

**Transcript of  
WashREIT  
Third Quarter 2021 Earnings Conference Call  
October 29, 2021**

---

## Participants

Paul McDermott - Chairman, President & Chief Executive Officer  
Stephen Riffée - Executive Vice President & Chief Financial Officer  
Amy Hopkins – Vice President, Investor Relations  
Grant Montgomery - Vice President, Head of Research

## Analysts

Bill Crow – Raymond James  
Blaine Heck – Wells Fargo  
Michael Lewis – Truist Securities  
Tony Paolone – JP Morgan  
John Pawlowski – Green Street  
Jim Sullivan – BTIG

## Presentation

### **Operator**

Welcome to the Washington Real Estate Investment Trust Third Quarter Earnings Conference Call. As a reminder, today's call is being recorded. Before turning the call to the company's President and Chief Executive Officer, Paul McDermott, Amy Hopkins, Vice President of Investor Relations will provide some introductory information. Amy, please go ahead.

### **Amy Hopkins – Vice President, Investor Relations**

Thank you and good morning everyone. Before we begin, please note that forward-looking statements may be made during this discussion. Such statements 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 were distributed yesterday and can be found on the Investor Relations page of our website.

Participating in today's call with me will be Paul McDermott, President and Chief Executive Officer, Steve Riffée, Executive Vice President and Chief Financial Officer, Drew Hammond, Vice President, Chief Accounting Officer and Treasurer, and Grant Montgomery, Vice President and Head of Research. Now I'd like to turn the call over to Paul.

### **Paul McDermott – President & Chief Executive Officer**

Thank you, Amy. Good morning, everyone, and thanks for joining us today.

I'd like to start off with an update on the progress of our Southeastern market expansion following our commercial asset sales. I will also discuss the efforts that are underway to transform our operating model, and current market conditions in the DC Metro and Atlanta, where we are actively growing our footprint. Steve will then update you on our portfolio performance and trends and will discuss our third quarter results and outlook as we execute our transformation.

Starting with our geographic expansion, we are pleased to report that in just over four months since our transformation announcement, we have already deployed or tied up over 55% of our \$450 million target. We have deployed, or are under binding contract to deploy, approximately \$154 million and we have been awarded another \$97 million that is moving toward a binding contract. We also have other opportunities that we are pursuing, all of which align with our strategies and offer very strong NOI growth prospects. We have a very active pipeline and remain confident that we will meet our target over the balance of this year and perhaps into early next year.

During the quarter, we closed the sales of our office and retail portfolios as planned. We closed our first Southeastern multifamily acquisition, The Oxford, on August 10<sup>th</sup> for \$48 million. We have three additional acquisitions in process including two communities that are under binding contract for \$106 million and a \$97 million property that is moving toward a binding contract. We expect all three to close during the fourth quarter.

We have and will remain disciplined, and we are only underwriting assets that fit our strategy and provide stronger NOI growth. Three of our initial properties align with our B class portfolio strategy, with price points that target the deepest demand segments in their respective submarkets, and the other property aligns with our Class B value-add strategy and offers a near-term value-add renovation pipeline.

Our first acquisition, The Oxford, is a 240-unit garden style community in the city of Conyers, Georgia. The area is primarily comprised of family households who want the benefits of living in the suburbs combined with connectivity to Downtown, Midtown, and the South Atlanta business districts along with proximity to local employment nodes including the Interstate 20 Corridor, which is experiencing significant investment as employers expand into the area.

The Oxford was built in 1999 and over the past five years, same store rent growth for the submarket's 1999's product has outperformed the average for all 90's vintage apartments in the Atlanta market, and significantly outperformed the overall Atlanta market rent growth for all apartments. Over the past three years, the submarket has widened its outperformance versus the region's 90's vintage rent growth by over 3%.

The Oxford has performed very well during the first two and half months we've operated it with very strong new lease rate growth of 25% during September and increasing to 26% in October. Occupancy is tracking above our expectations driven by very high retention rates and new leasing activity. We acquired The Oxford at a cap rate of 4.7% and we expect an NOI growth rate that will be very high for the next three years.

Two of the properties that we currently expect to close in the fourth quarter are located in Henry County, in the southern suburbs of Atlanta, where rent growth has outperformed the overall Atlanta market on a trailing five and three-year basis and is projected to continue to outperform over the next several years. These properties are a strategic fit aligning with our Class B portfolio strategy, with price points that target the deepest demand segments in Henry County. We will provide more details after we close.

In terms of our plans for our remaining capital and growth beyond, we are underwriting opportunities to acquire Southeastern communities with low double digit NOI growth prospects, which is stronger than our initial expectations when we decided to enter these markets. While the Southeastern markets are competitive, we have several advantages that appeal to sellers and are helping us to succeed. We have a 55-year track record of owning and operating multifamily properties and a strong track record of execution, which allows for a smooth and efficient due diligence process. We have well established relationships in the multifamily industry that transcend into our new Southeastern growth markets that we are profiting from. Additionally, we are an all-cash buyer with no financing contingencies, which sets us apart and adds a greater level of certainty of execution to the seller.

