11-February-2016

Armada Hoffler Properties, Inc. (AHH)

Q4 2015 Earnings Call

CORPORATE PARTICIPANTS

Louis S. Haddad
President, Chief Executive Officer& Director

Michael P. O'Hara
Treasurer, Chief Financial Officer

Eric L. Smith
Secretary, Chief Investment Officer

MANAGEMENT DISCUSSION SECTION

Operator: Welcome to Armada Hoffler's fourth quarter 2015 earnings conference call. At this time, all participants are in a listen-only mode. After management's prepared remarks, you'll be invited to participate in a question and answer session. At that time if you have a question, please press "star 1" on your telephone.

As a reminder, this conference call is being recorded today, Thursday, February 11, 2016.

I will now turn the conference call over to Michael O'Hara, Chief Financial Officer at Armada Hoffler.

Please go ahead.

Michael P. O'Hara
Treasurer, Chief Financial Officer

Good morning and thank you for joining Armada Hoffler's fourth quarter 2015 earnings conference call and webcast.

On the call this morning, in addition to myself, are:

Lou Haddad, CEO and Eric Smith, our Chief Investment Officer, who will be available for questions.

The press release announcing our fourth quarter earnings along with our quarterly supplemental package was distributed this morning.

A replay of this call will be available shortly after the conclusion of the call through March 11, 2016.

The numbers to access the replay are provided in the earnings press release.

For those who listen to the rebroadcast of this presentation, we remind you that the remarks made herein are as of today, February 11, 2016, and will not be updated subsequent to this initial earnings call.

During this call, we will make forward-looking statements, including statements related to the future performance of our portfolio, our development pipeline, impact of acquisitions and dispositions, our construction business, our portfolio performance and financing activities as well as comments on our outlook.

Listeners are cautioned that these statements are subject to certain risks and uncertainties, many of which are difficult to predict and generally beyond our control.

These risks and uncertainties can cause actual results to differ materially from our current expectations and we advise listeners to review the risk factors discussed in our press release this morning and in documents we have filed with, or furnished to, the SEC.

We will also discuss certain non-GAAP financial measures, including but not limited to FFO and Normalized FFO. Definitions of these non-GAAP measures, as well as reconciliations to the most comparable GAAP measures, are included in the quarterly supplemental package, which is available on our website at www.armadahoffler.com.

I would now like to turn the call over to our Chief Executive Officer, Lou Haddad… Lou…

Louis S. Haddad
President, Chief Executive Officer & Director

Thanks Mike.

Good morning and thank you for joining us today.

This morning we posted our full year 2015 results. With Normalized FFO per share of 93 cents, we achieved the high end of our increased guidance range. From our core portfolio, to the execution of the projects in our development pipeline, to our third party construction business, we realized tremendous growth across all areas of our Company during this past year. Most importantly, we took proactive steps and made what we believe to be the right real estate decisions to position our Company for sustained future performance and long-term value creation.

I'll begin with highlights from this past quarter, and year, and close with comments on 2016. Mike will then provide details on the quarter as well as our 2016 guidance, which we introduced this morning.

At the beginning of the year, I reiterated our long-term growth strategy. We create value through:

- New real estate development.
- Organic growth in our core portfolio.
- Our third party construction business.
- Strategic acquisitions.
- And efficient capital recycling.

This morning I am proud to report that we delivered on each of these fronts during 2015, resulting in significant year-over-year growth in NOI, Same Store NOI, construction gross profits, FFO and Normalized FFO. Mike will walk through each of these metrics in detail shortly.
While I'm pleased to report such great results, I'm more focused on the long-term value that our management team continues to create as a real estate producer and investor, not just as an investment vehicle. The fundamental and guiding principle of our real estate company for the past 37 years remains unchanged – to invest in and develop the highest quality real estate in our target markets. If there's one thing that our management team has learned over the 30 plus years we've been together, it's that high-quality real estate stands the test of time, appreciates over the long-term and is very difficult to duplicate. While quarterly FFO growth is well-received, long-term asset value or NAV growth is our prime focus.

I'll start with the primary growth engine of our Company, our development pipeline. During 2015, we placed into service four new assets – two office buildings for the Commonwealth of Virginia, Sandbridge Commons shopping center and the Oceaneering International building – each on schedule and on budget. The Commonwealth buildings and Sandbridge Commons remain in our Core Portfolio. As we discussed on our last call, we sold the Oceaneering building at a handsome 20% profit and reinvested the net proceeds into a portfolio of high-quality retail assets that I'll discuss in a few moments.

We continued to make progress on the projects in our active development pipeline. Both Johns Hopkins Village and Lightfoot Marketplace are on track for mid-2016 deliveries. Pre-leasing activity at both properties has been strong. As of today, 56% of the apartments at Johns Hopkins Village are pre-leased and over half of the retail space is under negotiation. Lightfoot Marketplace currently stands at 71% pre-leased, including the addition of a 22,000 square foot, build-to-suit building for Children's Hospital.

