H&R REIT

Q4 2023 Conference Call

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9:30 AM

Operator: Good morning, and welcome to H&R REIT's Q4 2023 Conference Call.

Before beginning the call, H&R would like to remind listeners that certain statements, which may include predictions, conclusions, forecasts or projections and the remarks that follow may contain forward-looking information, which reflect the current expectations of management regarding future events and performance and speak only as of today's date.

Forward-looking information requires management to make assumptions or rely on certain material factors and is subject to inherent risks and uncertainties, and actual results could differ, materially, from the statements in the forward-looking information.

In discussing H&R's financial and operating performance and in responding to your questions, we may reference certain financial measures, which do not have a meaning recognized or standardized under IFRS or Canadian Generally Accepted Accounting Principles and are, therefore, unlikely to be

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Non-GAAP measures should not be considered as alternatives to net income or comparable metrics determined in accordance with IFRS as indicators of H&R's performance, liquidity, cash flows and profitability. H&R's management uses these measures to aid in assessing the REIT's underlying performance and provides these additional measures so that investors can do the same.

Additional information about the material factors, assumptions, risks and uncertainties that could cause actual results to differ, materially, from the statements in the forward-looking information and the material factors or assumptions that may have been applied in making such statements, together with details on H&R's use of non-GAAP financial measures, are described in more detail in H&R's public filings, which can be found on H&R's website and www.sedar.com.

I would now like to introduce Mr. Tom Hofstedter, Chief Executive Officer of H&R REIT. Please go ahead, Mr. Hofstedter.

Tom Hofstedter: Thank you, and good morning, everyone. Thanks for joining us, today, to discuss H&R's fourth quarter and year-end 2023 results.

With me on the call are Larry Froom, our Chief Financial Officer, and Emily Watson, Chief Operating Officer of our Lantower division.

I'm pleased to report that we have continued to successfully execute on our 5-year strategic plan to reposition the portfolio to be a more simplified and growth-oriented REIT, as was highlighted in our most recent press release.

Since announcing our strategic repositioning planning, two and a half years ago, we have made considerable progress, having successfully completed the spin-off of Primaris REIT, valued at approximately $2.4 billion, and we have completed, to date, the sale of initial 45 properties totaling $2.4 billion with a further $300 million of sales still to close, later this year.

We have repurchased to date 27 million units to $340 million and decreased our debt from $6.1 billion to approximately $3.7 billion at year-end, thereby improving our debt to total assets from 50% to 44%, as at December 31, 2023.

Importantly, at year-end 2023, our total office exposure was reduced to 17% of real estate assets plus nine additional properties representing a further 7% that are advancing through the rezoning and intensification process.

We expect to continue the strong momentum with the announced sale this year of further $293 million of properties,

including the sale of $232 million of 25 Dockside Drive, an office building by the Waterfront of Downtown Toronto.

Our recent board additions, including independent lead trustee notice, Donnie Clow, Lindsay Brand and Leonard Abramsky, underscore our dedication to effective governance and strategic advancement, and we look forward to working with them to help us achieve our objectives. And with that, I'll hand it over to Larry.

Larry Froom: Thank you, Tom, and good morning, everyone. In my comments to follow, references to growth and increases in operating results are in reference to the year ended December 31, 2023, compared to the year ended December 31, 2022.

H&R's same-property net operating income on a cash basis increased by 10.3%. Breaking this growth down between our segments, Lantower, our Residential Division led the way with an 18.7%, increase or a 14.3% increase in U.S. dollars. Emily will provide more details on this shortly.

Industrial same-property NOI on a cash basis increased by 12.5%, driven by rent increases for new and renewed tenants.

The tenants at our two new industrial developments in Mississauga, totaling 336,800, square feet took possession this month and will begin paying rent in Q2.

Office same-property net operating income on a cash basis increased by 5.2%. This increase was largely attributable to

these termination payments, bad debt recoveries and the strengthening U.S. dollar.

H&R received lease termination payments from office tenants in 2023 amounting to $5.2 million, $3.4 million of this relates to 6900 Maritz Drive in Mississauga, where the REIT's current 105,000 square foot office property will be converted into a brand-new 122,400 square foot industrial building. Demolition has already begun and construction on the new building is expected to begin in the spring.

And lastly, retail same-property net operating income on a cash basis increased by 5.7%, primarily driven by increased occupancy at River Landing and the strengthening of the U.S. dollar.

Q4 2023's FFO was $0.30 per unit, compared to $0.31 per unit in Q4 2022. FFO for the year ended 2023 was $1.33 per unit, compared to $1.17 per unit for the year ended 2022. Included in FFO for 2023 is $30.6 million of proceeds from the sale on option to purchase land. Excluding this item and other non-recurring items such as lease termination fees, FFO would have been $345.4 million for the year ended 2023, or $1.23 per unit, an increase of 3.9%, compared to 2022.

