Management's Prepared Remarks
Third Quarter 2018 Conference Call
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Brendan Maiorana
Senior Vice President, Finance and Investor Relations

If any of you have not received yesterday's earnings release or supplemental, they're both available on the investors section of our website at highwoods.com. On today's call, our review will include non-GAAP measures, such as FFO, NOI and EBITDA*re*. The release and supplemental include a reconciliation of these non-GAAP measures to the most directly comparable GAAP financial measures.

Forward-looking statements made during today's call are subject to risks and uncertainties, which are discussed at length in our press releases as well as our SEC filings. As you know, actual events and results can differ materially from these forward-looking statements. The Company does not undertake a duty to update any forward-looking statements.

Ed Fritsch
President, Chief Executive Officer

While interest rates have increased and REIT stock prices have contracted, economic indicators remain sound and fundamentals in our business remain healthy with rising rents and steady demand from existing customers and new prospects. As you know, we've worked hard to have built a fortress-like balance sheet…and while lowering leverage has modestly reduced near-term earnings growth, we have arrows in our quiver to fund our development pipeline without meaningfully impacting our balance sheet metrics or triggering a prerequisite to issue additional shares.

Turning to the third quarter, we delivered FFO of $0.86 per share and leased 884,000 square feet of second gen office space, including 278,000 square feet of re-lets. In addition to solid leasing volume, we also posted strong leasing metrics. In the third quarter, we garnered GAAP rent spreads of +18.5% and cash rent spreads of +3.2%. Net effective rents on leases signed in the quarter were roughly in-line with our recent five quarter average. Furthermore, in five years' time, we've increased net effective rents by more than 25%. Given our strong leasing metrics, in-place cash rents are up 4.9% compared to a year ago. As anticipated, with Fidelity's known move-out of 178,000 square feet from the 11000 Weston building in our Raleigh division, our occupancy declined 50 basis points to 91.3%. Excluding this move-out, occupancy would have increased 10 basis points. As reflected in our outlook, we expect occupancy to improve by year-end.

We continue to generate growth with our development program. Since our last earnings call, we've scotched over 115,000 square feet of first gen leasing, which represents more than half of the remaining spec space in our development pipeline. The strongest move in the quarter was at Virginia Springs I in Nashville where we're are now 100% pre-leased, up from 38% last quarter. This strong leasing has accelerated this development project's projected stabilization date six quarters ahead of our original pro forma…from the third quarter of 2020 to the first quarter of 2019. Similarly, given strong demand, we fully anticipate accelerating the stabilization of 751 Corporate Center in Raleigh six or seven quarters ahead of our original pro forma. Also, we placed two development projects in service representing a total investment of $67 million and encompassing 223,000 square feet. First, our $29 million, 87,000 square foot, 100% leased build-to-suit headquarters and ambulatory service center for Virginia Urology in Richmond. Second, Seven Springs II in Nashville, a $38 million, 136,000 square foot project that is 74% leased.

After placing these two projects in service, our development pipeline is now $658 million and 96% pre-leased. This pipeline will provide meaningful cash flow as it delivers over the next few years. As a reminder, we have $195 million of 100% pre-leased development delivering in 2019. These projects are:

- Virginia Springs I in Nashville, which as I mentioned will now be delivered and placed in service in the first quarter of 2019;
- Our third building for MetLife's Global Technology Center in Raleigh, which is on track to deliver in the second quarter of 2019; and
- Mars Petcare's U.S. headquarters in Nashville, which is scheduled to deliver and be placed in service in the third quarter of 2019.

With regard to construction costs, we continue to see them rise at approximately ½ percent per month, in line with the zip code we've been experiencing the past few years. As you know, we are largely insulated from cost increases on our current development pipeline given our build-to-suit projects are open-book, and we have GMP contracts in-place for our multi-customer development projects.

During the past several years, demand for new space has remained strong despite higher rents. In addition, we continue to have conversations with a number of sizeable pre-lease prospects across several potential projects. This sustained level of interest leads us to believe the depth of demand should remain attractive as construction costs and rents continue to rise. As a reminder, our initial 2018 development announcement outlook was $100 to $350 million. With our $285 million Asurion build-to-suit announcement, we surpassed our original mid-point by $60 million.

Turning to building dispositions, our current 2018 outlook is $80 to $120 million with $31 million closed thus far. We continue to expect a number of non-core asset sales to occur before year-end.

We've kept our acquisition outlook unchanged at $0 to $200 million. For the few assets that have been in the market, pricing for BBD-located, Class A office properties remains highly competitive with cap rates in the mid-5s-to-low-6s. We continue to evaluate on and off-market opportunities with a commitment to prudent investing.

In summary, strong leasing activity in our operating portfolio and continued focus on disciplined capital recycling, combined with carefully managed operating expenses, a strong balance sheet and a highly pre-leased development pipeline, sets the table for growth in our cash flow and NAV over the next several years.

