Highwoods PROPERTIES

Management's Prepared Remarks
Fourth Quarter 2018 Conference Call
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Brendan Maiorana
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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
Chief Executive Officer

To state the obvious, it's been a volatile couple of months in the financial markets as the Dow, RMZ, interest rates, and other financial indicators have whipsawed. Volatility in the financial markets is nothing new. In fact, it seems to be the new norm. When looking back a year ago, there was a volatile start to 2018, although the trend lines were opposite. It's easy to get swept up in the headlines and day-to-day movements in the financial markets. However, economic fundamentals, as reflected in the unemployment rate and job creation, remain conducive to growth, matches the conditions we've seen on the ground in "BBD Office-ville", where fundamentals remain solid. We continue to experience healthy demand from customers and prospects, new supply risks are generally in check across our footprint, and rents continue to rise.

We had a lot of discussions last year about Amazon's HQ2 search, especially after four of our cities were included in their whittled down list from 238 to the final 20. The ultimate HQ2 search turned out to be what we call "HQ2.5" following Amazon's announcement that it split their requirements among New York, metro D.C., and Nashville, where it will put an operations center. To put this Nashville job growth announcement in perspective, Amazon's plan to add 5,000 new jobs is the single largest, office-using job expansion announcement in Nashville's history, and on a per capita basis, 5,000 new office jobs in Nashville is a greater increase than the 25,000 new jobs Amazon will create in New York. Amazon's Nashville offices will be housed beside our now underway Asurion project and our 1100 Broadway development site where we can build up to 1.2 million square feet. Needless to say, we remain jazzed about the outlook for Nashville.

Overall, as evidenced by our strong leasing stats posted in the fourth quarter – with GAAP rent spreads up 20.2% and net effective rents 6.3% above our trailing five quarter average – we're pleased with the performance and encouraged by the outlook for our portfolio. We continue to see strong interest for expansion and relocation space from users leveraging the business friendly environments, high quality of life, and moderate cost of living enjoyed across our markets.

Turning to our results, 2018 was a solid year for our company.

First, we delivered per share FFO of $3.45, near the high end of our original outlook of $3.35 to $3.47. Same property cash NOI growth was 0.7%, or 1.1% when adjusting for fourth quarter 2018 dispositions not included in our original forecast. This compares to our original range of 1 to 2%. Cash NOI growth was impacted by higher-than-expected concessions, driven by earlier-than-anticipated sizable, future-year renewals, which sets us up for better growth going forward. During the year, we achieved rent spreads on 2nd gen office leases of +4% on a cash basis and +19% on a GAAP basis … while keeping leasing costs consistent with prior trends.

Second, we announced $285 million of 98.3% pre-leased development, delivered $85 million that is 99.6% leased, AND increased the pre-leasing on our pipeline by signing 1.0 million square feet of first gen leases. Our $691 million pipeline is now 93% pre-leased. Development continues to be a key growth engine for our company.

Third, we continued to cull our portfolio with the sale of $86 million of non-core properties.

Fourth and finally, we improved the balance sheet while investing heavily in our development pipeline and replenishing our land bank, without issuing any shares on the ATM. We were able to maintain our debt-to-EBITDA ratio at 4.75 times.

In Q4, we delivered FFO of $0.86 per share. Our same property cash NOI growth during the quarter was +1.5%, which includes the full quarter impact of Fidelity's move-out at 11000 Weston in Raleigh. We leased a healthy 918,000 square feet of second gen office at positive cash rent spreads of 5.8% and GAAP rent spreads of 20.2%. Portfolio occupancy finished the year at 91.9% -- towards the upper end of our most recent outlook.

As a result of our continued strengthening cash flow, bolstered by improving rents and development deliveries, we increased our dividend for the third consecutive year to an annualized rate of $1.90 per share. Since the beginning of 2017, our dividend is up 12%, which is in addition to the $0.80 per share special dividend we declared in December 2016.

In last night's earnings release, we provided our initial 2019 per share FFO outlook of $3.44 to $3.56 with a mid-point of $3.50. There are a number of items that impact our year-over-year growth rate, including:

- the 11000 Weston restoration fee received in 2018 that won't repeat in 2019;
- the increased G&A expense attributable to certain in-house leasing costs that are now expensed but were previously capitalized; and
- the late in 2018 dispositions.

