Transcript of
Elme Communities
Third Quarter 2023 Earnings Conference Call
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Participants

Amy Hopkins - Vice President of Investor Relations, Elme Communities
Paul McDermott - Chairman, President, and Chief Executive Officer, Elme Communities
Tiffany Butcher - Executive Vice President and Chief Operating Officer, Elme Communities
Steven Freishtat - Executive Vice President and Chief Financial Officer, Elme Communities
Grant Montgomery - Vice President of Research, Elme Communities

Analysts

Jamie Feldman - Wells Fargo Securities, LLC
Alan Peterson - Green Street Advisors, LLC

Presentation

Operator
Hello, and welcome to the Elme Communities Third Quarter 2023 Earnings Conference Call. As a reminder, today's call is being recorded.

At this time, I would like to turn the call over to Amy Hopkins, Vice President, Investor Relations. Amy, please go ahead.

Amy Hopkins - Vice President of Investor Relations, Elme Communities
Good morning, and thank you for joining our third quarter earnings call. Today's event is being webcast with the slide presentation that is available on the Investors section of our website, and will also be available on our webcast replay.

Before we begin our prepared remarks, I would like to remind everyone that this conference call contains forward-looking statements that involve known and unknown risks and uncertainties, which may cause actual results to differ materially, and we undertake no duty to update them as actual events unfold. We refer to certain of these risks in our SEC filings.

Reconciliations of the GAAP and non-GAAP financial measures discussed on this call are available in our most recent earnings press release and financial supplement, which was distributed yesterday and can be found on the Investors page of our website.

And with that, I would like to turn the call over to our CEO, Paul McDermott.

Paul McDermott - Chairman, President, and Chief Executive Officer, Elme Communities
Thanks, Amy. We delivered solid third quarter operating performance, and the operating trends that we are seeing today align with our expectations and guidance for the remainder of the year.

Therefore, we are maintaining the midpoint and tightening our FFO guidance. In terms of our recent company updates, we closed on the acquisition of a 500-home apartment complex in the inner suburbs of Atlanta for $108 million on September 29. This acquisition rounds out our Atlanta footprint and improves our future growth profile. I'll talk more about this acquisition in a minute.

Additionally, we welcomed a new member to our Board of Trustees. Susan Carras is an accomplished leader in the real estate industry, who brings extensive multifamily transaction experience and a deep network of relationships. We look forward to the valuable insights that she will bring to our board. I'll focus my prepared remarks today on our recent acquisition and future external growth expectations; Tiffany will cover our operating trends and growth initiatives; and Steve will discuss our balance sheet and guidance updates.

Turning to our recent acquisition, we acquired Elme Druid Hills at a forward yield above 6%, including the impact of leveraging our existing expense base. We were awarded the deal through a competitive bidding process, where our ability to provide certainty of execution as an all-cash buyer worked to our advantage.

We expect the acquisition to become accretive over the next 12 months. This is an attractive real estate deal for Elme for the following reasons.

First, it fits squarely into our Class B value-add strategy, which targets communities with rent levels that are 85% to 95% of the market median with renovation potential. This provides the opportunity to grow rents and create value over time without directly competing with new supply. Elme Druid Hills offers the opportunity to renovate all 500 homes, as Class A homes in the surrounding area are priced about at a 21% premium above our in-place rents, leaving more than enough room to renovate and capture our targeted return. Furthermore, the area is somewhat insulated by new supply with only one new delivery since 2021 and limited new supply under construction within a 3-mile radius.

Second, it's located in an affluent area with a growing job base. North Druid Hills offers seamless accessibility to over 550,000 jobs within a 3-mile radius and is close to Atlanta's most important new medical developments. Children's Healthcare of Atlanta and Emory Healthcare's Executive Park expansion, which has generated over $3 billion in investments. Employment in our target net income band grew more than 17% over the past 5 years in the Briarcliff submarket, where average household income is $98,000, supporting an average rent-to-income ratio for Elme Druid Hills' residents of 20%.

Third, rent growth at Elme Druid Hills has outperformed the submarket and broader Atlanta market average on a trailing 5-year and 10-year basis.

Fourth, it is an expansive property that sits on nearly 50 acres. Elme Druid Hills is the second largest multifamily property acreage within a 3-mile radius, yielding a ratio of approximately 10 homes per acre, which is a significantly more land per unit than the average for new deliveries over the past 5 years and offers longer-term redevelopment options. This community is a rare find in a mature affluent inside-the-perimeter location.