While cap rates have tightened further since June, we are keying in on opportunities that will yield outsized rent and NOI growth and align with our strategic goals. Investment discipline is critical for us, and we've spent a lot of time and effort researching and selecting our target markets and strategies for each market.

Our research tells us that the industrial mix of an economy can determine what rent growth will look like over the long term. Our current target markets of Atlanta, Raleigh/Durham and Charlotte have outsized exposure to industries that drive productivity growth, which creates a virtuous feedback loop of job and income growth, in-migration, and increasing education levels.

Year-over-year effective rents for Atlanta, Raleigh/Durham and Charlotte grew by 19.8%, 19% and 17.6%, respectively, in September as reported by RealPage. New lease trade outs were even stronger, averaging 22.7% across the three markets, and a 580-basis point inflection between June and September.

Annual demand also surged across these markets as in-migration and household formation drove record-setting absorption. Reported first quarter annual demand had already exceeded the five-year average in each target market, yet it climbed over 23% higher from the first to third quarters. Raleigh/Durham posted second quarter annual demand at 142% of its five-year average, while Charlotte and Atlanta's second quarter annual demand topped 162% and 161% of their five-year averages, respectively.

In order to maintain a disciplined approach and invest in these economies without competing with new supply, we're evaluating acquisition opportunities at the submarket level and targeting vintages with price points located at the deepest section of the demand curve. We are targeting renters that are benefitting from economic and wage growth but remain underserved by new supply, which provides us the opportunity to create a quality living experience while also growing rents without competing with new supply.

We remain in active negotiations pursuing additional opportunities and would like to tie up another \$200 million in multifamily assets that we expect can now be completed by early 2022. Again, we remain disciplined and are

committed to allocating capital according to our strategy. We have passed on opportunities that did not meet our criteria or would not generate accretive growth.

While we believe diversifying and expanding our footprint makes sense, we will also continue to explore acquisition opportunities in Northern Virginia should they create greater value. The Washington apartment market is exhibiting some of the same positive trends that we are seeing in our Southeastern target markets. Year-over-year effective rents climbed 647 basis points from June to September. Suburban Virginia's performance followed a similar pattern, but with even stronger growth, with year-over-year effective rent growth accelerating to 9.7% in September.

Our DC portfolio is positioned well with 80% of our portfolio in Northern Virginia, where the rapidly expanding consumer technology sector continues to drive job and income growth. Furthermore, our value-oriented price points offer favorable supply and demand fundamentals over the long-term as the regional housing shortage worsens and cost of homeownership and new apartment supply remains unaffordable for mid-market renters.

Before I turn it over to Steve, I'd like to discuss the efforts that are underway to transform and expand our operating model. As many of you know, we have been planning this transformation for several years, and our transformation plan includes bringing property level management in-house while building a new operating platform for the future. Over the past year, we have worked with a consultant to map out a plan to optimize our operational design as we scale our multifamily portfolio.

We are now in Phase One of this project, which includes three phases in total. We're making steady progress against the roadmap that we laid out and we anticipate that by the time of our year-end call, we will have selected all technology, established the elements required to support our operations including a comprehensive human capital program, and established a new brand that best defines our approach for investors, residents, and employees. At that time, we expect to be able to give guidance on G&A and transformation costs as we will be actively building out the platform. We hope to execute Phase Two, which includes Core Platform Implementation, in 2022, and Phase Three, which incorporates the onboarding of our property management functions to our internal systems, starting in late 2022 into mid-2023.

While we control our revenue strategy and do all capital planning internally, day-to-day marketing, maintenance, and property management staffing have been outsourced. Following the complete internalization of property management and enhancements to our operational platform, we expect to realize significant operational benefits, from streamlining our business processes through the use of technology to establishing a closer connection with our residents to operational design efficiencies as we scale the business and optimize G&A expenses.

At the property level, we believe that there are operating efficiencies ahead of us from internalizing property management because we are designing an operating platform aligned with our strategies for resident experience and employee satisfaction and growth. By utilizing corporate functions in a centralized model, we can be highly scalable, which will allow us to grow NOI at a much higher rate than G&A expenses. By designing and implementing our operating platform from scratch, we are not limited by existing infrastructure and will offer value and opportunity to all our stakeholders.

Now I'd like to turn the call over to Steve to discuss our performance and trends, the status of our value creation opportunities, our third quarter results, and our near-term outlook as we execute our transformation.

**Steve Riffie – Executive Vice President & Chief Financial Officer**

Thank you, Paul, and good morning everyone.

The lease rate momentum that we experienced during the summer months has continued into the fall and we are positioned well heading into the winter months with low double-digit lease rate growth on our most recent new lease executions. New lease rate growth was 9% for leases signed in September and 11% for leases signed thus far in October on an effective basis. On the renewal side, there has been very strong demand, and renewal lease rate growth was over 6% for September renewals and over 7% for October renewals on an effective basis.

