PSBQ221
Jeff Hedges
PS Business Parks Incorporated
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Operator: Good afternoon and welcome to the PS Business Parks Second Quarter 2021 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 *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 *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, and thank you for joining us for the Second Quarter 2021 PS Business Parks' Investor Conference Call. This is Jeff Hedges, Chief Financial Officer. With me today is our President and Chief Executive Officer, Mac Chandler; 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 Mac.

Mac Chandler: Thank you, Jeff. Good morning, good afternoon to those in the East. Welcome to PS Business Parks Second Quarter 2021 Earnings Call. On today's call, I will highlight our second quarter achievements and provide a rundown on our markets and investment activity. Jeff will then provide an update on our financial results, balance sheet, and capital allocation.

Our second quarter was encouraging at many levels and it's rewarding to see the fruits of our labor. This starts with another quarter of strong lease production. We signed more leases for more square footage in the first half of 2021 than we did in the first half of any of the five previous years. Occupancy increased by 70 basis points over the quarter to end at 93.5%, led by our Industrial portfolio which averaged 95.1% for Q2. These gains are contributing to our Same Park cash NOI which for Q2 increased by 13.5% over the same period in the prior year.

Our team continues to utilize our capital efficiently. Through the first half of the year, lease transaction costs were $2.71 per square foot or just 6.7% of contractual rent. The powerful combination of compounding cash NOI and an astute deployment of capital contributed to our growth and funds available for distribution. Specifically, our Q2 FAD increased 22.2% over the same period in the prior year.

Now, let's turn to our markets. In Seattle, the industrial sector remains strong and the overall market is approximately 95% leased. Interest in our product is high with demand driven by logistics and fulfillment users. This activity came through in our Q2 industrial cash rent growth of 12% and retention of 70%. Last quarter, we touched on our 48,000-square-foot vacancy at our 212 Business Park. We have had good activity, but nothing to date is pending.

In Northern California, the market continues to pick up momentum. The logistics sector is the leading demand driver, but now we are seeing a broader base demand as well. Industrial rent growth in Northern California was 12.4%. The improvements to our 140,000-square-foot vacancy in Hayward are now substantially complete and the space is available for median occupancy. We had a tenant on the one yard line this past quarter but unfortunately, they put the transaction on hold. It's a part of the business, as anyone knows, but our team is anything but complacent and we are doing all the right things to identify a quality customer. It's uncertain if it would be leased by year-end but we remain very confident in the space and the location for the long term.

Moving to Southern California, as the region continues to open, the team is seeing strong demand for logistics, smaller last-mile companies, import/export firms, and construction. The mid-counties industrial market

is especially strong with vacancy less than 1%. This has contributed to our strong average occupancy of 96.7% and retention of 80.6%. In Texas, industrial demand is healthy, particularly in Austin where our weighted average occupancy is 97.5% in the second quarter. Industrial activity in Austin was led by medical construction users as well as the expansion and immigration of technology-related businesses.

As mentioned last quarter, an office user will be vacating a 67,000-square-foot space within a flex building in North Austin in September. The building is well located and our plan is to reposition the space and potentially subdivide their premises in order to meet the demand in the market.

In Dallas, Q2 occupancy was 81.1% due primarily to large vacancies at Royal Tech Flex Park in Las Colinas, which ended the quarter at 66% occupied. We are currently marketing the vacant suites at Royal Tech. However, our expectation is the occupancy in Dallas will lag our other regions for the remainder of 2021.

In Washington Metro, our Industrial portfolio continues to perform well with Q2 occupancy coming in at 92.3%. Our office portfolio was 87.4% occupied, certainly better than the competition, but lagging the overall portfolio. Demand for suburban office is improving as employees continue to return to the office, and we have seen a notable increase in tour activity this quarter. Our GSA leases continued to renew but overall, there doesn’t appear to be an increase or decrease in GSA demand.

Florida is leading all of our markets due to increasing demand from business services, logistics, distribution, and e-commerce. Average occupancy for Q2 was 96.9%, rent growth was 8.8%, and activity is

exceeding pre-pandemic levels. Occupancy at our MICC Park in Miami was 96.9% with small and midsized industrial users driving demand, allowing us to set the market with rents at an all-time high.