Adjusting for these items, our FFO per share growth in 2019 would be 3.8% at the midpoint of our outlook.

A few of the other major items in our outlook include same property cash NOI growth of 2.0 to 3.0%. which Mark will provide more color on. Our disposition outlook is $100 to $150 million, which represents a relatively typical year of sales activity for us. Our acquisition outlook has a low-end of zero and a placeholder of $200 million at the high-end. This range may sound familiar since it's the same we provided for the past two years. Given the wall of capital available to acquire BBD located assets, there haven't been quality buildings available at the risk-adjusted returns we felt would be acceptable to our shareholders. Lastly, our development announcement outlook is $100 to $375 million. We continue to have conversations with several large anchor prospects that give us confidence towards the likelihood of announcing more projects in 2019.

Also, last evening, we announced we will develop GlenLake Seven, a $41 million, 126,000 square foot office building in West Raleigh. This will be the fifth building in our GlenLake campus. The existing four buildings, which encompass more than 600,000 square feet, are 98% occupied. The project will break ground in the second quarter of 2019 with construction scheduled to be completed in the third quarter of 2020 and a targeted stabilization date in the fourth quarter of 2021. The project is 28% pre-leased based on Highwoods intention to occupy approximately 35,000 square feet upon completion. We already have interest from prospects, which gives us additional confidence of meeting our projected stabilization date. In addition, our most recent delivery in GlenLake stabilized in the beginning of 2017 – two quarters ahead of pro forma and NOI some 10% above our original underwriting. Our success at GlenLake, and other recent, modest-sized spec projects we've started in Raleigh – notably 751 Corporate Center and 5000 CentreGreen – were factors in our decision to start GlenLake Seven.

In closing, I applaud our team for their dedicated efforts throughout 2018, especially in posting impressive GAAP and cash rent growth numbers, inking a whopping 1.0 million square feet of re-lets, and capturing 1.0 million square feet of first gen leases. We are excited to kick-off 2019 with a third consecutive dividend increase, an improved organic growth outlook, and sustained optimism around our development platform, including our 2019 scheduled deliveries of $195 million encompassing 551,000 square feet that are 100% pre-leased.

Ted Klinck
President, Chief Operating Officer

After over a year of HQ2 suspense, we're excited Amazon selected Nashville for its Operations Center of Excellence. This speaks to the strength of the Nashville market and it will be next door to our 553,000 square foot Asurion headquarters development and our 1100 Broadway site where we can build up to 1.2 million square feet of office. Amazon's announcement is just one of the many stories shining a spotlight on our Southeastern footprint, which benefits from high quality of life, low business costs and access to well-educated talent pools. We expect continued interest in our markets as economic fundamentals remain strong. Demand is healthy across our footprint, while supply remains generally in-check.

In addition to healthy market fundamentals, we are optimistic about our portfolio and expiration outlook. We made meaningful progress in 2018 reducing future near-term rollover risk by locking in several large 2019 and 2020 renewals. At year-end 2018, our 2019 expirations represented 8.9% of annualized cash revenue, which is approximately 110 basis points below where the average was the prior two years.

Turning to the fourth quarter.

We had strong leasing evidenced by beating our prior five quarter average on several fronts:

- 384,000 square feet of new second generation leases was a 65% beat
- $16 per square foot net effective rents was a 6.3% beat
- 20.2% GAAP rent spreads was a 330 basis point beat
- 5.8% cash rent spreads was a 340 basis point beat

Our fourth quarter same property cash NOI growth was positive 1.5% despite lower average occupancy compared to last year. This growth was driven by annual bumps on nearly all of our leases and solid rent spreads on commenced leases. In 2019, we expect same property NOI growth to accelerate over 2018.

Our portfolio occupancy improved 60 basis points from the end of the third quarter, mostly attributed to new starts in Atlanta, Tampa and Richmond. Our overall portfolio ended the year at 91.9%, and 6 of our 9 divisions were above 92%. Atlanta and Raleigh were the only two divisions where occupancy was below 90%, and given these are our two largest divisions by square footage, they present sizeable organic growth potential.