Concessions declined dramatically from June through September and are nearing pre-Covid levels. Total concessions for September move-ins declined over 95% compared to June move-ins driven by both a decline in the number of new leases with concessions and a decline in the average concession amount per lease. The percentage of new leases with concessions declined from an average level of 60% during the first half of the year to only 9% of new leases for September move-ins. The average concession value for new leases where concessions were granted declined by 60% from \$1,300 for June move-ins to approximately \$560 per home for September move-ins.

Occupancy remains strong, with a forward trend that will allow us to continue to increase rents. Same store average occupancy grew 40 basis points in October compared to the third quarter.

Our suburban lease rates continue to outperform our urban lease rates, although, the gap has narrowed due to the strong rebound we are experiencing across our urban portfolio.

Blended lease rate growth was 7% for leases signed in September and over 8% for leases signed in October on an effective basis, which represents a significant increase from the third quarter average. For move-ins that took place during the third quarter, blended lease rate growth was 3.5% on average on an effective basis, representing a 620-basis point increase from the second quarter. Lease rate growth for September and October move-ins and lease executions with November and December move-in dates indicate steady and consistent improvement through year end.

We expect strong lease rate growth through the winter months and into the spring and summer leasing seasons in 2022. Rents have shown a swift recovery. The inflection, as indicated by the rapid weekly improvement in lease rate growth, began toward the end of June and rental rates improved rapidly through the summer. In August we started signing new leases that were above pre-Covid levels for the majority of our portfolio. Specifically, the average effective rent for new leases in the third quarter was above the same month in 2019 for 17 of our 21 same-store properties. In fact, new leases for our suburban portfolio were 10% above the 2019 level on average, in the third quarter, highlighting how well our suburban properties performed during the pandemic.

We expect to see steady growth in average portfolio-wide rent levels as the market recovery works its way into our rent-roll over the next year. Our ability to capture this embedded growth will be slower during the winter months as less than 25% of our leases expire between November and February. During this time, we will be

focused on balancing rent growth with retention, as maintaining a balance in fundamentals heading into 2022 will set us up for anticipated exceptionally strong spring and summer leasing seasons. As we enter the spring and summer, we will be positioned to capture both the impact of the recovery and market rent growth beyond the Covid-related recovery.

The Trove lease up momentum continues, and it is now over 85% occupied. We expect Trove to be a key growth driver adding approximately \$7 million of NOI in 2022 and \$7.6 million of NOI in 2023. We also continue to monitor demand levels at Riverside, where we have a shovel ready opportunity to add 767 units which we put on hold when Covid hit. While lease executions at Riverside are on a positive trend, we are currently monitoring projected lease rate growth to support this development.

Our renovation programs are actively ramping up after they were temporarily paused during the pandemic. We have a pipeline of approximately 2,700 units in our same store portfolio. As expected, the pace of renovations picked up through the summer months while unit turnover is seasonally high. In many cases we preserved the renovation opportunity for the next turn as we are achieving strong effective rent growth without currently having to make a capital investment. Year-to-date, we have fully renovated over 130 units and invested capital in upgrading 110 additional units. We are securing low to mid double-digit cash on cash returns year to date. We expect to spend \$3 million on our renovation program this year ramping up to approximately \$7.5 to \$8 million next year for the current same store portfolio.

In the spirit of our transformation into a multifamily REIT, we have made changes to our earnings materials and non-GAAP financial metrics to be more in line with, and comparable to, other Multifamily REITs. We believe that our new presentation makes comparisons of our operating results more meaningful and provides additional insight into our operating performance and trends.

First, we've provided a more detailed expense breakdown of both controllable and non-controllable expenses, including property operating, taxes and insurance and property management.

Second, we have included detail of our same-store operating results by geographic region as we continue executing our strategic plan to diversify into multiple geographic regions.

Third, we modified our calculation of NOI to exclude property management expenses, which is more consistent with the multifamily industry standard and better presents the impact of our trends in occupancy rates, rental rates and operating costs on our operating performance. We've retrospectively adjusted our previously reported multifamily NOI for comparability, and overall, this adjustment has increased our NOI margin by 300 to 400 basis points.

Fourth we updated our definition of NOI for residential communities to exclude NOI from ground-level retail tenants. The separation of non-residential NOI from residential NOI provides a better representation of our core performance by distinguishing between the core operations of the business and ancillary NOI.

Fifth, we changed the name of the non-GAAP measure Funds Available for Distribution, or FAD, to AFFO because we believe that AFFO is the more common term in the multifamily sector. We did not make any change to the calculation and there is no difference in the definition of AFFO and FAD as previously labeled.

Sixth, we expanded our disclosure of same-store metrics adding operating margin and effective lease rate growth.

Finally, we combined our earnings release and financial supplement into one earnings package.