H&R's cash distribution of $0.70 per unit was 18.6% higher than the cash distributions of $0.59 in 2022. H&R's 2023 payout

ratios remained healthy at 52.8% of FFO and 63% of AFFO, notwithstanding the increase in distributions.

Net asset value per unit as at December 31, 2023, was $20.75 per unit, a decrease from $21.80 at the end of 2022. H&R recorded a downward fair value adjustment of $197.6 million for Q4 2023, as the REIT's proportionate share. The downward fair value adjustment for the year ended December 31, 2023, was $486.1 million as the REIT's proportionate share.

Debt to adjusted EBITDA improved from 9.6x at the end of 2022 to 8.5x at the end of 2023. Debt to total assets as the REIT’s proportionate share on December 31, 2023, was 44%, unchanged from the end of 2022 and liquidity at December 31, 2023, was in excess of $950 million with an unencumbered property pool of approximately $4.2 billion.

And with that, I will now turn the call over to Emily.

Emily Watson: Thanks Larry and good morning everyone. – I’m happy to be on this call to discuss our fourth quarter same-store results from our multifamily platform and discuss some operational highlights.

Occupancy ended the quarter at 94.6%, 72 basis points lower than the third quarter and 41 basis points lower when compared to Q4 of 2022. Same-Asset property net operating income from our portfolio in U.S. dollars increased by 12.6%, and 14.3%

respectively, for the three-months ending on December 31st, 2023 and full year 2023 compared to their respective 2022 periods.

We continue to see positive signs of demand with Q4 resident retention at 62% and 94% occupancy in the Sunbelt and Jackson Park is achieving 75% retention and 99% occupancy. Move-outs due to home purchase remain low at 11% of total move-outs and rent-to-income levels remain affordable, in the low 20% range, allowing for future headroom in rental growth.

Lingering high interest rates have maintained the spread between bid and ask prices and continue to constrain the number of trades completed in the fourth quarter. Based on our recent third-party appraisal and a handful of sunbelt sales comps, we have raised our FMV cap rates by 25 basis points to 5% and believe the rate is appropriate and supported. Cap rates are expected to remain low, relatively speaking, for the institutional quality assets in the sunbelt with capital flows interested and focused on long-term heavy sunbelt multifamily allocation.

On the development front, Lantower West Love in Dallas, TX is expecting its first TCO including 75 units in late March. We are very excited to deliver what we believe is a best in class asset with unparalleled amenities. We look forward to commencing pre-leasing later this month. Also, in Dallas, TX,

Lantower Midtown has reached floor 5 – its top level – in 3 of its 6 turns and is currently 70% framed. Drywall is ongoing at Turns 1 and 2.

We are progressing through the different phases of design, drawing, and permitting on the remainder of our sunbelt development pipeline and expect to receive more building approvals as we progress through the year.

On the operational front, we continue to focus on expanding NOI margins through centralization efforts and value add opportunities. During the fourth quarter, we installed over **300** private yards with an average amenity charge of **$150** and **59%** return on investment. This investment is focused on increasing the tenure of our resident stays, thus lowering our costs and increasing effective rent.

In summary, the Lantower platform continues to achieve positive results and strong performance relative to our multifamily counterparts. I would like to recognize everyone on the Lantower team for receiving three awards in the fourth quarter – the Emerging Technology award and Best Places to Work in Multifamily from "Multifamily Leadership", as well as, Glassdoor's Best Places to Work. These awards exemplify the

‘winning culture’ that Lantower embodies and is the key reason the team continues to deliver top tier results.

And with that, I will pass along the conversation back to Tom.

Tom Hofstedter: Operator, we can open up the lines for questions, please.

Operator: Thank you. Ladies and gentlemen, we will now begin the question-and-answer session. Should you have a question, please press the “*”, followed by the “1” on your touchtone phone. You will hear a three-tone prompt acknowledging your request. If you are using a speaker phone, please lift the handset, before pressing any keys.

First question comes from Mario Saric at Scotiabank. Please go ahead.

Mario Saric: Hi, good morning, and thank you for taking the questions. First question, I may have missed it, but if we exclude 25 Dockside, is there enough visibility for you to provide a target disposition range for 2024?

Larry Froom: Good morning, Mario. We provided a target disposition pretty late in the year last year, and to be quite frank, we were pretty sure we were going to hit that target. So, we're not going to give any target, right now. We have two assets that we have on the books almost totaling $300 million

for sale, we've done $430 million last year and a lot more the year before. We hope to at least achieve those same levels as last year, but we don't want to set any targets, right now.

Mario Saric: Perfect. Okay. And then just sticking to potential dispositions, any update on Hess Tower and what you're thinking there?