Brooks Crossing, our joint venture with the City of Newport News, continues to evolve and grow. Just last month, we completed and sold to the City a new 7 million dollar police precinct. For the next phase of the project, we're currently projecting 50,000 square feet of mixed-use space and are in negotiations with a Fortune 500 office tenant to anchor the project. Brooks Crossing represents yet another public-private partnership on the heels of the two dozen other such transactions that have been our hallmark over the past four decades.

We ended 2015 with the announcement of our investment in the new 93 million dollar Point Street Apartments project. As I discussed on our last call, Point Street is located on the waterfront, in the highly desirable Inner Harbor East of Baltimore, and is expected to feature 289 luxury apartment units and 18,000 square feet of retail space. The opportunity to invest in the project arose from our long association with Beatty Development Group, a relationship grounded in the one billion dollars plus of projects that we've completed in the Inner Harbor over the past two decades.

As both a mezzanine lender and the project's general contractor, we realize market rate interest income and fees during the lengthy development and construction process, while at the same time avoiding the stress on our balance sheet during development and initial lease-up. With our option to purchase an 88% interest in the project at cost upon completion, we preserve a healthy wholesale to retail spread.

Most importantly, Point Street Apartments represents our next step in building a portfolio of the highest-quality real estate. Our broad-based capabilities and track record allow us to selectively invest in some of the best projects in our target markets. We are confident that, over time, the quality of our assets and the lower cap rates they command will translate into a higher NAV.

We continue to explore a number of similarly structured opportunities with other experienced developers who are seeking a strong development, construction, and financial partner with all of the capabilities that we bring to the table. While it would be premature to discuss specifics at this time, I can reiterate the attributes that we are targeting in new product for our pipeline:

- Class A assets with high barrier to entry locations.
- Diversification, primarily targeting the Raleigh-Durham, Charlotte and Baltimore markets.
- Strategic expansion at Town Center.
- A healthy development spread of approximately 20% created through premier site selection, cost and timing control through our operating companies and leveraging public private partnerships when appropriate.
- Joint Venture opportunities utilizing our unique ability to co-develop and construct.

We have enough confidence in a number of these potential projects to include their impact in our 2016 guidance range and look forward to executing agreements and making official announcements in the coming weeks.

Shifting to the foundation of our Company – our Core Portfolio – our stabilized assets continue to outperform.

During 2015, we grew cash same store NOI by 5.5%. The fourth quarter of 2015 marked our 6th consecutive quarter of significant same store NOI growth. The organic growth in our portfolio was driven largely by strong retail and multifamily leasing at the Town Center of Virginia Beach, providing further proof of the quality and growth potential of our flagship asset.

At the end of the year, our core portfolio occupancy stood at a solid 95%. Occupancy across all product types at the end of the year stood in the mid-90s and during the third quarter, we successfully managed both Encore and Liberty Apartments to stabilization.

Turning to our third party construction business. Our general contracting segment finished the year in line with increased expectations reporting 5.9 million dollars of gross profit, an increase of almost 30% over 2014 and well above our historical run rate. Our progress on the 170 million dollar Exelon tower in Baltimore's Harbor Point continues on schedule toward completion this spring. Just next door to the Exelon site, our team has already begun construction on Point Street Apartments. Here in Virginia Beach, our work on a new Oceanfront hotel is underway as well. With over 83 million dollars in backlog, and several promising opportunities in the pipeline, we expect this segment of our business to continue to generate profits above our historical average.

On the acquisitions and dispositions front, 2015 and the initial weeks of 2016 were busy.

During the year, we sold the Sentara Williamsburg medical office building and the newly delivered Whetstone Apartments and utilized the net proceeds to acquire Stone House Square, Socastee Commons and Providence Plaza. As a result, we successfully monetized the wholesale to retail value spread created by our development process and expanded our geographic reach into Maryland, as well as North and South Carolina. Furthermore, our development and construction expertise lends itself to potential development opportunities at both Providence Plaza and Socastee Commons.

In April, we acquired Perry Hall Marketplace in a common stock transaction, further solidifying our Maryland portfolio. In July, we completed the acquisition of Columbus Village, a transaction in which the seller took back over 14 million dollars of value in OP units. This five acre parcel adjacent to the Town Center of Virginia Beach is a prime target for redevelopment and fits squarely within our investment philosophy and long-term strategy.

In October, we completed the sale of the Oceaneering International building for 30 million dollars and just after the turn of the year, we completed the sale of the Richmond Tower office building for 78 million dollars. We used the proceeds from these sales to partially fund the acquisition of a 170.5 million dollar retail portfolio totaling 1.1 million square feet across 11 assets. The core of the acquired portfolio consists of six retail centers well positioned along the I-85 corridor between Raleigh-Durham and Greenville. These core assets feature major anchor tenants including Harris Teeter, PetSmart, T.J. Maxx, Bed Bath & Beyond, Ross Dress for Less, Hobby Lobby and Petco. The remaining five assets are disposition candidates.