All of these adjustments are described in detail on page 14 of the third quarter earnings package.

Now turning to our financial performance. Net income for the third quarter of 2021 was approximately \$31 million, or \$0.37 per diluted share compared to a net loss of \$1 million or \$0.1 per diluted share in the prior year.

Core FFO was \$0.20 per diluted share, reflecting a year over year decline of \$0.16 due to the impact of our commercial asset sales.

Multifamily same-store NOI declined 40 basis points compared to the prior year driven by the impact of leases signed during the pandemic. As expected, the rapid rebound in core multifamily operating trends that began toward the end of the second quarter is, and will continue to, have a more gradual impact on our financial performance. While new lease executions began to improve rapidly starting in June and into July, those move-ins started to impact our results in late August, and we expect the inflection in lease rates to have a greater impact on our fourth quarter results.

Furthermore, the impact of concession amortization peaked during the third quarter driven by the timing of the peak in concessions, which occurred toward the very end of 2020 into the first quarter of 2021. The impact of concession amortization on monthly NOI peaked in August and began to decline on a monthly basis in September. Excluding the impact of amortization related to concessions granted in prior periods, same store multifamily NOI increased 2% on a year-over-year basis during the third quarter.

Our resident credit continues to be excellent. For the small amount of delinquent rents that we have, local rent assistance programs have helped us on the margin to date. We collected 99% of multifamily rents during the third quarter and received \$400 thousand of local government rent assistance from residents. Year-to-date, residents have received over \$1.4 million of rental assistance.

Other NOI, which represents Watergate 600, declined 4.9% in the third quarter compared to prior year period primarily due to higher taxes and payroll expenses and a favorable bad debt recovery in the prior year period.

Leasing activity at Watergate 600 has been steady despite the challenging environment of the DC office market. We signed an 8,200 SF new lease with a credit tenant during the quarter and two renewals and one expansion post quarter end. Our percentage leased has increased to 92% and we have activity to allow us to create further value in the asset. This one remaining office asset is an iconic building with riverfront and monument views, high-quality institutional tenants and a weighted average lease term of eight years, and we continue to see opportunity to create value by owning and leasing Watergate 600.

Touching on our outlook for the balance of the year, we are reinstating full year 2021 guidance with a Core FFO range of \$1.05 per share to \$1.08 per share.

We estimate that our same store multifamily portfolio will contribute between \$90 and \$90.5 million of NOI for the year. At the midpoint this implies an approximately 4.5% multifamily growth rate for the fourth quarter compared to the prior year period. We expect healthy same store NOI growth in the fourth quarter and further growth in 2022.

Trove and The Oxford are expected to contribute between \$3.75 and \$4.25 million of 2021 NOI. Watergate 600 is expected to contribute approximately \$12.75 million of NOI.

We completed the sale of the office portfolio on July 26<sup>th</sup> for gross proceeds of \$766 million and completed the sale of retail portfolio on September 22<sup>nd</sup> for gross proceeds of \$168.3 million.

We acquired The Oxford on August 10<sup>th</sup>, which as Paul highlighted, has performed very well thus far and is tracking ahead of underwriting based on rents.

As we have discussed, we entered into binding agreements to acquire two communities in the Atlanta market for \$106 million and are moving toward an additional binding agreement for another property for \$97 million. All three of these transactions are expected to close during the fourth quarter.

We redeemed all \$300 million of senior unsecured notes that previously were scheduled to mature in 2022 on August 26<sup>th</sup> and repaid \$150 million of amounts outstanding under the term loan maturing in 2023 on September 27<sup>th</sup>.

We ended the quarter with a very low net debt to EBITDA ratio of 1.4x.

While we may be in the mid to high five times net debt to adjusted EBITDA range in the first year after executing these transactions, as we progress through the second and third years of multifamily NOI growth, we would aspire to operate in the lower half of the five to six times range. We have very little debt maturing in the near term, none earlier than 2023, and our equity versus debt ratio is expected to get close to 80% to 20%, which would be very strong. We have no secured debt in our capital structure which provides us with flexibility to take on some agency debt or other secured debt as we acquire apartments. Moreover, we believe we will continue to have most of our line available, so strong liquidity will be maintained. We currently have approximately \$1 billion of liquidity including the full availability of our \$700 million line of credit which we further extended another four years this quarter.

Before I turn the call back to Paul, I'm pleased to share that earlier this month we published our 2021 ESG report, which outlines our ESG vision and objectives as a multifamily company. With this report, we are proud to be among the first multifamily REITs to commit to achieving net zero carbon operations. We detail a number of exciting ESG projects underway, including pursuit of green building certifications for multifamily Class B assets, growing our pipeline of on-site solar projects, and the integration of climate risk into the company's overall enterprise risk management framework including evaluating climate risk and asset resilience as part of our underwriting process.

And with that, I will now turn the call back to Paul.

**Paul McDermott – President & Chief Executive Officer**



Thank you, Steve.