Finally, this is an exceptional price, representing a deep discount to replacement costs of over 30%. And we believe that this acquisition will perform very well over time and drives long-term shareholder value. We onboarded Elme Druid Hills onto our operating platform and retained the entire community team, providing continuity for existing residents. The Elme Druid Hills team joins us with extensive local community management and leasing experience. And we could not be more pleased to welcome them to our company.

And with that, I'll turn it to Tiffany to discuss our operating trends and growth initiatives.

Tiffany Butcher - Executive Vice President and Chief Operating Officer, Elme Communities

Thanks, Paul. I'll start by reiterating that our outlook for the same-store multifamily NOI growth remains in a high-single-digit, which represents very strong performance during a year of transition. We generated effective blended lease rate growth of 3% during the quarter for our same-store portfolio, comprised of renewal lease rate growth of 5.1%, and new lease rate growth of 0.1%.

Renewal rates remain strong throughout the fall, and we continue to experience very strong resident retention, averaging 61% during the quarter. Thus far, we have signed renewal offers for October and November lease expirations, a 5.5% on average, representing a stable trend compared to the third quarter average. We expect blended lease rates to moderate over the remainder of the year towards the low-single-digits.

Our focus on building occupancy earlier this year put us in good position heading into the winter, and we continue to experience the pricing power needed to maintain occupancy within our targeted range. Same-store occupancy averaged 95.6% during the quarter, up 20 basis points compared to the prior year. Same-store multifamily average effective rent per home increased 4.9% in the third quarter compared to the prior year.

Turning to renovation. We achieved an average renovation ROI of approximately 14% year-to-date, and we're on pace to complete over 300 renovations this year. Including the renovations, we expect to complete at Druid Hills starting in late 2024, our pipeline now stands at approximately 3,300 homes, which represents more than enough runway to drive renovation-led value creation for the foreseeable future.

Turning to rent-to-income. The rent-to-income ratio for new residents remains in line with our historical average. The average rent-to-income ratio for new lease was signed in the third quarter with 24% indicating that our rent levels are affordable to our new residents. Furthermore, our communities continue to offer a compelling value proposition versus Class A product, a cornerstone of our strategy. Even as new supply has caused rent compression between Class A and Class B communities in our market, particularly in high supply areas, the affordability gap between our communities and new lease-ups in their submarkets remains greater than 30%.

The durability of these gaps exist due to our acquisition discipline targeting communities well below market median price points and allocating capital to submarkets that are not as impacted by new supply. Only one quarter of our submarkets currently have a community in lease-up.

Moving on to our growth initiatives, we have completed the transition of community level operations, while retaining 93% of our community teams, which has positioned us to now focus on driving operational improvements to increase profitability.

Thus far, we have achieved interest expense savings by accessing rent payments earlier, began capitalizing on new fee income opportunities, revised our vendor payment process to take advantage of rebates, identified opportunities to share resources and team members amongst communities that are located in close proximity. And we are 75% of the way through our smart home technology rollout. We are pleased with these initial accomplishments and the progress we have made thus far. And we are excited about the opportunity to make continued progress next year.

We continue to expect to generate between $4.25 million and $4.75 million of FFO from these initiatives above what we would have otherwise generated through 2025 with additional opportunity beyond that based on centralizing components of a leasing and maintenance process. We look forward to providing more details we continue to make progress on our centralization plans.

And with that, I'll turn it over to Steve to cover our balance sheet and outlook.

Steven Freishtat - Executive Vice President and Chief Financial Officer, Elme Communities

Thanks, Tiffany. Our balance sheet is in very good shape with no secure debt and no debt maturities until 2025 with options to extend our 2025 term loan maturity another 2 years. Our annualized adjusted net debt-to-EBITDA remains in line with our targeted range and is expected to trend to the mid-5s by year end.

Following the acquisition of Elme Druid Hills, our liquidity position remains strong with approximately $550 million or 80% of the total capacity available on our line of credit. In terms of our capital allocation strategy going forward, we are focused on finding opportunities to recycle capital out of lower growth, higher CapEx communities, and furthering our geographic expansion.

Now, turning to our outlook for the balance of the year. We are tightening our core FFO guidance range to $0.97 to $0.99 per fully diluted share. As Tiffany discussed, our operating fundamentals are trending in line with our expectations and we are seeing stable traffic and occupancy trends into the winter.