We recognize that the weighted average exit cap rate for Richmond Tower and Oceaneering exceeds the going in cap rate for the portfolio acquisition, resulting in the sacrifice of some short-term FFO. With our current cost of capital, we would typically refrain from purchasing six and a half cap assets, however the opportunity to redeploy our equity from predominantly single-tenant office assets in the Richmond and Hampton Roads markets into a portfolio of high-quality retail assets in the Carolinas – each anchored by solid credit, brand-name tenants – was the right real estate decision. In our evaluation, increasing our presence in the major Carolina markets and diversifying our overall risk profile were well worth the cap rate tradeoff. Furthermore, this transaction allowed us to defer taxes on the significant gains realized on the sales of both Richmond Tower and Oceaneering. Our management team – collectively the largest owner of the Company – remains committed to making the right real estate decisions in order to create long-term value for all shareholders.

We believe that Armada Hoffler is the only REIT that provides investors the opportunity to benefit from three profit centers in real estate:

1) The ownership of income-producing properties, which is where most REITs focus,

2) The profitable development of institutional-grade properties at wholesale cost, for either portfolio placement or for sale to recycle the capital at a gain, and

3) In-house construction, which not only generates substantial profits from third party business but also controls cost and schedule in our development projects. We believe that this third factor is unique to Armada Hoffler across the entire REIT universe.

We will continue to execute across these profit centers to maximize the investment returns of our shareholders.

As we look ahead to 2016, I continue to be optimistic about our Company and the opportunities presenting themselves in our predevelopment pipeline. And despite the number of asset dispositions that we've executed in the last 15 months, we continue to project growth in the coming year. But once again, I'll emphasize that our focus is not on next quarter's or next year's growth in FFO. Our attention is on growing our portfolio with the highest quality real estate in the best locations in order to maximize value creation and return it to our shareholders.

Along those lines, I am excited that the Board of Directors has declared a cash dividend of 18 cents per share for the first quarter or 72 cents on an annualized basis. This represents a 5.9% increase over the prior quarter's dividend.

We believe this reflects the Board's confidence in our long-term strategy – the successful execution and delivery of the projects in our predevelopment and active development pipeline – and the Board's commitment to enhancing value and returning it to our shareholders.

This dividend increase is made possible, not only by all the successes that I've outlined from 2015 but the growth we anticipate in 2016. As everyone has seen, we provided our 2016 guidance this morning of 93 to 97 cents of normalized FFO per share. With a development pipeline where delivery of new projects can be somewhat lumpy from year-to-year and the conclusion of a number of recent dispositions, we believe that the anticipated year-over-year growth we expect in 2016 on top of the 13% growth we experienced in 2015, is emblematic of a strong management team, a focus on quality real estate decisions, and a diversified real estate company and business model.

With that, I turn the call over to Mike and then we will take your questions. Mike…

Michael P. O'Hara
Treasurer, Chief Financial Officer

Thanks Lou and good morning.

Today I want to cover the highlights of the quarter, the full year, thoughts on our balance sheet, and additional details on our 2016 guidance.

This morning, we reported FFO of 22 cents per share and Normalized FFO of 24 cents per share, which was at the high end of our expectations.

For the full year, FFO was 87 cents per share and Normalized FFO was 93 cents per share. This compares to FFO of 80 cents and Normalized FFO of 82 cents for 2014.

As a reminder, FFO excludes gains on real estate, which was 5 million dollars for the quarter and 18 million dollars for the full year. Despite this treatment, as we have discussed in the past, asset sales and capital recycling will continue to be an element of future shareholder value creation. On a related note, because we structured these transactions as 1031 tax-free exchange, there are no taxable gains in 2015. Tax efficiency remains one of our corporate goals.

Please see page 10 of the supplemental for the Normalized FFO calculation. Excluded items this quarter consist of debt extinguishment losses, property acquisition costs, development and other pursuit costs, and mark-to-market adjustments for interest rate derivatives. The most notable of these adjustments was 885 thousand dollars in acquisition, development and other pursuit costs, which is largely due to the January portfolio acquisition.

We had another strong quarter of same store NOI growth. Same store NOI growth was positive 2.0 percent on a GAAP basis and positive 4.5 percent on a cash basis compared to the fourth quarter of 2014. For the year, same store NOI growth was positive 3.2% on a GAAP basis and positive 5.5% on a cash basis compared to 2014.

At the end of the quarter, our core operating portfolio occupancy was 95.3 percent with office at 95.8 percent, retail at 95.5 percent and multifamily at 94.2 percent.

On the construction front, we reported a segment gross profit, in the fourth quarter, of 1.1 million dollars on revenue of 41 million dollars. For the year, we reported a segment gross profit of 5.9 million dollars on revenue of 171 million dollars. This compares to a segment gross profit of 4.6 million dollars on revenues of 103 million dollars for 2014.

At the end of the fourth quarter, the Company had a third party construction backlog of 83 million dollars.

To summarize our 2015 performance metrics, the company excelled in all areas. Normalized FFO increased 11 cents per share or 13 percent, construction gross profit increased 1.3 million dollars or 28 percent, AFFO increased 19 cents per share or 31 percent, and Same Store Cash NOI increased by 5.5 percent. In addition, we believe this past year's asset recycling improved the quality of our portfolio and underlying cash flow.

Now turning to our balance sheet.

We continued to take actions to enhance flexibility and strengthen our balance sheet including increasing the capacity of the credit facility, hedging our interest rate exposure and completing a modest equity raise.