Overall, we are off to a very good start progressing on our geographic expansion and have executed most of our transformation to a multifamily company. We have completed the sale of our Commercial segments and we have closed on one asset, have two under contract and, as we said, we have been awarded one more asset in Atlanta. We have an active pipeline of opportunities that align with our strategies, and we remain confident we can allocate this capital appropriately over the balance of this year and into early next year.

For the balance of 2021 we remain focused on investing our remaining capital and firming up our plan to transform and expand our operating model. We expect to achieve operating efficiencies as we scale the business and execute our plan to bring property-level operations back in house. We look forward to keeping you updated on our progress as we expand our geographic footprint and transform our operating platform.

Now, the team and I would like to open the call to answer your questions.

**Operator:** At this time, we will be conducting a question-and-answer session. [Operator instructions].

**Operator**

Thank you. Ladies and gentlemen, the floor is now open for questions. Our first question today is coming from Jim Sullivan at BTIG. Your line is live. You may begin.

**Q:** First of all in terms of the acquisition activity, I believe on the additional acquisition the Oxford you indicated a cap rate of 4.7%, and I was unclear whether that 4.7% was based on the underwriting you did at the time of the acquisition or whether it was based on kind of the current run rates that you're achieving.

**Steve Riffie – Executive Vice President & Chief Financial Officer**

It was based on our underwriting, at the time of the acquisition taking into account what's happening on a trailing basis but not necessarily projecting the exact same rental growth that they've achieved over the last six months for the prolonged underwriting period.

**Q:** Now that cap rate, I believe, is somewhat higher than you've been talking about in conversations before you started actually closing acquisitions, and I guess you know given the liquidity and given your ambitions in terms of acquisitions in the coming couple of months here, is that 4.7% indicative of where you think you're going to be? I think you have been talking about rates may be closer to 4% earlier?

**Steve Riffie – Executive Vice President & Chief Financial Officer**

There's no doubt that since we rolled this out in June that there's cap rates have compressed further competitively in the Southeast market, with about 55% of our target in terms of what we wanted to get out from a capital allocation standpoint now tied up or insight, we're averaging a 4%, and we would go a little under that. The other thing that I want to point out is, we talked about what we thought NOI would be like over the first three years when we set that target based on our research, what we're actually finding in our underwriting is that the NOI growth that we have for the first three or four years are multiples of what we had originally assumed when we had our initial cap rate target. So we are identifying assets that are right on strategy. We see some cap rate compression

but we're actually seeing NOI growth that's much greater than we originally assumed. So we're happy that this is going to create the growth that we wanted through geographic diversification so far.

**Q:** The assets that you have under agreement or heading for agreement on. You indicated that one of them is a B value-add. And I wonder in that respect if you could share with us what the expected spend per unit would be. I know it's early days, you might not have finalized this but whatever indications you could give would be helpful.

**Paul McDermott – President & Chief Executive Officer**

We're still in negotiations on that asset and so we're happy to talk about that once the deal is closed. But since we're still in negotiations with the seller, I'd prefer to defer that for now.

**Q:** Okay, fair enough and then finally for me -- the operating platform rollout that you described and it was helpful to get that detail into the phasing and in timing. I'd be curious if you have established the budget for that and of that cost if you could share with us what you project that cost to be what percentage of - if any you can provide for that cost that would be capitalized versus expensed.

**Steve Riffie – Executive Vice President & Chief Financial Officer**

We have a preliminary estimate of that. We really would like to give that detail after we finish Phase One, which should conclude here near year-end and we do expect a portion of that to be capitalized. We're in Phase One which is scoping out the technology platform the whole human capital plan for integrating this at the operational level and branding and then the web technology, and were going through a process and the actual amount that we would spend depends on the selections we make here in Phase One. I have a preliminary estimate don't really want to put it out till the February call when we have a budget that I'm very confident in. Almost half of it would be capitalized on the preliminary budget that I look at. We really look forward to giving clarity. The team is working very hard right now and we're trying to target to have it done before our February year-end call, so that we can speak to that and talk about the timing and the phase-in and kind of what our goals are in terms of what we might be able to achieve as a result of implementing it.

**Operator**

Our next question today is coming from John Pawlowski at Green Street. Your line is live, you may begin.

**Q:** One follow up clarifying question, the cap rates. Steve, the 4% cap rates is that on a forward 12-month basis or in place NOI concept?

**Steve Riffie – Executive Vice President & Chief Financial Officer**

It's on a forward under our underwriting. Looking at what we're going to be doing at each of the properties and that's a blended cap rate across the 4. The first one was higher. The last one was a little lower to blend to a 4% so far.

**Q:** Okay, makes sense. Paul, could you understand we'll wait for actual quantification of the roll out of the operating platform, but the intensive human capital program you alluded to. Can you just give us some more details of what that actually entails? The number of senior executives you ought to bring on overall head count expansion, just a bit more context on the human capital program will be helpful.

