Highwoods PROPERTIES

Management's Prepared Remarks
Third Quarter 2017 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. The release and supplemental include a reconciliation of these non-GAAP measures to the most directly comparable GAAP financial measures.

Any forward-looking statements made during today's call are subject to risks and uncertainties and these are discussed at length in our annual and quarterly 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

Since our last earnings call, the biggest news in the office business this side of the Atlantic has been Amazon's post of HQ2. While several of our cities have been mentioned by numerous pundits as contenders to land HQ2, we're not going to speculate on which metro area Jeff Bezos and his Amazon team may pick. However, we find their list of desired criteria a validation of our BBD strategy. We're thrilled to see Amazon's HQ2 grocery list of desired attributes so closely align with the characteristics of our BBD markets, which include:

- Access to a well-educated workforce;
- Growing population centers;
- A stable, business friendly climate;
- High quality of life; and
- Attractive cost of living.

The unique manner and epic proportion of this posting is something all of us will pay close attention to as it unfolds. Regardless of what Amazon ultimately decides to do, the confidence they are showing in their long-term growth outlook with HQ2 can be viewed as a good story for the economy.

Shifting to Highwoods, fundamentals on the ground remain steady. We continue to see positive net absorption across our markets. New supply is highly pre-leased and less than 2% of total market, which mitigates the risk to office fundamentals. The backdrop of continued positive net absorption and modest supply has driven a steady increase in net effective rents.

Turning to the third quarter, we delivered 86 cents of FFO per share, about 4% higher than last year. The quarter included a little over a penny of land impairment charges related to a parcel that we no longer expect to develop, but this charge was mostly offset by a term fee. Our strong financial performance was driven by:

- Continued growth in same property NOI;
- Accretion from recently delivered development projects; and
- Lower interest expense.

Given our positive results, we have increased our 2017 FFO outlook to $3.36 to $3.38 per share, which implies a penny and a half increase at the mid-point.

On the operational front, same-property cash NOI growth was positive 3.4% in Q3. We signed 1.1 million square feet of second gen office leases with GAAP rent spreads of positive 11.3%, while cash rent spreads were slightly negative at -0.9%. Strong fundamentals across our markets and the beneficial impact of annual escalators has led to our 6th consecutive quarter of positive double digit GAAP rent spreads.

Our occupancy was 92.1% at the end of Q3, a dip from the end of the second quarter driven by previously disclosed known move-outs in Atlanta and Richmond.

At the 211,000 square foot former HCA space in Nashville, we're 46% re-let and now have strong prospects for another 30%. In Richmond, we're already 77% re-let on the 163,000 square feet that SCI vacated in the third quarter, and we have prospects for the balance of the space. In Buckhead, the two blocks encompassing 137,000 square feet returned to us in the third quarter by Morgan Stanley and Towers Watson have already been white-boxed and are well positioned to capture large user demand in a submarket where the availability of large contiguous blocks is limited.

Disposition activity was heavy during the quarter, as we closed $93 million of sales, including our share of a joint venture sale. Most of these sales closed late in the third quarter, and we expect an additional $44 million of building sales to close in Q4. As we've previously disclosed, our Q3 and Q4 disposition activity will be about $0.02 per share dilutive to 2017 FFO, virtually all of which will affect the fourth quarter. As a reminder, in keeping with our strategic plan, we routinely evaluate our portfolio for non-core properties and expect to continue to be regular recyclers of assets. At a weighted average disposition cap rate of approximately 7.5%, pricing for these non-core properties was reasonable. Following the JV sale we closed in Q3, we now receive only 1.5% of our revenues from joint ventures.

Regarding acquisitions, we continue to evaluate on and off-market opportunities with a focus on prudent investing. The acquisition market has been relatively quiet thus far in the year, and while modestly improved of late, the preponderance of recent for-sale assets has been lower quality than what we're seeking. There are a few opportunities we're monitoring, but at this point in the year, the likelihood of closing any acquisitions before the calendar flips is low. As a result, in our revised outlook table, we are assuming no building acquisitions will close before year-end.

Our development program continues to be a meaningful driver of earnings, cash flow and NAV growth for our company. At $225 million of 82% pre-leased development starts encompassing 769,000 square feet announced so far this year, we have already exceeded the high-end of our original outlook of $220 million for 2017. We continue to see opportunities for highly pre-leased development projects. While it's always difficult to forecast if and when a sizable user will commit to a development, we're encouraged by the conversations and level of activity.

Our overall development pipeline spreading across 5 markets encompassing 1.5 million square feet represents a total expected investment of $440 million, and is 78% pre-leased on a dollar-weighted basis. At our $41 million, 167,000 square foot 5000 Centre Green development project in Raleigh, shell construction is complete and our first customers have begun to move in. We're now 46% pre-leased, up from 26% last quarter, and we have strong prospects for another 30% of the building, while we're still two years from pro forma stabilization.