We are confident that we will achieve high-single-digit same-store NOI growth for the year and we are reiterating our same-store NOI guidance range of 8% to 9%. Inclusive of Elme Druid Hills, we now expect our non-same-store multifamily NOI to range from $13 million to $13.75

million. We are tightening our guidance ranges for other same-store NOI, which consists of Watergate 600 and G&A.

We are updating our interest expense guidance to reflect the impact of acquiring Elme Druid Hills. With the internalization of community level operations now behind us, we will no longer be recognizing transformation costs going forward. And, finally, we continue to expect our core AFFO payout ratio for this year to be at or below our mid-70s target.

In terms of our valuation, the public markets are valuing our multifamily business at an implied cap rate in the mid-7% range, which we do not believe reflects the long-term embedded value of our multifamily portfolio. As we advance our operational initiatives, execute value-add renovations at strong returns, capitalize on smart home technology investments, and continue to identify opportunities to improve and grow our portfolio, we expect to improve our valuation and earn a lower implied cap rate over time.

And now, I'd like to open it up for questions.

Operator
Thank you. At this time, we will be conducting a question-and-answer session. [Operator Instructions] Thank you. Our first question is coming from Jamie Feldman with Wells Fargo. Your line is live.

Q: Great. Thanks. Good morning, and thanks for taking my question. So, I guess just to start, you gave good color on the Atlanta acquisition. You talked about potentially doing more in other markets. Can you just talk about what you're seeing out there? I think if you just kind of weave the narrative we've heard so far in earnings, and even we did a call with RealPage, a couple weeks ago. I mean, they're actually seeing more pressure on B. RealPage is seeing more pressure on B. I think UDR is saying the same thing, just because you've got developers of new supply that are getting really aggressive trying to fill it and they're taking tenants away. It sounds like you're not seeing that, but can you just give more color across your submarkets and tie it into kind of what you might see in the acquisition market along those lines?

Grant Montgomery - Vice President of Research, Elme Communities
Sure, Jamie. So this is Grant Montgomery talking. I just wanted to give you a heads up on that, because we really did look into that data as well that RealPage published. And I think one of their points that they made is that depending on the level of new supply coming into market, there was definitely an impact that was registered in that closing of the rent gap between Class A and B across the country nationally. And so, we looked at it in a similar methodology. And what we saw is that in their data, they showed that in submarkets where you had new supply, annual supply, net inventory ratios of 1% to 3%, they were measuring that in about a 21% gap between Class A and Class B.

In our submarkets, we were having that same methodology of looking at new lease-ups versus our product. We have actually a 30% gap in our submarkets. So that's been a key part of our strategy overall is really positioning ourselves at that below the 95% market median rents, so that we're not competing head-to-head. Our most recent analysis of the data using RealPage information shows that we're really only competing, for example, in Atlanta against about 13% of the new product is priced below that point. And so, although, certainly, are in markets where supply is having an impact, we are seeing really less direct head-to-head, because we've been disciplined from the beginning and are price significantly below those new price points.

Q: Okay. That's very helpful. Yeah, I figured it had more to do with the supply risk in your submarkets, it was just different than some of these others, but that makes a lot of sense. Can you comment on blends' renewals and new lease spreads in the non-same-store Atlanta portfolio?

Tiffany Butcher - Executive Vice President and Chief Operating Officer, Elme Communities

Sure. So, let's start with the same-store portfolio and then we can move into non-same-store. For the same-store portfolio, we're expecting renewals to continue to trend in the 3% to 5% range. And then for effective new lease rates, we're seeing that the DC metro is trending kind of slightly negative, and Atlanta is trending towards the negative mid-single-digits by year end. So on a blended basis, we're expecting the DC metro area to be between 3% to 4% and Atlanta to be approximately -1%. You would see those same trends that I talked about for Atlanta carrying into the non-same-store portfolio.

Q: Okay. So, I mean, what are your early thoughts on 2024 rents? If you're seeing new lease to negative.

Tiffany Butcher - Executive Vice President and Chief Operating Officer, Elme Communities

Yeah, so we're going to give our guidance in February. So we're going to be able to provide a lot more detail on the trends at that time. But, overall, I would say right now, it varies significantly by market and by sub-market. What we're seeing today is a continued gradual normalization of rate growth as we head into the typical winter leasing season. Our DC metro portfolio is performing very well and showing the stability that we would expect and that we've seen in our core markets over the longer term.

In Atlanta, we're seeing more of an impact from the timing of evictions as we work through our eviction pipeline, which still includes some leases that were underwritten before we owned the properties and improved our credit standards. So the impact of backfilling eviction related vacancy has created more near-term impacts on rates and occupancies. However, overall, we're still seeing very high retention and very strong renewal rates in our Atlanta communities. And so, we are working through the current eviction pipeline, which is going to set us up well for 2024.