In December, we issued 3.5 million shares of common stock which – net of issuance costs – raised 35.1 million dollars. In addition, we continued to use the ATM program last quarter as expected, raising 3.7 million dollars of gross proceeds at an average price of $10.21 per share.

The proceeds from these transactions were used to repay a portion of the credit facility, which was used to fund our development activities and a portion of the 11 property portfolio acquisition. These equity raises, as well as our plan to sell five of the non-core assets from the recent portfolio acquisition, are intended to achieve two main objectives:

- De-lever the company to keep our debt metrics and leverage ratios in line with our corporate goals and
- Position the company to take advantage of new investment opportunities.

At the end of the quarter, we had total outstanding debt of 382 million dollars including 74 million dollars outstanding under the 150 million dollar revolving credit facility.

In January, we added three properties to the credit facility borrowing base to increase the capacity by 25 million dollars to 225 million dollars.

We continue to evaluate our exposure to higher interest rates and look for opportune times to enter hedges. During the quarter, we purchased a 75 million dollar LIBOR interest rate cap at 1.25%. With this new cap, as of December 31st, all of our debt was fixed or hedged.

Now turning to development.

As we discussed last quarter, the Point Street Apartments project is not consolidated, and therefore does not stress our balance sheet during construction and lease up. Projects of this size and duration require debt and equity for over two years with no return on that capital. With the mezzanine debt structure, we are paid a return on our investment, earn a construction fee during development and have the option to purchase a controlling interest in the property upon completion. Our current investment in Point Street is in the form of a 23 million dollar mezzanine loan which bears interest at 8 percent. As with any development project, it takes time for construction to ramp up, so from a timing standpoint, we do not expect the 23 million dollar loan to be fully funded until late second quarter. The construction contract is expected to be approximately $67 million dollars with a fee of 3%.

Earlier, Lou discussed additional pipeline projects that are close to being finalized. Two of these projects have an impact on future earnings. One of these is a multi-family project that is similar in size to Harbor Point apartments and is expected to utilize the same mezzanine-debt structure.

The other is a joint venture of which we are the minority partner. Our construction company will be the general contractor on both of these projects and will earn third party construction fees. While these two projects are included in our 2016 guidance, the construction contracts are not yet signed and thus not included in our year-end backlog of 83 million dollars.

On the asset recycling front, we closed on the sale of the Oceaneering building in October and Richmond Tower last month. Combined the sales proceeds were 108 million dollars which represents a 7.6 cash cap rate. These proceeds were reinvested in mid-January, to fund a portion of the purchase of the 11 retail properties, which had a total cost of 170.5 million dollars. Based on our 2016 budgets, which include recent leasing activity, the going in cap rate would be 7.0% for the entire portfolio, however, for the six core assets that will remain after selling the 5 non-core properties, the going in cap rate will be closer to six and a half percent. Inclusive of the equity raise and selling the 5 non-core properties, this transaction will be dilutive by five cents per share on a cash basis.

As Lou discussed, we feel this was the right decision for the company as we manage for the long-term and make decisions based on asset quality, tenant risk and cash flow – not quarterly earnings. We also believe this transaction of trading from a predominantly single noncredit office tenant into six retail centers anchored by solid credit, brand-name tenants, improves the company's overall cap rate and risk profile.

Starting on page 27 of the supplemental are details on this acquisition, including pro-forma December 31st data. This pro-forma information includes only the six core assets located along the I-85 corridor in the Carolinas.

Now, let me walk you through the full-year 2016 guidance that we introduced this morning.

We expect 2016 Normalized FFO in the range of 93 to 97 cents per share.

Our 2016 estimates are predicated on the following assumptions:

- GAAP NOI in the 62.3 to 63.0 million dollar range.
- Third party Construction Company gross profit in the 4.7 to 5.2 million dollar range.
- General and administrative expenses in the 8.8 to 9.1 million dollar range.
- Interest income from our mezzanine financing program in the 2.9 to 3.1 million dollar range.
- Interest expense in the 16.3 to 16.9 million dollar range.
- The sale of the five non-core retail properties by June 30.
- And, 47.2 million weighted average shares and OP units outstanding.

This guidance does include the impact of the two pending pipeline projects I discussed earlier.

However, this guidance excludes any impact from future acquisitions, asset sales other than the five retail assets, or other capital markets activity with the exception of continuing the ATM program.

Before we turn to Q&A, I would like to make a comment about first quarter of 2016.

In the past, earnings in the first quarter of the year have been lower than the subsequent quarters. However, we do not see that being the case this year.

I'll now turn the call back to Lou.

Louis S. Haddad
President, Chief Executive Officer & Director

Thank you Mike.

Thank you for your time this morning, and your interest in Armada Hoffler. Operator, we would like to begin the question and answer session.

QUESTION AND ANSWER SECTION

Operator: Thank you. Ladies and gentlemen, if you have a question at this time, please press "star 1" on your telephone. If your question has been answered and you wish to withdraw it, you may do so by pressing "star 2". If you're using a speakerphone today please pick up your hand set before entering your request.

Thank you. Our first question this morning is coming from the line of Rob Stevenson from Janney Montgomery Scott. Please proceed with your question.

