of what's happened with the pandemic and how that might shape how folks work in the future, is there any thought - maybe we'll wait until a CIO or CEO comes to the company? In terms of what that portfolio will look like in the next couple of years, you think you'll accelerate dispositions or maybe some redevelopment initiatives aside from the Tysons project?

John Petersen: Sure, Eric. We've been pretty outspoken about this and as it relates to our office portfolio, where it makes sense and where we don't feel we have the ability to redevelop a particular park or parks, we're going to strategically look at how we can exit some of our office and we've done I think a pretty good job over the last couple years of doing that and that hasn't changed and won't change. Having said that, we do have some pretty nice office parks that we think have the ability overtime for a higher and better use and we're going to continue to explore those options as well.

So, I think we're steady-as-she-goes on that strategy and try and reduce our office portfolio where it makes sense over the next couple years.

Eric Frankel: Interesting. That's helpful. Just going back to I guess to an earlier question on the bottom, if you will. So, your leasing spreads certainly looks like they've recovered mostly versus the second quarter. I guess the exception looks like the East Bay. So, is there any explanation in terms of why rental rate growth seems to have slowed significantly or turned negative in that market versus every other industrial flex market?

John Petersen: Yes, Eric. No, nothing specifically related to the East Bay at all. So, as we go through the next quarter or two or year or two, we're going to be able to mark-to-market as the economy recovers pretty quickly. Our average lead time, as you now, Eric, is a little over three years and we're going to be able to as this market turns around, we're going to be able to get to market rates pretty quickly. But specifically, regarding East Bay, there was nothing unusual there to speak of.

Eric Frankel: So, the markets not especially weak or strong, it's just maybe just whatever idiosyncratic lease that came due?

John Petersen: No. We have higher market rent there. As you know, we've been increasing our mark-to-market in the East Bay over the last several years quite nicely and so there may have been one or two situations but nothing - I mean East Bay is still a tight market for us and that's where we have the vacancy, as I mentioned earlier. But no, I think that's still a good market and it's still an active market. Maybe not as active as it was a year or two ago clearly because of COVID, but there's still activity up in Northern California to be clear.

Eric Frankel: Got you. All right. Just a final question, you kind of referenced your California portfolio with the moratorium. You have a fair bit of kind of quasi retail businesses. What percent of your portfolio in California is actually open for business or your [Crosstalk]?

John Petersen: The majority - yes. High 90% are open for business.

Eric Frankel: Okay.

John Petersen: Yes, to be clear. When we talk about the moratorium, that's on evictions and rent payments and those kinds of things. Not opening, no. I can't think. Even restaurants are able to open and serve on patios and outdoors in California. Well, you know, Eric, I mean.

Eric Frankel: Yes, sure. [I don't think] that there were actual businesses that were closed, that's all.

John Petersen: No. I mean there may be one or two, but all of our California customers are open for business, maybe not to extend they like in terms of indoor seating and restaurants and we may have a fitness center too that have to have restrictions, things like that, but that's really it. All of our other businesses are wide open.

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

John Petersen: Thanks Eric.

Operator: Once again, it's * and 1 for any final questions today, * and 1. We'll pause a moment. [Pause] It does appear we have no further questions. I'll return the floor to Jeff Hedges for additional or closing remarks.

Jeff Hedges: All right. Thank you, everyone, for joining us here today and we look forward to talking with you again soon. Have a great afternoon.

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