Q: Thank you. Okay, and then I guess just last for me, I mean, this was the first quarter post-internalization and internalization expenses. I mean, as you think about just running the business in the platform, is there anything left to get done, any other initiatives or this is absolutely kind of new sailing from here in terms of the organization?

Steven Freishtat - Executive Vice President and Chief Financial Officer, Elme Communities

Jamie, this is Steve. And you're right from a transformation cost perspective, we had those hit in the third quarter. And we're saying we don't expect anything as far as transformation costs going forward. Everything is internalized and we focused on, now running the business, running it well and efficiently, getting our policies and procedures in place. Where Tiffany talked about the $4.25 million to $4.75 million of upside really focused on achieving that over the next 24-plus-months.

Q: Okay. But are there any like other initiatives you guys are thinking about that might come up in 2024? Or do you feel it – I'm sorry, go ahead**.**

Tiffany Butcher - Executive Vice President and Chief Operating Officer, Elme Communities
Yeah, sure. I would say, absolutely. And I think it really revolves around all of the different initiatives that go into creating that $4.25 million to $4.75 million of operational upside. And more specifically, the five kind of key areas that we see making up that FFO upside. First of all, smart home packages, as I said, in our prepared remarks, we've already installed a smart home technology packages and 75% of our units expect to complete the remainder through this year. So that'll have a positive impact starting in 2024. We're also very focused on occupancy. We are changing our processes and procedures around pre-movement inspections, marketing, et cetera, to help improve our occupancy and our days vacant.

And then, we have a lot of different fee income opportunities that we're working on and looking at strategically that will bring new fee revenue into the portfolio. We're also working on cash management and other expense initiatives. Now that we have everything in-house, we've been able to take advantage of the earlier collection of rents. And then we are very focused on centralization-related opportunities and opportunities to share staff across communities, which we can now take advantage of since the operations are in-house. So those are kind of the five key areas that make up that FFO upside.

And as we've said before, about 20% of that will be recognized this year. And then, the remainder will be recognized across 2024 and 2025.

Q: Great. Thank you very much.

Operator
Thank you. [Operator Instructions] Our next question is coming from Alan Peterson with Green Street. Your line is live.

Q: Hey guys, thanks for the time. Tiffany, I have a question on the Atlanta market. I know that you touched on evictions there. Total portfolio occupancy of 91.6 [ph] at the end of the quarter, is that the floor for occupancy due to bad debt issues? Or are you guys still working through additional or incremental bad debt issues within the market?

Tiffany Butcher - Executive Vice President and Chief Operating Officer, Elme Communities
I would say, overall, we are still working through the eviction pipeline. But on the back end, we

are also putting in place effective new lease incentives to help drive occupancy of the portfolio and new marketing initiatives to make sure that we are backfilling those vacancies as quickly as possible. And then, I think it's very important to note that in addition to that, we have put in place new credit screening criteria that is also helping improve the credit quality of the residents that were backfilling in those vacancies.

Q: So out of that 91.6, how many more units or what percentage of the portfolio is still delinquent within Atlanta?

Tiffany Butcher - Executive Vice President and Chief Operating Officer, Elme Communities
I think that overall the bad debt within the Atlanta portfolio is going to continue to moderate. And we are going to continue to see that bad debt improve month over month if we head into the remainder of this year and then into 2024.

Q: Understood. Maybe just shifting over to the acquisition. Paul, I know that you mentioned that you guys are looking at a 6% yield. Is that 6% yield on a year one basis? And I know that you talked about some of the renovation upside, and it sounds like there's some potential densification or even expansion over the next, call it, 24 months at that property. How are you guys thinking about it from, call it, a year three and beyond yield standpoint in terms of the underwriting there?

Steven Freishtat - Executive Vice President and Chief Financial Officer, Elme Communities
Yeah, this is Steve, again. And I'll kind of start with that and then transfer it to Paul to kind of talk about the upside and the out years. But the 6% is in an internal yield based on what we expect over the first 12 months. So, it's a year one, and we think that this becomes accretive within those 12 months. So from a cap rate perspective, we're pretty excited about that. We're obviously very excited about the real estate and the opportunities here.

And I'll turn it over to Paul to talk about renovations and where we see the upside.