Dave Rodgers
Analyst, Robert W. Baird & Co. Equity Capital Markets

Q

Hey, good morning, guys. I just wanted to follow up quickly on what the activity looks like in office leasing, obviously with the dove tail into Main Street office, but a little bit more color on just kind of what the type of activity you're seeing across the portfolio where you do have some availability, Lou?

Louis S. Haddad
President, Chief Executive Officer & Director

A

Thanks, Dave, and good morning. Dave, it's been pretty slow over the last quarter in office leasing. We're not seeing a lot of velocity of tenants. We've got a couple of things working that'll add some occupancy to 4525 specifically, but right now people are not doing as much looking as we would prefer, but, ultimately, we feel very comfortable with where we sit, both at 4525 and of course the rest of the portfolio is essentially leased.

Dave Rodgers
Analyst, Robert W. Baird & Co. Equity Capital Markets

Q

Okay, that's helpful, and maybe a similar question on the apartment side. I'm just trying to get a gauge of activity in your market, what type of activity you're seeing. Obviously, the occupancy is high, but just kind of curious about the available to lease as you look forward a little bit, and the overall demand and ability to keep rates high in the assets that you do own.

Louis S. Haddad
President, Chief Executive Officer & Director

A

Yes, we're not seeing any blips out there at all. We always experience—in the fourth quarter and the first couple of months of the year, things seem to slow down, this year isn't any exception, but we're seeing a lot of activity and we feel really good about where this is going to end up for this year.

Dave Rodgers
Analyst, Robert W. Baird & Co. Equity Capital Markets

Q

Okay, and last question maybe for Mike. Mike, a little bit on just maybe simplifying down the sources and uses for this year between the asset sales, between some of the development spending that you have. If you could run through a sources and uses for the year, it would be helpful. Thank you.

Michael P. O'Hara
Treasurer, Chief Financial Officer

A

Good morning, Dave. So over the past couple of months, we've certainly worked hard on getting the balance sheet set up for this coming year. We did the equity raise in December, we increased the capacity on our credit facility in January, and we'll continue to use the ATM. We're also working with a funding group on a credit facility to add more properties that we just purchased into the borrowing base to get more capacity from that standpoint. So, we've been working hard to get the balance sheet set up for the year and we believe we've done that.

Dave Rodgers
Analyst, Robert W. Baird & Co. Equity Capital Markets

Okay, great. Thanks, guys.

Operator: Our next question comes from the line of Rob Stevenson with Janney Montgomery Scott. Please proceed with your question.

Rob Stevenson
Analyst, Janney, Montgomery, & Scott LLC

Q

Good morning. Lou, how should we be thinking about the disposition of these five non-core retail assets? Is it a situation where they're up for bid now and you take the proceeds when you get them? Are you sort of waiting until you have a need to fund some development or do you find another acquisition to sort of use it as a tit-for-tat type of thing? How should we be thinking about this as it flows through 2016?

Louis S. Haddad
President, Chief Executive Officer & Director

A

We're anticipating selling all of those assets in the first half of the year. We wanted to take our time. We did some evaluations as to whether we wanted to hold on to any of them, what kind of opportunities that there may be, but generally we—and, of course, this is always subject to change with new information, but, generally, we concluded that our capital's best deployed elsewhere. I'm going to turn it over to Eric Smith and he can tell you what kind of process he's going through in order to get rid of those.

Eric L. Smith
Secretary, Chief Investment Officer

A

Sure. I appreciate that, Lou. It's a balance, obviously, between wanting to glean the most value out of the assets, and obviously, as Lou said, we're looking at the first half of the year as part of the balance sheet strategy that Mike articulated earlier. Having had this portfolio out in the market recently, there was obviously an opportunity to go back somewhat quickly after we closed on the portfolio in mid-January to see if any of those buyers who had been interested at a sell portfolio or asset-specific level, and had already done due diligence, were out there, and we certainly took advantage of that and we'll glean here shortly the results of that. That being said, if it makes sense to do a more fully marketed campaign to either reap value at the individual asset level that's higher that what that quicker process may have created, or to see if there is a portfolio buyer out there for these five non-core assets, we will certainly do that if we don't see the value we would like to see in the near term. So, it's a bit of a balancing act on value, as well as against that backdrop of the balance sheet strategy.

Rob Stevenson
Analyst, Janney, Montgomery, & Scott LLC

Q

Okay. Do you have any acquisitions that are in the pipeline right now that's sort of lined up to close against these, or, Mike, is there some level of dilution in the guidance from the first-half sale of these properties without a corresponding redeployment of the proceeds?

Michael P. O'Hara
Treasurer, Chief Financial Officer

A

Rob, the first thing we're looking at now, we have to get some capital back in the house. So we're going to look at the extent we can raise by selling these, and then based upon where that is, what's coming up for other opportunities and where our balance sheet is, we'll look at other acquisitions

Louis S. Haddad
President, Chief Executive Officer & Director

A

Yes, and to dovetail off of that, it won't surprise you, I think this is consistent with what we showed in the past about our acquisition strategy. Obviously, our primary focus is doing acquisitions that look similar to the ones in the past 12 to 18 months, which were off-market, relationship-based activity that could utilize operating partnership units with assets that fit well into our portfolio, and not necessarily chasing marketed deals unless they make a kind of sense and check a box that leverages one of our capabilities either on the development side or otherwise. That's our acquisition strategy as we sit here today.