Moving to our development projects, Freeport, our 83,000-square-foot industrial development in Dallas, is on track to exceed our yield expectations. The building is currently nearly 40% leased with rents approximately 50% above pro forma. We have solid interest in the remainder of the building and we are tracking to have it fully committed by year-end.

In Seattle, the building permits for our 212 development were delayed another quarter as the city of Kent is still inundated due to staffing cuts. Fortunately, one of our two permits is approved and the second one is imminent. However, sourcing our steel trusses for small projects such as 212 is a challenge and we anticipate breaking ground in the fourth quarter or first quarter of next year.

Construction of the Brentford at the Mile, our 411-unit multifamily development in Tysons, Virginia, is on schedule. Concrete foundations and columns are complete and framing is well underway. We plan to deliver the first units in summer 2022.

On the disposition front, in June we sold Park East Corporate Center, an office-oriented flex park and subsequent to quarter end, we sold our Monroe Office Park located in Herndon. The combined cap rate of both transactions was approximately 5.5%. The sale is consistent with our strategy to opportunistically divest nonstrategic assets.

We have also announced that we are considering the sale of two additional assets, Lusk Business Parks, a flex park in the life science cluster of San

Diego and a sub-portfolio of flex buildings at Royal Tech at Las Colinas. We are under no pressure to sell these assets and we will only consider transacting if our pricing and timing expectations are met. We are actively in the market for acquisitions that meet our high standards, particularly multi-tenant industrial parks that allow us to add value through our best-in-class leasing and operating platform. We hope next quarter to provide an update on some compelling acquisitions that we are pursuing.

Before I turn the call over to Jeff, I'd just like to acknowledge the dedication of our team. In the past quarter, I've had the opportunity to tour all of our markets and spend time in our local offices. We have a truly amazing team that cares about our customers and our stakeholders. My hat's off to them. Jeff?

Jeff Hedges: Thank you, Mac. I'll begin with an overview of our financial results for the quarter and six months ended June 30, 2021. Net income allocable to common stockholders for the three months ended June 30 was $45.6 million or $1.65 per diluted share, while core FFO was $61.8 million or $1.77 per share, representing an 11.7% increase from the same period in the prior year. For the six months ended June 30, net income per diluted share was $2.66 and core FFO per share was $3.44, representing a 4.3% increase from the prior year.

During the quarter, cash net operating income attributable to our Same Park portfolio was $73.1 million, a 13.5% increase from the prior year. The increase in Same Park cash NOI was driven by cash rental income growth of 10.7%, primarily due to rental rate growth and an increase in occupancy, but was also partly attributable to the fact that we had less net write-off abatement and rent deferral activity in Q2 2021 than the prior year.

During the quarter, we incurred approximately $150,000.00 from net write-off abatement and rent deferral activity in our Same Park portfolio compared to roughly $5.6 million a year ago. For the six months ended June 30, Same Park cash NOI increased 6.4% over the prior year, driven by a 5.8% growth in cash rental income.

Funds available for distribution, or FAD, was $54.5 million for the three months ended June 30, representing a 22.2% increase from Q2 2020. For the six months ended June 30, FAD was $104.8 million, an 11.6% increase from the prior year. In addition to the previously mentioned cash NOI growth, FAD continues to benefit from low recurring capital expenditures which, for our Same Park portfolio, registered at 9.9% of NOI. As I said on our prior call, these low recurring capital costs are a continuing reflection of our team's efficient use of transaction capital, but also partially attributable to timing of certain capital improvements. Our expectation is that recurring capital measured as a percentage of NOI will increase slightly in the second half of the year to be closer to our historic average.

Turning now to the balance sheet, we ended the quarter with $116 million of unrestricted cash and our credit facility remains undrawn. Subsequent to quarter end, we also sold Monroe Office Park in Herndon, Virginia for $41.3 million. We intend to utilize operating free cash flow, cash on hand, and as necessary our credit facility to fund investment activity, including development and future acquisition opportunities. I'd also like to highlight that our Series W preferred shares become callable at our auction on October 20th.

As many of you know, we have historically sought to opportunistically refinance series of preferred equity when rates are attractive. At this time,

we have not made a determination as to what we may do with regard to our Series W shares. However, market conditions are favorable and as the call date approaches, we will monitor the capital markets and our cash needs as we evaluate our capitalization opportunities.