Paul McDermott - Chairman, President, and Chief Executive Officer, Elme Communities
Thanks, Steve. Yeah, Alan, and I'm going to draft a little bit off of Grant's comments on RealPage and what he saw. When we look at this, and I think we've set the bar appropriately high for our acquisitions criteria, I mean this is the only one we've seen in probably 12-plus to 18 months, where we thought it had the potential that we think it has. Aside from the spread between Class As, we look at the demographics of the North Druid Hills market, how much capital's got in there, the amount of jobs around our property that are continuing to go.

We think we're going to be dealing with a higher credit profile here. In that, the income band for the demographics we are targeting has increased 17% over the last 5 years. But when I look at the property itself, and we think this was a great real estate deal, the property itself, we're looking at 10 units per acre right now. And if you look at the deliveries over the last 5 years, all the properties in that submarket have averaged 75 units per acre. So we really do believe that there are densification opportunities here, and that this can be kind of looked at as a covered land play.

But, I think, for us right now, and just we've been banging on this market for a while, when we looked at buying this at 2.16 a door, we think replacement costs, depending on land prices, entitlements, et cetera, it's probably somewhere between 3.10 and 3.40 a door. So we looked at this as a 33% discount to replacement costs. So we think that actually sets us up for a nice land basis if we did want to do some type of densification moving forward.

But I can tell you just, because there's been a lot of discussions about cap rates, et cetera, the feedback we've gotten, we were not the highest bidder on this asset. I think what the distinguishing feature for us was being all cash, offering our seller certainty of execution. And it was our observation to move now and create the value while we could. So that's why we moved forward with Elme Druid Hills.

Q: I appreciate those comments. Maybe, Steve, just on the 6% yield comments and the accretion there, you guys drew down the line and I'm assuming the lines and, call it, the mid-6% range in terms of a funding source. Is there a longer-term funding plan that gets you to that kind of accretion mark for Druid Hills?

Steven Freishtat - Executive Vice President and Chief Financial Officer, Elme Communities

Yeah, Alan, so our line is actually at 6.25% right now. And we're certainly evaluating options and could look to term out a portion of our line of credit balance with the secured or unsecured debt. And we'll see what the Fed does in the coming couple of months. But we do see the secured and unsecured debt market out there as far as loans being made, but the pricing is challenging. So for now, we're certainly comfortable keeping the balance on the line, and we still have ample capacity on our line to do, anything additional if you wanted to, but we'll continue to monitor the markets and look to do something longer-term if it were to make sense.

Q: All right. Maybe one last one for me in terms of forward external growth plans. I understand the comments on recycling out of higher CapEx assets into geographic expansion. Across the best use of funds today, would it be to continue to scale the platform into geographic expansion or potentially look at buyback opportunities considering where the stock is trading at?

Steven Freishtat - Executive Vice President and Chief Financial Officer, Elme Communities

Yes, Alan, so, obviously, we do consider stock buybacks and look at that, but we remain focused on one couple of things. One is we've built out a platform that is scalable and looking at growth to scale the company, but we also look at maintaining the strength of our balance sheet. So, when we think about additional things that we can do, obviously, we said that we're turning to a mid-5 by the end of the year, so we're very comfortable with where we're turning from a leveraged perspective.

Additional diversification, we could certainly recycle assets. We've got some assets maybe in the DC area that might be lower growth, have higher long-term CapEx needs that we could recycle into higher growth assets in the Sun Belt. In addition to that, we've kind of mentioned all of these, but we also have the operational upside, the $4.25 million to $4.75 million, yeah, we're focused on executing on. With the acquisition of Elme Druid Hills, now we have a renovation pipeline at 3,300 units.

The smart home technology, which we started rolling out this year, we're going to continue that in doing Phase 2, which allow us to do self-guided tours. So we think that we've got a lot of growth drivers embedded in our portfolio that we're looking to execute on and anticipate that that will allow us to earn a lower implied cap rate over time. And then, we'll look to grow with our cost of capital when it makes sense. Obviously, it doesn't pencil out right now, but if it makes sense in the future, we'll certainly look to do that as well.

Q: I appreciate the time, guys. And thanks for taking the questions.

Operator
Thank you. And if there are no further questions, I'd like to turn the floor back over to management for any closing comments.

Paul McDermott - Chairman, President, and Chief Executive Officer, Elme Communities
Thank you. Again, we'd like to thank everyone for your time and interest today, and we look forward to speaking with you and seeing you in-person over the next few weeks. Thank you, everyone.

Operator
Thank you. This concludes today's conference, and you may disconnect your lines at this time. And we thank you for your participation.