Rob Stevenson
Analyst, Janney, Montgomery, & Scott LLC

Q

Okay, but any corresponding dilution from the first-half sale of these assets is already included in the guidance range?

Michael P. O'Hara
Treasurer, Chief Financial Officer

A

Yes, we've included the sales of those five non-core in the guidance.

Rob Stevenson
Analyst, Janney, Montgomery, & Scott LLC

Q

Okay. Then, Mike, what's the incremental positive impact from any of the two projects that you talked about that you didn't put into the pipeline yet because contract haven't closed but that are in the guidance? Is it a couple of pennies, is it a penny? Is it material?

Michael P. O'Hara
Treasurer, Chief Financial Officer

A

It's broken down into two areas, Rob. One is in the interest income. One of them is structured as a mezzanine debt, so you can see we have new guidance this year with interest income, and the other piece is in the backlog. I don't want to get into breaking down the pieces and parts at this time, but it's all included in our guidance.

Rob Stevenson
Analyst, Janney, Montgomery, & Scott LLC

Okay. Thanks, guys.

Louis S. Haddad
President, Chief Executive Officer & Director

A

Rob, another comment. It's Lou again. You brought up the question of dilution and we've included that dilution in our guidance for 2016. We've also included the dilution from selling the higher cap assets and flipping it into lower cap assets. I just want to stress to everybody the significance of that move. Essentially, while it would be really nice to have FFO over a dollar this year, which we would had we not done that transaction, what we did is we took over $100 million worth of facilities that were anchored by a regional law firm and an oil exploration equipment company and turned that into buildings that are anchored by people that sell food, dog food, sheets and towels, and we feel really good about making that decision.

Rob Stevenson
Analyst, Janney, Montgomery, & Scott LLC

Q

Well, you guys are still having positive earnings growth despite that, right?

Louis S. Haddad
President, Chief Executive Officer & Director

A

Correct.

Rob Stevenson
Analyst, Janney, Montgomery, & Scott LLC

Q

I mean, the midpoint of the guidance range basically is about 9% earnings growth, even with that dilution in there.

Louis S. Haddad
President, Chief Executive Officer & Director

A

Yes, we're expecting growth again this year. Like I said, it could have been substantially higher had we been managing for the short term. So, thanks very much.

Rob Stevenson
Analyst, Janney, Montgomery, & Scott LLC

Okay. Thank you, guys.

Operator: Our next question comes from the line of John Guinee with Stifel. Please proceed with your question.

John W. Guinee
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Okay, great, thank you. So, essentially, you guys, you build office, you sell office, you acquire retail. It looks to us like you're basically just selling the Kroger portfolio. It looks to us like two of them are just pretty much standalone. Fifty percent of the—maybe 65% of the 406,000 square feet, it's just all Kroger credit. What does that $3.1 million income stream of primarily Kroger credit sell for?

Louis S. Haddad
President, Chief Executive Officer & Director

Eric.

Eric L. Smith
Secretary, Chief Investment Officer

A

Sure. Thanks, Lou. It's obviously, John, based on—or I guess, despite the Kroger credit, you have a mix of assets here. You have some stronger assets in the South Bend and Nashville locations, based on those particular markets, they're slightly larger centers, higher quality assets overall, and then you have three smaller assets, more rural in nature, et cetera. So, when you think about it, particularly about the Kroger credit, but also the mix and location of the assets themselves, they're obviously going to trade higher than the going-in cap rate on the whole portfolio. Whether that's mid-8s or somewhere slightly higher or lower, the market will bear out as we go through the process, I articulated earlier. But that's our thought process right now.

John W. Guinee
Analyst, Stifel, Nicolaus & Co., Inc.

Q

So, if I look at page—you know, there's a lot of numbers floating around. I think Lou had said earlier we generally don't acquire 6.5 cap real estate. Is it safe to say that, if I'm looking at Page 17, at $170 million at a 7.2 cash cap rate, and then you sell off these five Kroger anchored, does that mean the net cap rate on the balance of the 650,000-square-foot Harris Teeter power center assets is a mid-6 cap rate? Is that what we're looking at?

Eric L. Smith
Secretary, Chief Investment Officer

A

That's correct, John.

Louis S. Haddad
President, Chief Executive Officer & Director

A

That's it, John, you got it exactly.

John W. Guinee
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Okay, my God, all right. Thanks a lot.

Operator: Our next question comes from the line of Bill Crow with Raymond James. Please proceed with your question.

Bill Crow
Analyst, Raymond James & Associates.

Q

Good morning, guys. I have a couple of questions for you. The first question is, if you go back to the time that you initially underwrote the acquisition of the retail portfolio, how have the cap rates on the five assets you're looking to sell, how has that changed? What are the brokers telling you about the increase in cap rates, if any, over the last four months, five months?