After taking care of three of the five 2019 expirations greater than 100,000 square feet earlier in 2018, we were only left with FAA and T-Mobile going into the fourth quarter of 2018. The FAA lease is scheduled to expire in 4Q 2019 and we remain confident in signing a long term renewal. With T-Mobile, we executed a short term extension taking their 116,000 square foot lease through the end of first quarter 2020. We now have five quarters before T-Mobile vacates, and given our lead time, combined with the healthy parking ratio and efficient floorplate at Preserve V, we expect good interest in the space.

As is a normal pattern for us, we expect occupancy to dip early in the year and then recover in the latter part of the year. We expect year-end occupancy of 91.25% to 92.75%, with a midpoint of 92%. While early in the year, we feel good about the interest we're seeing in the few large vacancies in our portfolio.

Now to our markets.

Atlanta posted positive net absorption of 331,000 square feet in the fourth quarter, as reported by CBRE. We are tracking 3.3 million square feet of development underway, which is around 30% pre-leased. This approximates 2% of total stock. Midtown, rapidly growing in its appeal and vibrancy as evidenced by significant recent announcements, accounts for nearly half of this new supply. We signed 300,000 square feet of second generation leases during the quarter with 16.9% GAAP rent spreads. We continue to make progress releasing the 137,000 square feet FBI vacated in Century Center in 2018. As mentioned previously, we've released 32% and now have signed LOIs to take us to 83%. We've also had strong leasing in Buckhead the past two quarters and are now stabilized at One and Two Alliance and Monarch Tower. We're heavily focused on leasing up the remaining approximately 100,000 square feet in Monarch Plaza, where we're seeing significant interest. Lastly, Riverwood 200, which you may recall we started 39% pre-leased, is currently 91.4% leased, up 120 basis points from last quarter, and is expected to stabilize in 2Q 2019.

The overall Raleigh market garnered 944,000 square feet of positive net absorption during the quarter, per Avison Young. Class A asking rates have increased 8% year-over-year and overall Class A market occupancy is unchanged over the same period, ending the year at 90%. There are approximately 2.2 million square feet of office under construction, which is approximately 55% pre-leased. This represents 4.5% of total stock and is spread across six submarkets. We signed 93,000 square feet of second generation leases during the fourth quarter at robust GAAP rent spreads of 21.1%. We have seen steady interest in the 178,000 square foot 11000 Weston property, previously occupied by Fidelity. We have over 500,000 square feet of prospects, including both single building and multi-customer users. We are encouraged by the level of interest we've seen and look forward to converting this into signed leases. Our 751 Corporate Center development, which was 35.3% pre-leased at announcement, is currently 98.4% leased, up from 87.6% at 3Q. The project will stabilize during the first quarter of 2019, more than a year ahead of pro forma.

Nashville posted positive net absorption of 181,000 square feet during the quarter, as reported by CBRE. Market occupancy ended the year at 90%, an improvement of 20 basis points from last quarter. We are currently tracking 2.5 million square feet of competitive spec space, around 10% of competitive stock, that is currently 17% pre-leased. We expect approximately 1 million square feet will deliver during 2019 and is currently 39% pre-leased. We signed 120,000 square feet of second generation leases at strong GAAP rent spreads of +32.1%. As a reminder, Virginia Springs I, which was 34% pre-leased at announcement, is now 100% leased and will be placed in service during the first quarter, more than a year ahead of pro forma.

Lastly, Tampa experienced positive net absorption of 136,000 square feet for the year, as reported by Cushman & Wakefield. This was driven by strong gains in Westshore and downtown, partially offset by negative net absorption elsewhere in the market. Class A rental rates were up 3.6% compared to a year ago. Approximately 580,000 square feet is currently under-construction, less than 2% of total stock. We signed 189,000 square feet of second generation leases at 23.8% GAAP rent spreads and ended the year at 95.3% occupied, up 240 basis points since last quarter. The most activity was at SunTrust Financial Centre in downtown, where occupancy finished in the high 90s. We've substantially outpaced our occupancy and rental rate expectations since acquiring the property in 2015.