**Paul McDermott – President & Chief Executive Officer**

I'd be happy to do that once it's completed, but as Steve alluded to, we are in the preliminary stages of formulating that. Because you cover so many multifamily REITs, we are basically taking property level operations and bringing them in-house and you're pretty familiar with what it is to staff an asset. We are putting that pen to paper right now, as Steve alluded to, we'd probably have a better idea of what that will look like by the year-end earnings call in February.

**Steve Riffie – Executive Vice President & Chief Financial Officer**

Paul the only thing I would add, we do expect from our preliminary work when we put the initial roadmap together working with consultants, we expect to achieve efficiencies very much operationally and at the property management level there will be staff tighter. There will be some functions that are centralized and so we do see an opportunity to create some of those efficiencies once it will be fully integrated.

**Q:** Last question, months and months keep rolling by and we are getting back to normal, particularly in the apartment rental side. But there's still this unnerving lull in terms of a rebound in office utilization. So now got a little bit more leasing done at Watergate. Does a lack of a resurgence in office utilization make you want to accelerate the sale of Watergate?

**Paul McDermott – President & Chief Executive Officer**

We've been fairly consistent in saying that there's still some opportunity to create value at the Watergate. As Steve alluded to in his remarks, we did find one lease we extended another, our WALT on that property is now eight years. I think we're seeing some good activity right now. And we'd like to get some more leasing activity accomplished. We're keeping our eye on the DC market. And when we think the time is appropriate to bring it to the market to create optimal value, we're going to do that.

**Operator**

Our next question today is coming from Anthony Paolone at JPMorgan. Your line is live. You may begin.

**Q:** First, further on the cap rate discussion, just to make sure we have our definitions right here. You said forward 12 months NOI and is that before or after property management costs that you seem to be taken out these days about 3.5%. And then also any Capex reserves?

**Steve Riffie – Executive Vice President & Chief Financial Officer**

It is basically our NOI over our purchase price, is the way we calculate that. We've definitely underwritten our own internal costs and our property management costs are built into the structure. So when we we're looking at that initial cap rate, we were taking into account what we think our cost structure will be at the property level. In terms of Capex, you know we are underwriting Capex in terms of what we want to do with the building kind of year by year as we look at it. If we were to make additional capital investments, we're not including that in the initial cap rate as we don't on others, but we do report that. When we look at the renovation opportunities, that are part of that Capex, we think of those as individual ROI opportunities, that you know create their own their own return.

**Q:** But that for then is before the property management expense number?

**Steve Riffie – Executive Vice President & Chief Financial Officer**

The way we had written it, it actually did take into account the property management expenses, the redefining of it for financial reporting to be comparable to other companies did not change the way we've been looking at it traditionally in our acquisition models.

**Q:** Just trying to making sure we're talking about the same thing. I think you'd mentioned maybe a 10% suburban rents that are above 2019 levels. But, if you can give a number to the overall portfolio loss to least right now.

**Steve Riffie – Executive Vice President & Chief Financial Officer**

The loss to lease for the portfolio, we did put out an updated investor deck last night also. We do have a loss to lease slide on there. So our urban loss to lease right now is around 17%, suburban is actually a little lower blended loss to lease is around 14%.

**Q:** On this property management platform, building out the organization, I guess the question is, if you finish up this \$450 million that you set out to do. Is that enough to really have the scale you need to do better than then using third parties?

**Paul McDermott – President & Chief Executive Officer**

We're going to obviously continue to scale the platform. That's the whole reason we're going through this exercise. We have many ways to do that. We would expect to be continuing to draft off the momentum of the \$450 million initially, for example, we still have the Watergate to monetize. We've been approached about JVs, as you know we have Riverside that's shovel ready where we could also repatriate capital into other markets. We've got a lot of opportunity in front of us. But the whole point here is to build this up to gain some of those efficiencies that we've alluded to that we're trying to create by re-doing the platform.

**Q:** With the stock in the \$25, \$26 range can you make sense of using the equity here to do these deals?

**Steve Riffie – Executive Vice President & Chief Financial Officer**

The thing that we wanted to do initially, with all of the moving parts, as everybody seems to acknowledge and comment, the multiple things like that we are going to do will take a while to make sense. We're trading basically on an implied cap rate that's wider than the other multifamily REITs. Knowing that we've got a good leverage, good balance sheet, a lot of flexibility. We've got to get capital out. We wanted to initially give ourselves time. So we're sitting here with capital already raised, from the transformation to still reinvest. We also have at least two other sources of capital that might make sense before we have to go back to other markets but we wanted to create a capital structure that allows us access to all the different markets as capital continues to change, under conditions in terms of what's the most optimal way to go. We still have Watergate to harvest, as a source of capital for expansion, and we also have a huge development opportunity sitting on a huge asset in Riverside that there's a lot of capital that would like to partner with us, to continue to develop and expand that. We have no joint ventures, no secured debts. We got a pretty clean structure to look at different sources of capital. In that, if we entered into a joint venture where we kept an interest in that, that might provide a lot of capital for other geographic expansion as well. We hope that we've simplified the company's structure, that it's easier for equity investors to look at us and say, now we know what class of asset you are, and we're not worried about one or two of the other classes and hopefully we'll have access to that capital. We believe that we've got such a clean balance sheet that we can access different kinds of debt capital, including secured debt. If that's the right way to structure apartment deals. We got enough capital to get the initial wave done and created flexibility and optionality

for two or three steps before saying we absolutely have to go raise equity. That's the way we thought about it strategically. So far we're still executing that way.