With nearly $400 million of development delivered in 2017 that are, on average, 85% leased, we expect a meaningful increase in cash flow as these projects stabilize and cash rents commence over the next several quarters. Development is a core competency for us and an ongoing engine of strengthening cash flow and earnings growth.

The combination of strong operating fundamentals, a solid balance sheet, and stabilization of well pre-leased development projects sets the table for solid growth in cash flow over the next several years.

Ted Klinck
Executive Vice President, Chief Operating and Investment Officer
As Ed noted, we continue to see steady fundamentals across our markets. It's noteworthy that six of our nine markets scored in Baird's top 10 public REIT markets in terms of office-using job growth in September. We've spoken often about strong job growth in Atlanta, Nashville and Raleigh. It's nice to see Richmond, Tampa and Orlando also garnering accolades by being in the top 10. This report, plus many other regional forecasts, supports our view that steady fundamentals should continue for the foreseeable future.

Turning to the quarter, we had increased leasing volume with attractive economics. We leased 1.1 million square feet of second gen office space with an average term of 5.2 years. As Ed mentioned, GAAP rent spreads were positive 11.3%, the sixth consecutive quarter of double digit increases. While our cash rent spreads were slightly negative after five consecutive quarters of positive spreads, the negative cash rent spread in Q3 was attributable to 2 renewals where we traded no TIs for a reduced face rate.

Evidence of improving rents in the portfolio is reflected by our average in-place cash rents at quarter end, which were 1.3% higher per occupied foot than a year ago. This includes our recently delivered 500,000 square foot Bridgestone Americas tower, which is in our occupied square footage even though cash rent doesn't commence until the middle of the fourth quarter.

As previously forecasted, our portfolio experienced three sizeable move-outs during Q3. Total portfolio occupancy was down 60 basis points compared to Q2, ending at 92.1%. Based on signed leases in hand, we anticipate a recovery late in the fourth quarter. Our year-end occupancy outlook remains unchanged at 92.2-93.2%.

Turning to our operational performance, we grew same property cash NOI by 3.4%. The 50 basis point dip in average occupancy during the third quarter was more than offset by the contribution from annual rent escalators and leases commencing with higher cash rents. Our updated same property outlook for the year is 3.75 to 4.25%. The mid-point of 4.0% is nearly 100 basis points higher than our original outlook.

Now to our markets.

In Richmond, the market has experienced steady growth, with office-using job growth during the quarter of 3.6%, more than twice the national average. According to Cushman & Wakefield, market vacancy was 7.5% at the end of the third quarter, down 150 basis points compared to the prior year. Average market asking rents increased 4.5% year-over-year. On last quarter's call we mentioned already re-leasing 64% of the 163,000 square feet that SCI vacated in August. Our re-let percentage is now up to 77%, and as Ed mentioned, we have prospects for the balance of the space. We signed 160,000 square feet of second gen deals in Richmond during the quarter with GAAP rent growth of 13.6%. Occupancy in our Richmond portfolio was 90.0% at September 30th and is expected to exceed 92% by year-end. Lastly in Richmond, we're on budget and on schedule to deliver our 100% pre-leased, $29 million build-to-suit for Virginia Urology in Q3'18.

Turning to Atlanta, in the last four quarters Atlanta's office employment growth has been the strongest among the 10 largest metro areas in the country. As Ed mentioned, occupancy in our Atlanta portfolio was impacted by the previously disclosed known move-outs in Buckhead that occurred in the third quarter. We remain upbeat about Buckhead's long-term prospects, the quality and location of our assets and our ability to backfill these vacancies.

Tampa has delivered on its long awaited reawakening during the last 12+ months. According to JLL, asking rents in Tampa are up 6.1% during the past year while vacancy is down 140 basis points. With no spec construction and a lack of large available spaces across the market, we continue to see strong growth in our portfolio. Our quarter-end occupancy was 94.1%, up 330 basis points year-over-year. We signed 130,000 square feet of second gen leases in the quarter with GAAP rent growth of 15.5%.

In Raleigh, the office market continues to benefit from strong economic growth and access to a talented workforce. Per Avison Young, Class A rents are up 5% year-over-year and Q3 net absorption was over 300,000 square feet. While there is 1.7 million square feet under construction spread out across seven submarkets, we believe approximately 800,000 square feet is competitive to our BBD-located portfolio and is 50% pre-leased. Our in-service Raleigh portfolio is 93.9% occupied, up 60 basis points from Q2. We posted solid GAAP rent spreads of positive 16.4% in Q3, the 9th consecutive quarter of double digit positive GAAP rent spreads. As we mentioned a few calls ago, one of our 2018 potential exposures is an approximate 175,000 square foot lease in Cary's Weston submarket of Raleigh that is scheduled to expire at the end of November 2018. While still early, in the event the customer does not renew, we would be entitled to a meaningful fee. Our 1.2 million square foot in-service portfolio in Weston is 100% occupied. We should know more by year-end.