Tom Hofstedter: The merger between Hess and Chevron right now, there is no visibility. We first have to get beyond the merger and make the deal. My guess is it's going to drag a little bit longer because the U.S. government is very concerned. But it will happen is my guess, and it will probably happen in June.

At this point in time, Hess and Chevron have not decided made any decisions on it, so it's early days. But until there's better clarity that there is nothing that's going to happen with Hess.

Mario Saric: Got it. Okay. And then, Tom, just maybe sticking with you, I think on the Q3 call, you kind of talked about residential value per buildable in the $200 per square foot range. It was as high as $325. Where does that stand, today?

Matt Kingston: Hi, Mario, it's Matt Kingston. I think we believe that the value in the GTA are down about 40% to 50%, depending on the site. The most recent trade we can point to is

First Capital and Woodbourne consummated on a deal at 1071 King West, which is around 200-210 a foot. I think that's a pretty premium price, though.

I think realistically, downtown transit oriented sites are probably mid- to high one. So somewhere between 150 and 200 a foot, I think is realistic, depending on how good the site is.

Tom Hofstedter: How good and how large the site is? If there's a discount and it's—get up to 600,000 square feet.

Mario Saric : Okay. That makes sense. And my last question, maybe for Emily. Just with respect to Lantower to the extent that you can, can you discuss '24 expected same-store revenue, same-store expense and same-store NOI?

Emily Watson: We are not going to give guidance just yet on that. We're really looking at what the market. We do have the Lead Core properties or JV deals on the West Coast that are coming into our same-store universe. We expect to moderate from what we have experienced in the last couple of years as kind of expected, there've been kind of banner years but, at this point, we're not providing guidance.

Mario Saric: Okay. Are you able to kind of give us a sense of where kind of blended lease spreads are going, both kind of on including renewal and new lease spreads?

Emily Watson: Sure. Yeah, Q4 was really the height of the deliveries in the Sunbelt. So we saw a lot of just the

combination of the heavy supply and the holiday season. That definitely had a downward pressure on the new lease trade-outs where they were down actually around 6%, 7%, 8%, I think, actually. But renewals still stayed in that 3% to 4% range. So, we ended Q4 with a blended range or blended negative 3, but so far in Q1, that we've seen a 160 basis point improvement in Q1, already with our new leases signed.

It's still down in that 6% range, but a blend of negative 1. So definite improvement. Q4, we had, or actually all of 23, we had about 100,000 units enter or the areas that we operate in, with a lot of the merchant builders really having pressure in that Q4 to get heads on beds, if you will, before the season before the end of the year, where Q1, we're seeing that pick up, and then we'll continue to see just coming into our peak leasing season, excuse me, in Q2.

So, we'll have still some heavy supply delivered in '24, Mario, but 75,000 units. So I think we were in the eye of the storm in Q4. And so far, we're off to a much better start in Q1.

Mario Saric: Great. Okay. And the expectation for that blended lease spread, the term positive, would that be in the second half of the year, or is that something that may be more of a '25 event?

Emily Watson: No, I do think that we'll see some pickup in Q3 and Q4. The supply will start to drift off and people kind of settling into that new norm. So, I expect that we'll probably end 2024 in a flat position and then definitely some pickup in 2025, as the market absorbs those units and really the deliveries just fall off a cliff. So flat for '24 and then ‘25, we should be able kind of get back to the new normal, not the days of '22 and '23.

Mario Saric: Understood, okay, thanks for the color. That’s it for me.

Operator: The next question comes from Jimmy Shan at RBC Capital Markets. Please go ahead.

Jimmy Shan: Thanks. Just sticking to Lantower still. So, how are you thinking NOI margin trend in '24. We've seen high insurance costs and all that. So how should we be thinking about costs on '24?

Emily Watson: Great question, Jimmy. I do think that we have concentrated on really focusing on the NOI margins for a while now through our centralization efforts, reducing some of our payroll costs, just economies of scale on our procurement initiatives, certainly adding the value-add initiatives that we've added.

So insurance costs, I think, will forever be as elevated as we saw in the increase in '23. I think some of the reinsurance

will open the market. At least coming back from NMHC last week, we had several kind of hopeful people saying that there was going to be more kind of normal increases next year, not what we saw in '23.

So I think focusing on NOI margins is definitely one of our strategic positions and has been. So, I don't anticipate our NOI margins to decrease, if anything, edge up just a tad over where we are now.

Jimmy Shan: Okay. That's helpful, thanks. And then on the asset sales, I know you don't provide--maybe just two questions. You don't provide any target, but can you characterize the environment, today? Does it seem worse or better? And then the other question on asset sale is you have an industrial property held for sale. I didn't think you were looking to sell industrial, maybe any color on that specific asset that you have for sale there.