**Operator**

Our next question today is coming from Blaine Heck at Wells Fargo. Your line is live.

**Q:** Great, thanks. Most of my questions have been asked, but one for Steve. How should we think about the potential dividend growth going forward now that your payout and portfolio have been reset, is it kind of fair to assume it should follow closely with AFFO growth from here?

**Steve Riffie – Executive Vice President & Chief Financial Officer**

I think so. We're coming in at when we reset the dividend level. We looked at it saying that our governor would be somewhere around a 75% AFFO payout ratio to kind of keep an eye on and we were comfortable that if after we get this \$450 million redeployed that we're going to be able to operate within that. As I said, one of the things we're very pleased about and one of the main reasons for geographic diversification is expansion to other markets that are growing better now. These are some of the best economic conditions that we've looked at in our own market in some time, in terms of loss to lease. We talked about the continued inflection and in terms of net effective rents for new leases and then we talked about October being 11% well the last two weeks were up to 12% and 13%. So things are trending well. But we're also seeing underwriting and seeing NOI growth that we're going to be happy about here even being greater where we're trying to allocate new capital too. It's important to diversify and if you think about AFFO growth, right now our recurring Capex to NOI is down around 5% and that's a lot different than when we had the commercial portfolio kind of dragging us and we think that we're being strategic about where we're allocating capital for greater NOI growth which will create greater AFFO growth. We will have the opportunity for AFFO to grow as we continue to execute this. And hopefully that means the dividend will have opportunities to grow down the road too.

**Q:** Very different from office.

**Steve Riffie – Executive Vice President & Chief Financial Officer**

Yes.

**Operator**

Our next question today is coming from Michael Lewis at Truist Securities. Your line is live. You may begin.

**Q:** I appreciate all the detail as you're doing this, this kind of meaningful repositioning. And along those lines, you talked about this opportunity to build what you want. Big picture question about what that means in terms of the portfolio, you mentioned buying this first asset at a 4.7% cap. It sounds like maybe you could do some that are sub 4%. Do you envision value-add opportunities, could you do redevelopment down the line? Is it equality in eight locations or is it a suburban strategy? How do you kind of think about it as you have this opportunity of build this portfolio up?

**Paul McDermott – President & Chief Executive Officer**

I would probably say all of the above, because we have allocations to all those buckets. If you recall our strategy that we laid out on June 15th when we talked about this transformation, we really talked about the B strategy and

how we would hit that. I'm going to ask Grant to jump in here in a second to really talk about that. But in addition to the three strategic spheres that Grant will go through, we also still have a 2,700 unit renovation pipeline. We have a 767 unit shovel-ready development opportunity, with some other development opportunities already embedded in our existing portfolio in this region. But before I go any further, let me turn it over to Grant to talk about those three.

### **Grant Montgomery – Vice President & Head of Research**

The core of our focus is on the renter, and we're really following the mid-market renter and those mid-market renters can be found in a variety of locations, both suburban and urban. Our Class B strategy is targeting areas that have this outsized submarket growth with future renovation potential that might not make sense today. But those submarkets that we've really identified have the underlying strength to really point to that future opportunity while harvesting the strong rent growth today. Secondly is a B value-add, which we have significant experience with here in the Washington DC, area and are finding opportunities in the Southeast as well. Those are ones where we have the immediate opportunity to do full scale unit renovations, and we're really focusing on properties in submarkets where the rent gap between those properties and the Class A product gives plenty of room to renovate and not compete directly against those while serving that underserved renter that may be in a more expensive sub-market and is underserved by the current product there. Finally as with our existing portfolio, we have some Class A- properties, which are of a higher quality, slightly different renter but still a mid-market renter, but really focused on the value orientation of that. And those were being really careful about in terms of our operations, so that we try to stay below about 110% of the market median rent. What we found from our research is that typically new developments in these markets, including Washington DC delivered about 120% to 130% of the market median. And if we can stay below that 110% rate on the Class A properties, we really miss a lot of the direct head-to-head competition and so we can be successful and that upper end of the mid-market strata as well. We'll build that portfolio out both in suburban locations, urbanizing locations across these markets. Sort of predicated upon where we're going and many of these markets a large volume up, it will be suburban because these markets are highly suburban in nature.