Ted Klinck
Executive Vice President, Chief Operating and Investment Officer

We continue to see strong demand for our well-located, BBD product. We've already made very good progress on our 2019 expirations. From the list of five 2019 expirations greater than 100,000 square feet, we have taken care of three – UMA and AT&T through renewals, and INC by selling Highwoods Tower Two at attractive terms to a user. This leaves the FAA and T-Mobile. We're confident in the probability the FAA will renew its 100,000 square foot lease given its location and their sole occupancy in the building. Regarding T-Mobile, they're not prepared to make a decision yet, and their 116,000 square foot lease doesn't expire until the end of November 2019.

We're paying attention to supply levels across our footprint. While there has been a modest increase in development activity, supply remains below prior peak levels and net absorption has been healthy, which has broadly enabled the markets to remain at equilibrium. I'll touch more on Nashville and Raleigh, where development has been more notable, when I turn to the market overviews. Solid fundamentals underscore that strong market demographics continue to appeal to businesses seeking to relocate to our footprint.

Now turning to our quarterly stats.

We leased 884,000 square feet of second gen office space, including 278,000 square feet of new leases. The new deal volume was approximately 30% higher than our prior five quarter average, while GAAP rent spreads were robust at +18.5% and cash rent spreads were healthy at +3.2%. Evidence of our strong leasing performance working its way into the portfolio can be observed by our average in-place cash rents at quarter-end, which were 4.9% higher than a year ago. Our third quarter same property cash NOI growth was positive 1.4% despite lower average occupancy compared to last year. The decline in occupancy was more than offset by contribution from annual rent escalators and leases commencing with higher cash rents.

Our updated year-end occupancy outlook is 91.5% to 92.0%. This range implies a mid-point of 91.75%, down 25 basis points from the mid-point of our original outlook. The decline in the mid-point is almost solely attributable to the unforeseen bankruptcy of a 62,000 square foot industrial user in Greensboro. At the end of the quarter, our industrial portfolio was 95.5% occupied, so we feel good about our ability to back-fill this block. We anticipate occupancy improving in the fourth quarter driven largely by signed leases that are scheduled to commence before year-end.

Now to our markets.

The Atlanta market's net absorption in the third quarter was 175,000 square feet, as reported by CBRE. This result is particularly strong considering two high-profile move-outs. State Farm vacated 185,000 square feet in Central Perimeter as they continued their consolidation into their owned campus, and AT&T vacated 300,000 square feet in Midtown and Buckhead. We do not believe any of this space is competitive to our nearly 2.0 million square foot Buckhead portfolio. During the quarter, there was 2.2 million square feet of office under construction across Atlanta, or approximately 1.6% of stock. Midtown accounted for more than half of the development, while nothing was underway at the end of the quarter in Buckhead. We signed 109,000 square feet of second gen leases during the quarter, with strong GAAP rent spreads of 29.5% and a healthy average term of 7.6 years. The quarter included meaningful progress in our Buckhead portfolio. Half of the 109,000 square feet were re-lets signed in Buckhead and we've agreed to terms for an additional 86,000 square feet. We look forward to executing those deals before year-end.

Raleigh saw 162,000 square feet of positive Class A net absorption during the quarter, as reported by Avison Young. This takes the year-to-date figure to positive 710,000 square feet, while class A asking rates have increased 5% year-over-year. We estimate there are 3.0 million square feet of office under construction in Raleigh, or 4.5% of total stock. When narrowing that perspective to our competitive set, the percentage of new supply is less than 2.0% of stock and is approximately 50% pre-leased. We signed 233,000 square feet of second gen leases during the third quarter with a weighted average term of 7.5 years. This includes the 105,000 square foot AT&T renewal I mentioned earlier. GAAP rent spreads were a solid 17.4%. We're pleased to see continued strong demand for first and second gen space in Raleigh.

Lastly, as reported by CBRE, Nashville posted positive net absorption of 151,000 square feet during the quarter and 460,000 square feet year-to-date. We're tracking a little over 3 million square feet under construction, which is roughly 30% pre-leased. Approximately 70% of this total is in the urban submarkets where we have 1.6 million square feet in our operating and development portfolio, but we have essentially no vacancy or any meaningful lease expirations until 2025. The remaining amount under construction is spread out from Brentwood to Cool Springs. We continue to feel good about our Nashville portfolio with our ability to maintain strong occupancy and capture improving rents. We ended the quarter with occupancy of 92.7% across our 4.2 million square foot operating portfolio. We signed 78,000 square feet of second gen leases at GAAP rent spreads of 21.9% during the quarter.

In conclusion, our strong leasing results and current level of activity indicate that demand remains healthy. Consistent net absorption across the broader markets has kept occupancy levels steady as new supply delivers. Continued demand for our well-located BBD product keeps us upbeat that we'll be able to continue reducing future expiration risk while leasing up pockets of vacancy.