Louis S. Haddad
President, Chief Executive Officer & Director

A

Yes, Bill, we're not seeing that happening. That may be something that's going to happen in the not too distant future, given what's going on in the marketplace, but so far the sales that we're seeing are holding up right with what the cap rates have been over the last six months. So, to make sure you guys understand, these five have—we took the opportunity to see what kinds of possibilities there may be, and what we're seeing is the same reason why they're going to trade in the 8 to 9% range versus what the overall portfolio was. A couple of these are redevelopment opportunities, which we might have taken had they been more located in our market or of a larger size. A couple of them are older Krogers, but they're much smaller than what their current footprint wants to be, so we're looking at the potentiality of a full redevelopment on them, and we decided that the returns just wouldn't be there to occupy our time.

Eric, anything to add to that?

Eric L. Smith
Secretary, Chief Investment Officer

A

No, I would only add maybe the perspective that, again, your comment is yet a third consideration as we think about this process over the first two quarters and what offers to accept and how quickly to close them. Obviously, if the near-term process doesn't yield the results and we're contemplating going with a fuller process that would take the full two quarters that risk of possible cap rate movement that you mentioned obviously has to be a consideration there as we think about that timing trade-off.

Bill Crow
Analyst, Raymond James & Associates.

Q

That's great, thanks. The other question I had, really, was on development pipeline, and more the shadow pipeline. You guys know, gosh, the vast majority of developers in the mid-Atlantic region, you've known them for a long time. What are they telling you about their thought process, given the economic data points, the stock market changes? Anything dropping out of the shadow pipeline that surprises you, any just change in trend that you're seeing?

Louis S. Haddad
President, Chief Executive Officer & Director

A

Bill, I'd have to say no, and you've got to understand our perspective. Given the fact that we're headed for a recession, which we all hope is not the case, it would be our fifth recession that we will have gone through. They all kind of have the same characteristics. There's a tremendous amount of deal flow out there right now. But, whether it's in boom times or recession area times, you can tell the projects that you should stay away from. So, we stick to that knitting. With a Company our size, it's not markets that you look at, it's submarkets, and within those submarkets, it's location. What we're looking at, what we're cherry-picking is the strength that's driven by high drivers and credit tenants, and that's always a much smaller subset of what's out there. So my guess is, with credit tightening, you're going to see a lot less of these fringe projects getting off the ground, which is just fine by us, and you'll continue to see the really strong projects that are well underwritten move forward. So, we're not seeing anything. If it makes it into our predevelopment group that means it was one out of 15 or 18 projects that we were evaluating, and so once it makes it there, I don't want to say it's bulletproof, but it's pretty darn close.

Bill Crow
Analyst, Raymond James & Associates.

Q

Anything you're seeing on the retail side in reaction to the consumer, or anything that's going on the retail side that makes you concerned, you know, more tenants on the watch list, anything like that?

Louis S. Haddad
President, Chief Executive Officer & Director

A

Again, that's a great question. It's a broad one. In our grocery-anchored retail, we're not seeing any duress at all. Our small shops are doing well. We're potentially 100% leased across that subset of the portfolio. On the larger projects, like a Town Center, where you're looking at fashion and specialties, there's some nervous people out there. If you've seen the result that came out in Urban Outfitters or even Lululemon, they're nervous. Their sales are doing fine right now. There's still a lot of bleed-off from the internet. But, we're seeing a lot of activity, and in fact, we hope that in the next month or so, to make a couple more announcements in that regard.

Eric L. Smith
Secretary, Chief Investment Officer

A

I would add one other recent data point. As we went through—this is Eric—as we went the diligence process on the portfolio, we obviously talked to tenants recently in our role as our asset management group and their role of managing our stabilized assets, but we obviously excel those touchpoints with those tenants as we were going through that due diligence process, so it's a fairly recent data point of having all those conversations, and what we found was that there were certainly, as we've already spoken to I think in the last call, a handful of the larger box tenants who had some comments about some downsizing in the 3,000 to 5,000 square feet range. We obviously looked at that closely to make sure we could re-lease that space and it was in good locations in the shopping centers. But we didn't hear anybody holistically moving out of markets or trying to close certain stores and refocus on others in the marketplace. There was some things on the margins from that experience, but nothing wholesale that gave us cause for concern.

Bill Crow
Analyst, Raymond James & Associates.

Great. I think I'll hold off on asking if you are in discussions with Amazon on their brick-and-mortar efforts. Guys, thank you.

Louis S. Haddad
President, Chief Executive Officer & Director

Thank you.

Operator: Our next question comes from the line of Craig Kucera with Wunderlich. Please proceed with your question.

Craig Kucera
Analyst, Wunderlich Securities

Q

Hey, good morning, guys. Lou, I appreciated your comments on the recession scenario and would like to revisit that. Really, in regards to how municipalities react as they start to see their local economy slow down, does that change the way they look at the public/private partnerships, do they look to do more, do they look to do less? What's been your experience?

Louis S. Haddad
President, Chief Executive Officer & Director

Craig, it's been our experience over three decades that they ramp up activity in those scenarios. If you think about it, the basic tenet of municipal government is that expenses are going to grow faster than income, and so in periods like this where that disparity gets even wider, they're even more looking to disproportionately affect the tax pay. So, for a relatively small amount of money—and of course stronger municipalities can get essentially money at zero percent right now—for a fairly small amount of money, they can incentivize something.