Lastly, I'll point out that we paid a dividend of $1.05 per share to common stockholders in the second quarter, and our Board recently declared a dividend of $1.05 per share to be paid in the third quarter of 2021 on September 30th to stockholders of record on September 15th.

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 comment, please press *1 on your telephone keypad. If at any point your question is answered, you may remove yourself from the queue by pressing the # key. We do ask that [when you] pose your question that you pick up your handset to provide optimal sound quality.

Our first question will come from Manny Korchman with Citi. Please go ahead. Your line is open.

Manny Korchman: Hi, everyone. I realize [maybe you could] give us some details on the acquisitions maybe with the next call, but just, Jeff, kind of balance the size of your potential dispositions in a couple of flex parks and [assets] you mentioned versus what those promising acquisition opportunities might be.

Mac Chandler: Hey, Manny. This is Mac. Let me try to address that in a different way. We're doing things a little bit different in a couple of ways. One, just me being here, I'm spending a lot more time on acquisitions and we're focusing more on it. Second is about a month ago, we hired someone

who's up in Seattle who's dedicated to working directly on these multifamily projects that we have underway and also the entitlements, and it provides just a lot more bandwidth for our acquisitions team to focus strictly on acquisitions. We're more focused on it than we have been previously and I think that's really helping us. There are some compelling opportunities that we're pursuing or as we mentioned, we're not ready to talk about that now, but I think we also have a lot of flexibility with these two potential sales that we talked about and we'll be patient with it. I think the buyers have such interest in them that we'll be able to manage the timing to our advantage and we see things as very promising.

Hopefully, that answers your question.

Manny Korchman: Yes, great. Thanks, Mac. Then with that person now dedicated, I guess alternate users would be the right way to phrase it, should we expect more of that to come and is that going to be concentrated in Virginia where you've done the multifamily conversions or elsewhere within the portfolio?

Mac Chandler: Well, certainly, Virginia is where the near-term starts are set up, and we're in a position to likely start our third phase at the Mile, which is already a master plan but we're going through working with the county to get the project finalized. There are also other opportunities within our portfolio on the West Coast as well where we have the ability to rezone our properties and attain entitlements that are favorable that increase the density, increase the value of the land, so that gives us great optionality in the future.

Manny Korchman: Thank you.

Operator: Our next question comes from Craig Mailman with KeyBanc Capital. Please go ahead. Your line is open.

Craig Mailman: Hey, guys. Maybe just following up on Manny's question on acquisitions, Mac, I know and I appreciate you don't want to talk too much about the acquisitions, but could you just talk about what type of opportunities you're looking at and what the relative yield profile may be versus what you've sold to date and what you're potentially looking to sell in San Diego and Dallas and maybe bridge the gap?

Mac Chandler: Sure. In general, our preferred asset class is really the - it's the larger multi-tenant parks, so one is where the average head size is generally quite small and consistent with our current portfolio. We like the properties that are management-intensive because our platform is built to do that, and those larger parks that are well located - and generally, we're looking for high-quality assets - have a starting yield in the high 3's to low 4's and they'll stabilize a few years later in the high 4's, that the wealth on these projects are 2.5 to three years, 3.5 years. The bigger difference is the long-term growth profile, so the assets we're selling have a flat-to-negative, long-term growth profile, but also they're quite capital intensive versus the projects that we're looking at are much more capital efficient and the cash flow profile is really a much more positive outlook, especially as you look further out in the future.

Craig Mailman: Maybe just a follow-up to that, so it sounds like you're trying to get rid of higher CAPEX assets that drag on the long term. What does that mean for the balance of office and maybe timing of selling out of that altogether, and maybe how much flex do you want to own? It's always a good asset class when things are good, but it can be a little bit more expensive when things get challenging.

Mac Chandler: Well, if you look historically, we have thinned our Office portfolio and I think we'll continue to do that, but we're not in a rush to do that. We'll do

that opportunistically, and you can see from the last two properties that we sold, we realized really pretty solid value. It's probably better than many expected. Averaging a 5.5% cap rate on these older assets was that manner of high expectations, so we'll look for opportunities.

Not all office assets within our portfolio are created equal. Some certainly have better long-term profilers than others, and that goes the same for flex. Some of our flex properties are more office-oriented and some certainly really resemble industrial properties. That ratio of office build-out is a pretty good indicator for performance, but it does differ market-to-market.