Mark Mulhern
Executive Vice President, Chief Financial Officer

In the third quarter, we delivered net income of $33.2 million, or 32 cents per share, and FFO of $91.6 million, or 86 cents per share. The quarter was clean other than the accelerated $1.3 million rent payment from Fidelity at 11000 Weston in our Raleigh division, which was their normal quarterly rent plus $0.5 million for their October and November rent. Rolling forward from second quarter FFO of 87 cents per share, the major change was the final recognition of the restoration fee from Fidelity in the second quarter of $1.9 million, partially offset by their aforementioned extra two months of rent recorded in the third quarter. We saw the normal seasonal increase in utility costs in the third quarter, but this was partially offset by lower repair and maintenance expense.

We reported same property cash NOI growth of 1.4% with average occupancy 200 basis points lower compared to last year. Included in same property growth is the $1.3 million accelerated rent payment from Fidelity. This is classified as a termination fee in the press release and in the table on page 4 in our supplemental package. As you know, we typically exclude termination fees from our calculation of same property NOI growth. Because the payment was to satisfy their full, original obligation under the lease, it was appropriate to include their accelerated payment in same property NOI. Our same property NOI growth in 2018 does not include recognition of their restoration fee. Eliminating the extra two months of rent received from Fidelity in the third quarter, and adjusting for their impact on our reported occupancy, same property NOI would've increased 0.9% with average occupancy down 140 basis points. Higher same property cash NOI was driven by healthy annual bumps on nearly all leases and solid growth on second gen leasing, partially offset by higher straight line rent.

Turning to our balance sheet, we ended the quarter with leverage of 35.5% and net debt-to-EBITDAre of 4.77 times. We haven't issued any shares on the ATM since the second quarter last year. We are committed to grow within our target debt-to-EBITDAre operating range of 4.5 to 5.5 times and have the flexibility to fund the remaining $325 million on our current development pipeline without the prerequisite of issuing shares or selling assets.

As we mentioned last quarter, we obtained $150 million of forward starting swaps that lock the underlying 10-year treasury at 2.905% in advance of a potential financing before July 2019. We don't have any debt maturities until our $225 million term loan matures in June 2020. As a reminder, the 1.68% LIBOR hedge on that term loan expires in January 2019. Other than this term loan, we have no debt maturities until June 2021 and our maturity schedule is well-laddered.

As Ed mentioned, we updated our FFO outlook to $3.42 to $3.45 per share. At the midpoint, this is 1 ½ cents above our previous outlook and 2 ½ cents above our original outlook. We also updated our same property cash NOI outlook to +0.8% to +1.2%. Last quarter, I mentioned we expected to trend towards the low-end of our original outlook of +1.0% to +2.0%. The reduction is primarily due to several sizable renewals signed even earlier than we hoped that have a free rent component and were not included in our original outlook. As you've seen in our revised outlook, our straight line rent forecast increased $6 million at the mid-point compared to our original outlook, mostly relating to our same property pool. Taking the $2.58 per share of FFO that we have reported year-to-date, our imputed outlook for the fourth quarter is $0.84-0.87 per share.

Finally, as you know, we will provide 2019 guidance during our fourth quarter call. In the interim, there are some items I would like to highlight:

- First, as Ed mentioned, we are scheduled to deliver $195 million of 100% pre-leased development over the course of 2019. We estimate the 2019 FFO accretion, inclusive of the burn-off of capitalized interest and reflective of the staged takedown of MetLife's third building, will be approximately 4 to 5 cents per share.
- Second, I mentioned earlier the potential for a fixed rate debt financing prior to July 2019. Given the maturity of the 1.68% LIBOR hedge in January 2019, we would likely use the proceeds to refinance our $225 million bank term loan and reduce our line of credit balance. With the treasury lock in place and the U.S. 10-year yield hovering in the low 3s, the all-in interest rate on a new debt financing would likely be in the mid 4s. Under this scenario, the full year impact of such a refinancing would be somewhere around 5 cents per share compared to our 4Q'18 run rate.
- Third, we currently have a little over $500 million of floating rate debt. While this is modest relative to our overall asset base, any increase in LIBOR would drive our interest expense higher.
- Last, like other REITs with in-house leasing teams, starting in 2019 we will be required under GAAP to expense certain leasing-related costs for non-commissioned employees. Based on 2018 projections and prior year actuals, we estimate the annual FFO dilution from this accounting change in 2019 will be approximately $2.5 million, or 2 ½ cents per share, and will appear in G&A.

Looking forward, as we've signaled the past few years, our free cash flow continues to strengthen and we expect this to continue with the delivery of our highly pre-leased $658 million development pipeline. While the timing will impact our cash flow in any given quarter or year, we feel very good about the long-term cash flow trajectory for the Company.