Finally, in Nashville, leasing activity and rents remain strong. Per Cushman and Wakefield, Class A vacancy is aligned with overall market vacancy at 7.8%. New construction is 2.3 million square feet, down from 3.5 million square feet in 2016, and is 50% pre-leased. With vacancy low and job growth steadily in the top 10 nationally, we don't view new supply as a major risk to Nashville's fundamentals. Our portfolio occupancy is 95.8%, up 10 basis points from Q2, and we posted solid GAAP rent spreads during the quarter of positive 16.7%.

In conclusion, strong demographic trends – population and job growth – combined with low current vacancy and limited speculative development support healthy fundamentals across our markets.

Mark Mulhern
Executive Vice President, Chief Financial Officer

We delivered third quarter net income of $57 million, or 55 cents per share, which included $19.8 million of gains from property dispositions, which are not included in FFO. Our FFO for the quarter was $91 million, or 86 cents per share, a 3.9% increase year over year. We received a penny of net termination fees, primarily from Towers Watson in Atlanta, which was more than offset by a 1.5 cent impairment primarily for land in the Southwinds submarket that we recently exited in Memphis. These two items essentially offset one another, making our reported FFO of 86 cents a relatively 'clean' number.

As Ed mentioned, we are pleased with our third quarter operational performance. We delivered same property cash NOI growth of 3.4% with average occupancy 50 basis points lower compared to last year. The improvement in cash NOI is driven by healthy contractual annual rent bumps on nearly all of our leases, leases commencing where we achieved solid growth on rent spreads and the burn off of free rent on several leases.

Turning to our balance sheet and financing activities, we ended the quarter with leverage of 34.7% and debt-to-EBITDA of 4.5 turns. While we are committed to grow generally on a leverage-neutral basis, we have the flexibility of funding the remaining $226 million of spending on our current development pipeline without the issuance of new equity and still maintaining debt-to-EBITDA around the mid-point of our stated comfort range of 4.5 to 5.5 times.

We had several important financing transactions close after the end of the quarter.

First, we recast our revolving credit facility. Our new facility has a capacity of $600 million, up from $475 million, and we reduced the LIBOR spread from 110 to 100 basis points. We believe the $600 million size works well for our Company. It provides us enough liquidity to fund near-term financing needs and serves as a short-term backstop if tapping the capital markets is not prudent. Second, we extended our $200 million term loan from January 2019 to November 2022, and reduced the LIBOR borrowing spread from 120 to 110 basis points. Third, we paid down $125 million of our $350 million term loan, which matures in June 2020 and bears interest at a LIBOR spread of 110 basis points. We had a strong reception from the lenders in our bank group, and thank them for their continued support of our Company.

Looking forward, we have only one significant debt maturity between now and June 2020, namely a $200 million bond with a 7.5% coupon that matures in April 2018. We're looking forward to the interest savings opportunity we expect from refinancing this 7.5% bond. As you may recall, we obtained $150 million of forward-starting swaps that effectively lock the underlying 10-year treasury at 2.44% with respect to a forecasted debt issuance before May 15th of next year. Assuming we refinance the April 2018 bond with a long-term bond, we would have no significant debt maturities for two years and our maturity schedule would be well-laddered with flexibility to fill-in medium-dated maturities if we need to raise additional capital.

As Ed mentioned, we updated our FFO outlook to $3.36 to $3.38 per share. The revised mid-point of $3.37 per share is a 1.5 cent increase from the previous midpoint, and 3.5 cents above the midpoint of our original outlook, or 6.5 cents above when excluding dispositions that weren't contemplated in our original range. As we noted last quarter, we expect approximately 2 cents of dilution in the fourth quarter from dispositions completed late in the third quarter plus expected closings in Q4. The improved outlook is predominantly driven by better than expected operational performance, partially offset by slightly higher G&A.

Taking the $2.55 per share of FFO that we have reported year-to-date, our imputed outlook for Q4 is $0.81-0.83 per share. There are several fourth quarter items that I will walk you through to help understand our revised full-year outlook:

- First, we expect $0.02 per share of dilution from dispositions.
- Second, we will incur about three-quarters of a penny lower FFO from the accelerated amortization of fees associated with the credit facility recast and term loan extension.
- Third, lower JV fee income will reduce FFO by about three-quarters of a penny.
- Lastly, lower NOI, driven primarily by lower average occupancy, will reduce FFO by half a penny.

Before we take your questions, I would like to reinforce a point that Ed made earlier. Year to date, we delivered $394 million of development that are, on average, 85% pre-leased. Due to pro forma lease-up periods and the impact of early possession revenue recognition, the cash NOI from these properties was negligible during Q3, but they were solid GAAP NOI contributors. As these burn off, cash flow from these properties obviously increases meaningfully. A significant portion of the increase in cash flow occurs in 2018. The ongoing execution and delivery of our development projects strengthens our cash flow in 2018 and beyond.