Tom Hofstedter: So, we don't have any industrial properties for sale. The sale that occurs is really an option the tenant has to buy, and so it’s really not indicative of market conditions at all.

The market today is, I would say, less liquid. It continues to get liquid and less liquid, both on the debt side and on the equity side. That's why every deal that we're doing is almost an off-market deal. There's no point putting it on

the market. It's really tailor made to specific buyers that have an asset in mind, and we have a use for that asset in mind.

It's going to stay sloppy until rates come down and put us positive leverage. At that point in time when the debt markets open up, the equity markets will open up. So it's remaining sloppy, remains very, very slow. And again, that's why it's hard for us to give guidance. And none of the properties that we will be selling probably are going to be put on the market, they will be off-market deals just like they have been in the past year.

Jimmy Shan: Okay. And Corus Quay, obviously, this is, the sale was at a really good price. And would there be any other assets that would be similar in the sense that it could be strategic to somebody else or to a different buyer? Anything in the portfolio that that would kind of resemble what you were able to achieve with Corus Quay?

Tom Hofstedter: So, I think the answer is, yes. And it's really going to be the same as Corus Quay. I'm not going to give specifics on that. But anywhere there is a user coming in, user market is going to pay more, obviously, than the venture market.

And if you look at the industrial, not that we're selling in the industrial, but just to highlight an example. We had in the past few years, small bay small user-oriented 100,000 square feet or 20,000 to 100,000 square feet buildings that went for a

substantial premium on a price per square foot basis to the larger counterparts because of the users or the buyers.

And I think that's going to continue. And you can look at any of our buildings and say that there's a potential for a user to come in, want to buy the real estate as a use, and they'll pay a premium. That's exactly what happened with Corus. And I think there are--I know there are assets that work, I don't want to be specific because I don't want to give it anything away, but there are assets that fit that bill, still.

Jimmy Shan: Okay, thank you.

Operator: Ladies and gentlemen, as a reminder, should you have any questions, please press "*", "1". Next question comes from Sam Damiani at TD Cowen. Please go ahead.

Sam Damiani: Thank you, good morning. Emily, maybe for you, just on the Lantower market and Sunbelt there. Have you seen the opportunity for acquisitions getting any more interesting? And if not, do you anticipate that to materialize, over the course of 2024?

Emily Watson: We track--Q4 was pretty weak. We tracked about nine deals that were similar vintage, same kind of footprint as we are. So, that was really low.

I think we'll pick up some in Q1 and Q2 that when we walked away from NMHC last week, it was really the second part of the

year where they were anticipating, as Tom alluded, the interest rates come down a bit and really start to see trade.

There is not the distressed market that I think we all hoped there would be kind of sweep in and be a great dancer, at all. So that really hasn't come to fruition. But if interest rates will play, then the second half of the year could be really interesting.

Sam Damiani: And you mentioned you walked from NMHC. Is that an asset class you're looking to add to the portfolio?

Emily Watson: No. NMHC is the National Multi-housing Council.

Sam Damiani: My mistake. And last question for me, maybe for you, Tom. On the dispositions, I know you're not providing guidance, but is the priority still Office over Retail on the disposition front, going forward?

Tom Hofstedter: Yeah, the answer is yes. But office business, as you can see from office sales, is very much tailor-made. So in some cases, you need to classify that the market can be not necessarily our deals we could find financial engineering to move product out with sell refinancing, etc.

On the retail front it's kind of simple, while retail is very available, there's no danger to it, it's not even food anchors, it’s stores, same as the Echo in a way, at least 12,000 to 14,000 square foot have decent term on them and high, high

credit. They're all metro, as well, so Shoppers Drug Mart. So they're easily salable, but every 100% of all buyers out there need financing. If you are of the opinion, like I think most people believe that for the latter part of this year, this rate is going to come down.

So your purchase price is going to be a direct reflection on where interest rates are going to go. If these prices will rise if the cost of financing lowers and there’s no point putting them on the market right now if you believe that in six months from now, the cap rates are going to go down due to the benefit of positive leverage or better leverage.

Therefore, no sales or prior sales on the retail front. We’ll hold off until we get the price. We’re going to put it on the market, and if we see the interest rates come down.

And on the office front, again, it's specific to the reason why someone would want to buy the asset. I do have hope and actually our expectation that we will continue to sell some office assets, but they’re all going to be off-market deals.

And again, it’s less a reflection of interest rates rather than the liquidity in the market.

Sam Damiani: Thank you, really appreciate the color. I’ll turn it back.

Operator: Thank you. That concludes today's Q&A session. I will turn the call back over for closing comments.

Tom Hofstedter: Thanks, everybody. Have a good day.

Operator: Ladies and gentlemen, this concludes your conference call for today. We thank you for participating, and we ask that you please disconnect your lines.