H&R REIT

Q1 2024 Conference Call

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9:30 AM

Operator: Good morning and welcome to H&R Real Estate Investment Trust's 2024 First Quarter Earnings Conference Call. Before beginning the call, H&R would like to remind listeners that certain statements, which may include predictions, conclusions, forecasts or projections in the remarks that follow may contain forward-looking information which reflects 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 comparable to similar measures presented by other reporting issuers.

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.sedarplus.com.

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

Tom Hofstedter: Good morning, and thank you all for joining us today to discuss our first quarter results. With me on the call are Larry Froom, our Chief Financial Officer, and Emily Watson, Chief Operating Officer of our Lantower division.

This year to date, properties and properties under contract sold totaled $411.7 million. This is in addition to the $2.5

billion of property sales before building the assets spun out between the announcement of the plan and the end of last year.

As of March 31, 2024, the Residential and Industrial segments comprised 62% of our total real estate portfolio, and as at March 31, 2024, our total office portfolio comprised 23% of total real estate assets. After the sales of Corus and Telus, we will be left with 18 office properties with a total value of $2.2 billion. Based on our current unit price of $9.30 compared to our NAV per unit of $21.05, it is as if the market is giving us zero value for these properties highlighting the value inherent in our unit price.

Average term to maturity on our office leases is 6.6 years. 81.2% of our office tenants have investment-grade ratings, underscoring the quality and location of our properties, and six of our office properties can be re-developed into residential properties with a significant increase to the current square footage. We will continue to realize value through the sale of our office properties and execution of our strategic plan.

And with that, I'll turn the call over to Larry for an update on our results.

Larry Froom: Thank you, Tom, and good morning, everyone.

My comments to follow references to growth and increases in operating results are in reference to the three months ended

March 31, 2024 compared to the three months ended March 31, 2023.

H&R's same-property net operating income on a cash basis increased by 1.4%. Breaking the growth down between our segments, Lantower, our residential division, had a 3.2% increase, and Emily will provide more details on this shortly. Industrial same-property NOI on a cash basis increased by 5.1%, driven by rent increases for new and renewed tenants as well as an increase in occupancy.

The tenants at our two new industrial developments in Mississauga totaling 336,000 square feet have taken position, and the rent free fixed during period will end in Q2 and Q3 2024 respectively. The average rent of $8.57 per square foot on our Canadian industrial portfolio is well below market rent, which bodes well for our industrial portfolio continuing to deliver strong results.

Office same-property NOI on a cash basis decreased by 3.7%. This decrease was largely attributable to a decrease in occupancy at our properties slated for future development, including 3777 Kingsway in Burnaby, BC, which is under contract to be sold.

Our office property is on strong urban centers with a weighted average lease term of approximately 6.5 years and is leased to strong creditworthy tenants with 81.2% of office revenue coming from tenants with investment-grade ratings.

Last year, H&R received a lease termination payment of $3.4 million from the tenant at one of our office properties at 6900 Maritz Drive in Mississauga. In Q1 2024, this property was transferred from investment properties to properties under development. The former 105,000 square foot office property is being converted into a brand new 122,000 square foot industrial building. Construction of the new building has just begun.

And lastly, retail same-property NOI on a cash basis increased by 5.7%, primarily driven by increased occupancy at River Landing. Q1 2024 FFO was 29.7 cents per unit compared to 31 cents unit in Q1 of 2023. H&R's cash distribution of 15 cents per unit for the quarter resulted in an FFO payout ratio of 50.5% and an AFFO payout ratio of 61%.

Net asset value per unit at March 31, 2024 was $21.05 per unit, an increase from $20.75 at the end of 2023. Debt to total assets at the REIT's proportionate share at March 31, 2024, was 44.5%, and liquidity at March 31, 2024 was in excess of $800 million with an unencumbered property pool of approximately $4.3 billion. Our unencumbered assets to unsecured debt coverage ratio was 2.2x at March 31, 2024.

Looking at our debt stack, we only have $243 million of mortgages due 2024. $111 million of those are on properties --

are secured by properties which we have under contract to be sold, and the balance will be refinanced or repaid from the proceeds from our assets held for sale.

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

Emily Watson: Thank you, Larry, and good morning, everyone.

Today, I'm excited to share our first quarter performance for our multifamily platform, highlighting significant operational achievements and providing insights into our future strategy. We've seen same-store revenue growth this quarter align perfectly with our expectations. Our multifamily platform continues to benefit from strong demand as evidenced by stable resident retention and positive traffic trends. While new supply is at a 30-year high, 100,000 units were absorbed in Q1, marking a 20-year high and showcasing the economic backdrop of continued job and wage growth.

Furthermore, our diversification across both Sun Belt and gateway cities has served us well in driving solid results.

Our operational efficiency shines through our financial metrics. We achieved the same asset revenue growth in U.S. dollars increasing by 1.5% for the first quarter and same asset net operating income from our portfolio in U.S. dollars increasing by 3.2% for the three months ending on March 31, 2024 compared to the respective 2023 period. Occupancy ended the quarter at 94.4%. We continue to see positive signs of demand with Q1 resident retention at 54% and 94% occupancy in the Sun Belt and our gateway cities achieving 74% retention and 97% occupancy.