In conclusion, we had a strong year of leasing driven by robust rent spreads and de-risking our future expiration schedule. As we start 2019, the environment remains healthy and is indicative of continued demand for quality, well-located office product.

Mark Mulhern
Executive Vice President, Chief Financial Officer

As Ed outlined, 2018 was a productive year for our company. Our financial performance was strong as we delivered FFO of $3.45 per share, towards the high-end of our original range of $3.35 to 3.47. The upside compared to our original outlook was driven by higher than expected GAAP NOI. During the year, we also announced $285 million of 98.3% pre-leased development and delivered $85 million of projects that were 99.6% leased.

For the fourth quarter, we delivered net income of $0.51 per share and FFO of $0.86 per share. There weren't any sizable unusual items in the fourth quarter, and for the first time in 2018, Q4 included no unusual items related to 11000 Weston. As a reminder we recognized restoration fees in Q1 and Q2 and received accelerated rent payments in Q3. We recognized a land impairment charge that netted to less than half-a-penny FFO impact related to a non-core industrial land parcel in Atlanta that we expect to sell in 2019. We also sold $55 million of non-core properties, which closed late in the quarter, and therefore didn't meaningfully impact our Q4 financial results. We estimate the full year dilutive impact of these sales at approximately $0.02 per share.

We provided our initial 2019 FFO outlook of $3.44-3.56 per share. At the mid-point, FFO is up approximately 1.5%, but as Ed highlighted, this would've been up 3.8% after adjusting for several items that distort the year-over-year FFO comparison. These items include:

- 3.6 cents per share of restoration fees related to 11000 Weston recognized in 2018 that will not be recognized in 2019;
- 2.2 cents per share impact from certain in-house leasing costs that will be expensed in 2019 which were previously capitalized; and
- 1.9 cents per share from the aforementioned dilutive impact of late 2018 dispositions.

Our outlook for 2019 same property cash NOI growth is 2 to 3%. We posted 0.7% growth in 2018, or 1.1% when adjusting for the impact of the disposition of Highwoods Preserve I in the fourth quarter of 2018 that wasn't in our outlook. The improvement in same property cash NOI growth in 2019 is driven by continued growth in rents, holding the line on op-ex, partially offset by modestly lower average occupancy. We expect same property growth to start low and improve steadily as we move throughout 2019.

Our year-end occupancy target is 91.25% to 92.75%. We expect occupancy will dip early in the year before recovering in the second half.

Finally related to our outlook items, we expect G&A in the range of $40.5 million to $42.5 million. Adjusting for the new GAAP requirement to expense certain in-house leasing costs, our 2019 G&A would be down 2% at the mid-point of our outlook. As you know, these previously capitalized costs were recognized as leasing costs in our CAD reconciliation, and therefore won't impact any prior year comparisons to CAD.

Last night, we also announced an increase in our annualized dividend from $1.85 per share to $1.90 per share. Our strengthening cash flow outlook is bolstered by $195 million of 100% pre-leased development scheduled to deliver in 2019. When evaluating the dividend, we balance our needs for capital reinvestment in the portfolio and our taxable income levels.

We maintained our fortress balance sheet in 2018 while investing heavily in our development pipeline. We invested approximately $195 million in development projects during the year, acquired a $25 million well-located development site in CBD Nashville, sold $86 million of non-core properties and issued no shares on the ATM, all while holding our debt plus preferred to EBITDAre ratio steady at 4.8x. We haven't issued any shares on the ATM since the second quarter of 2017. We're committed to grow within our targeted debt-to-EBITDAre operating range of 4.5 to 5.5 times and have the flexibility to fund the remaining $330 million on our current development pipeline without the prerequisite of issuing shares or selling assets. We remain confident in our ability to fund our growth initiatives and maintain a strong balance sheet.

Finally, as we mentioned previously, we obtained $150 million of forward starting swaps that lock the underlying 10-year treasury, and in the fourth quarter we obtained another $75 million of forward starting swaps. We now have $225 million of notional principal that locks the U.S. ten year at 2.86% in advance of a potential financing before July 2019. If we move forward with a financing, we would expect to use the proceeds to repay our $225 million term loan that matures in June 2020 and reduce borrowings on the line of credit. A potential long-term financing has been contemplated in our outlook range.