**Q:** I just wanted to ask about setting up the platform in these technology investments. I know in terms of cost, I think you guys had put a number out there, it included some debt repayment that maybe already came to fruition. How do we think about how those costs kind of layering in over time. Are you going to be splitting out transition costs from your Core FFO for several quarters, are there some big upfront costs? How will that kind of layering?

### **Steve Riffie – Executive Vice President & Chief Financial Officer**

We're going to try to be as transparent as possible in terms of breaking out things so you can track it. I think we initially had transaction costs related to all of the execution here and those went through multiple line items, including, the gain on the sale of our assets and the debt breakage costs and costs related to that. The transformation costs are probably going to go on through the phase of this project. So, when we look at G&A and talk about that for a second and relate it back to transformation costs. Right now, the 2021 costs are higher due to all this execution. In 2022 G&As should start to normalize and we intend to separate the transformation investments that we'll be making within 2022 and for our future platform and our full integration and hopefully be giving guidance in February about that. We talked about the phasing of this. So the first phase is not a significant investment, but it's underway right now and it's in our costs embedded in our cost structure for the fourth quarter. When we look at our G&A, that's implied for the fourth quarter of this year, the more significant costs and we'll give an estimate in February will be in 2022. Some will be expensed, but that's what we'll be implementing a complete integrated future technology platform. We will be creating the human capital structure, which includes all

the job descriptions, all the incentive programs, how we will operationally staff every location. It'll include the investments that we will make in web design and branding. We use technology for overnight pricing. It will all be integrated, some of which will be capitalized. And in our timing is to make the most of that investment and have it in place before we bring the first property back in an integrated way, which we're targeting for late 2022 in the phased in through mid-2023. We hope to lay that out so that can be tracked separately so we can start to normalize and we do expect operating efficiencies that will show up in a few places. Hopefully the NOI, the property and hopefully in the property management expenses, as we go forward. We also believe on the G&A side, it'll start to normalize and scalable as we have Sunset Commercial have made some of this investment. But very importantly, I think Paul talked about strategically, this all makes the most sense if we scale the business. G&A is very scalable at this company in terms of not having to add a significant amount of G&A as we expand. So we will try our very best to as we make this transformation. The only ongoing costs after we execute the final parts of the transactions will be the transformation related to the integration of the platform. And that should run into late 2022.

**Operator**

Our final question today is coming from Bill Crow at Raymond James. Your line is live. You may begin.

**Q:** Your team always does some great macro work, so I really want to focus there, and I think arguably your current target renter cohort might be relatively more sensitive to the inflationary pressures on trade and gasoline utilities, rental rate increases that are going into effect right now. And I'm just curious, as you look out a year, what you think about lapping the increases that are being pushed today. Do you think the Class B, of course we're big proponents of workforce housing, but do you think you'll be able to get the same rental rate increases a year from now as a Class A?

**Paul McDermott – President & Chief Executive Officer**

I'm going to ask Grant to jump in here real quick and then I'll follow up.

**Grant Montgomery – Vice President & Head of Research**

We don't expect rental rate increases 20% a year from now. So there will be some sort of tailing down of that going forward. But we are hardened by the strong income growth that we've actually seen. ADP came out with a report yesterday showing that wages have grown 3.3% across the US, and for those that were changing jobs is actually double that at 6.6%. But as it relates to what we're trying to do in our portfolio. The strongest growth was actually in the southeast, which was 3.8% and in some of the industries that our residents are likely to be employed in, such as trade, transportation and utilities. So, for example, our locations that we are acquiring in Henry County is really sort of the nexus of logistics for the Atlanta area. On trade, transportation, utilities wages are up 6.7% and construction wages up 5%. These are the type of people that will reside in our properties. We're really heartened by that. The news came out yesterday that Costco was increasing their wages as well. So unlike other times in our recoveries, we're actually seeing strong wage growth at the bottom of the strata to the mid-level of the strata. We're heartened by that in terms of what that means for the ability of our renters to be able to absorb some of the growing costs in terms of their rent budget moving forward into 2022.

**Paul McDermott – President & Chief Executive Officer**

The only thing I'd add to that is and I can't compliment Grant enough for how detailed he is on his answers. The only thing I would say in our experience, especially through Covid, when there was job loss pressure, even now looking for some perceived inflationary pressures, B just got stronger. We saw people leaving, the A to A- and

quite frankly, I looked at our suburban B during the Covid performance, as you recall a lot of people were questioning why we employed a B suburban strategy, not only the growth, but just the resiliency that we saw in that income demographic because it's really the only affordable product type that is located in an infrastructure with schools, retail services, et cetera. We think that the continued pressures may put some pressure on our renters, but we think it's at the steepest end of the demand curve. So we think we're going to see plenty of demand for that type of product moving forward.

**Operator**

Thank you. We have no further questions in the queue at this time.

**Paul McDermott – President & Chief Executive Officer**

I'd like to thank everyone again for your time and interest today. We will continue to update you as we progress our multifamily transformation, and we look forward to speaking with many of you over the next several weeks. Thank you.