Our issue, and, again, as it's been in the last four recessions, is no matter how much money somebody might be throwing at you, you've still got to decide whether or not it's going to be good long-term project. Some of these things need municipal help, because they really shouldn't be built, and so what we pride ourselves here, three decades later, in doing is separating that wheat from that chaff into something that's going to stand the test of time, and very much like Town Center. Town Center was born right on the heels of 9/11, it went through 2007 and '08, and it not had not had any issues throughout. So, you've got to make sure that you really cherry-pick the best opportunities.

But—long answer to a short question—that is part of our formula for a recession, construction ramps up. Not commercial construction, but institutional construction, medical construction and government construction, because they want to take advantage of lower prices, and public/private partnerships ramp up. What suffers, obviously, is your garden-variety retail office development.

Craig Kucera
Analyst, Wunderlich Securities

Q

I appreciate the color. How forward-looking are these municipalities? Are they looking 12 months in their rearview mirror or are they thinking ahead as far what may or may not be leased?

Louis S. Haddad
President, Chief Executive Officer & Director

Again, it's a really interesting question and I could go on for an hour on that one. Most municipalities don't have the fortitude to see past the next election cycle, and so a lot of them are looking for that quick hit, and we stay away from those guys. There are a few—and, coincidentally, it seems to go along with really high credit ratings—there a few that have 10- and 15- and 20-year horizons, and those are the people that we gravitate to.

Craig Kucera
Analyst, Wunderlich Securities

Q

Got it, and my last question is just on the balance sheet. Given that the futures market now doesn't seem to be seeing an interest rate hike until possibly 2018—you guys have heavily used floating rate debt rate with swaps—do you anticipate changing that in this environment, or I would have guessed you're probably going to stick with what seems to be working as long interest rates are remaining low and expected to remain low?

Michael P. O'Hara
Treasurer, Chief Financial Officer

A

Yes, Craig, we're going to continue to look at hedges. We find that we've been doing more caps, actually, than swaps. Buying caps is a really economical way to hedge interest rates. Lou and I have been talking here the last couple days, we're getting to a real good point right now to go out and buy some more caps, it's really cheap insurance.

Craig Kucera
Analyst, Wunderlich Securities

Got it. Okay, thanks.

Operator: Our next question comes from the line of Laura Engle with Stonegate Capital. Please proceed with your question.

Laura Engle
Stonegate Capital Partners

Q

Good morning and thanks for all the detail. Hope all is well. I wanted to see if we could touch back on the guidance just a little bit. One thing that was a bit higher than I expected were the acquisition development and other costs, and I wondered if that was—what was reported for the year, if that was a level we should expect for next year, and if that includes, I guess, some of these disposition costs related to the transactions this past year, as well?

Michael P. O'Hara
Treasurer, Chief Financial Officer

A

Good morning. So, we certainly had a lot of that cost in the fourth quarter and a lot of it had to do with this acquisition of the $170 million portfolio. From a GAAP standpoint, we're going to be expensing those costs as they take place, and most of the due diligence and wiggle work was all done in the fourth quarter, since we closed right after the first of the year on that. Looking out to 2016, it's tough for me to give you a number where it's going to be, it's certainly going to depend on what kind of acquisition activity we have out there, but I'd be surprised if we acquired another $170 million portfolio and spend that kind of money.

Louis S. Haddad
President, Chief Executive Officer & Director

A

We don't see that in the cards. That's one of the primary reasons why we report normalized FFO, because we're opportunistic in acquisitions and dispositions and don't have a specific plan.

Laura Engle
Stonegate Capital Partners

Q

Right, okay. Then, also related to the guidance, on the construction company guidance, you mentioned some of the contracts. Can you just review one more time, I guess, the timing on that, and you did say there's significant potential upside to that guidance number, because I think—I'm like the gentleman earlier, I have numbers all over the sheet, but is that guidance actually a bit of a decrease over the full year for 2015 as it stands, but it doesn't factor in this contract, correct?

Michael P. O'Hara
Treasurer, Chief Financial Officer

A

Correct. It is a decrease from last year. 2015 was a really strong year for the construction company, about one of the highest that I can remember generating those kind of profits. So, yes, we see it going down to where. It does include a couple contracts that are not signed, we expect to get firmed up here in the next couple of weeks to months. For instance, on Harbor Point, it looks like we've started construction, so we'll be getting a Notice to Proceed. I think we're operating under a couple million dollar proceed contract. We do some side work, well, we negotiate out the GMP here, which is imminent.

Laura Engle
Stonegate Capital Partners

Got it, okay, and all my other questions have been addressed. Again, it sounds like 2016 is going to be just a great year, so I'm looking forward to seeing how it progresses. Thanks again.

Louis S. Haddad
President, Chief Executive Officer & Director

Great. Well, thank you, everybody, for your time this morning. We look forward to—like we said, we anticipate having a few announcements in the next several weeks that finished out this pipeline, so stay tuned, and thanks again.

Operator: Ladies and gentlemen, this does conclude today's teleconference. You may disconnect your lines at this time. Thank you for you participation and have a wonderful day.