Craig Mailman: Then just maybe for Jeff, from a timing perspective and room with the dividend, to the extent you have some decent gains on any of these, do you have enough activity within the timeframe of 10/31?

Jeff Hedges: Yes. Hey, Craig. Yes, certainly, that would be great. With regard to the two sales that have closed, Monroe and Park East in Northern Virginia, we have the capacity to absorb those gains with or without an exchange. As Mac said, with the other two potential sales that we announced, we have timing flexibility there and certainly that will be considered if and when we do decide to go forward with the sales transaction, and we'll look to be strategic in how we manage the potential gain on those potential sales.

Craig Mailman: Then just one last one on the 140 in Hayward. Where was the mark-to-market on that potentially going to be and any details about the pipeline there and maybe why the tenant decided to step away?

Jeff Hedges: The tenant was a little coy about why they put it on pause. They actually didn't kill the deal, but they needed to put it on pause until the summer, so it may come back. We're not waiting around, but it had terrific rent growth. We're not ready to quote that. We don't want to work against

ourselves as other tenants are looking at the space, but we were very pleased with that deal and if it comes back, we will be. As I mentioned, there are other opportunities out there. It's for the right user who needs that space to be able to come across a space in that condition that's ready to go is pretty special, so the team feels very bullish about it. Just one of the things where sometimes you get down the one yard line and things don't make. That's the nature of the business.

Craig Mailman: Great. Thanks.

Operator: Once again, as a reminder, that is * and 1 for your questions, * and 1. We will take our next question from Blaine Heck with Wells Fargo. Please go ahead. Your line is open.

Blaine Heck: Great, thanks. Good morning out there. Mac, you just gave some great detail on what you're looking for on the acquisition side. Can you do the same for the assets that you're marketing for sale in terms of cap rate or other pricing targets as well as what are the characteristics that drove you to look to sell what you have sold and what's on the block right now?

Mac Chandler: Well, I wouldn't want to say anything that would discourage our buyers from not sharpening their pencil, but I'll point out less because it's a little different than most. There are two assets and it happened to be located right in the heart of the life science cluster, and San Diego is the third largest life science cluster and probably the fastest growing in many respects. The buyers looking at these two assets are likely going to tear these assets down and rebuild and go ground up because there's very favorable underlying zoning and the FAR to rebuild that product is available. We think we'll have very favorable pricing, and so we think we would achieve a cap rate that's far better than anything we would expect

to achieve on a forward IRR basis. It's part of the beauty of buying well-located property years ago and the markets grow up around you, and this is a good example of it, so you look around and the highest and best use is not the property. I'd say we've generated tremendous cash flow over the years, and the asset really is just sort of time to be something else. The interested buyers to date are largely life science developers, and so we're excited about the prospects for that.

Blaine Heck: Got it. That's really helpful. Just to follow up on that, Mac. As you look across the portfolio, and I'm sure you've seen most if not all of it at this point, how many more of these situations are there? How much more do you have in the noncore office bucket or even the kind of opportunistic sales bucket like you're describing in San Diego? How much of that is left and is there anything in the industrial or multifamily buckets you'd look to sell as well?

Mac Chandler: Well, I think that one's unique for the reasons I described. I don't think we have any similar to that, but there are other assets that have upside, not necessarily in a straight-up as a sale, but in the re-entitlement of these assets. That's where we're going to see some value creation there and we think bringing on this expertise and enhancing our ability to do that really is going to create some value creation opportunities over the next few years. Entitlements in the tight markets that we're in where there are high barriers to entry, it takes several years but we have patience and I think the bandwidth now and the expertise to create the value, and then we'll decide is it better for us to actually reinvest in the asset we have? Often, we may use a local partner, we may not, but we think there's real value to be created in those.

Blaine Heck: Okay. Thanks.

Mac Chandler: I would say it's not traditionally the core industrial assets. It's typically the older office product that we have that's sort of garden walk-up style and in some of the flex, but if that helps you to get your head wrapped around where those opportunities would lie.

Blaine Heck: Got it. Appreciate it.

Operator: Once again, if you would like to ask a question, please press *1 on your touchtone phone. We will pause to allow any further questions to queue.

There appears to be no further questions. I will turn the call back over to Mac Chandler for any closing remarks.

Mac Chandler: Just want to take a moment to thank everyone for your time and your interest in PSB. Please enjoy the rest of your day and we'll talk soon.

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