Move-outs to home purchase continue to trend at historical lows at 9% of total move-outs, and rent to income levels remain affordable at approximately 19%, excluding Jackson Park, allowing for future headroom and rental growth. We've included additional disclosures on Page 8 of the MD&A, which includes occupancy and average monthly rent per unit by region.

The first quarter passed without a decrease in interest rates, which continue to stagnate transaction velocity. Nonetheless, based on recent sales comparisons in the Sun Belt and a recent third-party appraisal, we are maintaining our fair market value capitalization rate at 5% for our Sun Belt portfolio. We anticipate these valuations to remain attractive for institutional quality assets in our target markets.

Turning to developments, our Lantower West Love project in Dallas achieved its first temporary certificate of occupancy on schedule with 75 units in early April. In addition to these units, we opened the leasing center and the majority of the property amenities on April 15, and with over 30 leases to date, we are encouraged by the leasing in the first full month of lease-up. We are looking forward to entering the summer leasing season with this best-in-class development.

Prospective renter feedback has been extremely favorable with our co-working spaces and cold brew on tap ranking as a crowd favorites.

At Lantower Midtown, also in Dallas, construction has progressed well with the development now 100% framed and the first turn of units finishing cabinets, flooring and countertops. We plan to commence lease-up at Midtown this summer.

On the Real Estate Development Trust number 1 front, the investor interest to invest alongside Lantower's existing development pipeline was highlighted by accelerated fundraising results. We feel this construct will create value for H&R shareholders as well as our REDT investors while maintaining financial flexibility and taking advantage of favorable depressed Sun Belt supply pipeline in the upcoming years.

Lantower Sunrise, a 330-unit development in the Orlando market, and Lantower Bayside, a 271-unit development in the Tampa market, are progressing as expected. We expect these developments to reach completion in early to mid-2026, which we believe to be an excellent time to deliver units.

We look forward to providing updates on these developments in the coming quarters.

In conclusion, Lantower's platform has demonstrated remarkable resilience and performance, outpacing many of our peers. While we navigate some near-term supply challenges, our focus on innovative practices and enhancing NOI margins through strategic initiatives continues to yield positive results. I want to extend my gratitude to our incredible team whose dedication to excellence and innovation has been pivotal in achieving these outcomes.

And with that, I'll turn the conversation back to Tom. Thank you for your continued support and trust in our vision.

Tom Hofstedter: Thanks, Emily.

And, operator, please open the call for questions.

Operator: Thank you. Ladies and gentlemen, we will now begin the question and answer session. Should you have a question, please press star followed by one. You will hear a prompt that your hand has been raised. Should you wish to decline from the polling process, please press star followed by two. And if you are using a speakerphone, please lift the handset before pressing any keys.

Our first question comes from the line of Sam Damiani from TD Securities. Please go ahead.

Sam Damiani: Thank you. Good morning, everyone. Maybe, Emily, just to start off with Lantower, what would be your updated views on the trends in the supply in your markets? When do you think they're going to taper off meaningfully? Any different views on that versus last quarter?

Emily Watson: Hi, Sam. Thanks for the question. No, actually, that really hasn't changed. We delivered, as you know, 100,000 units just in our markets in 2023, and it will edge that a little bit more in 2024. So far, the demand side of the equation I don't think gets enough fanfare, frankly, in the headlines, but -- with wage growth and starting to see the migration kind of be the same levels as it has before. I think '25, it's going to drop off pretty significantly. And again, '26 is really going to pick up for a banner year.

I think '25 will still probably absorbing some of the overhang of '24, but I would see '26 being set up to 6%, 7% rent growth just because we'll still have a supply shortage of all the folks that are coming to the Sun Belt states.

Sam Damiani: That's helpful. And just given the success of the REIT (sp), would you think about maybe starting construction on more projects in the near term? And if so, would you bias to do another REIT (sp) deal or do it more on balance sheet?

Emily Watson: I think we're always open to opportunities. So given the strength of the appetite that we saw so quickly, probably a better question for Tom, but I'd say, yes, we wouldn't pass on an opportunity to continue to develop at the attractive rate.

Tom Hofstedter: Yeah, Sam, when things change, when things get better, then we -- the market will let us use our capital to grow, then obviously, we'll do it on our own balance sheet. But until then, we continue using the REDT formula going forward.

Sam Damiani: Okay, and thank you. And last one for me - just on the mezz loan conversion to ownership in Brooklyn, how big was that mezz loan? And also, with the remaining mezz loans, is there any sort of high-level description you can give about the underlying properties?

Larry Froom: Good morning, Sam. I believe that mezz loan was about US $40 million. And the rest of the mezz loans, you wanted a bit of an update on what they currently -- what our current plans are on the rest of the mezz loans?

Sam Damiani: Looking to get a sense of what types of underlying properties are behind that pool of mezz loans?

Larry Froom: It's mostly the same. It's mostly lands (sp). Mostly the lands in the U.S.

Tom Hofstedter: Yes, but it's not very material. Sam, this was converted for 1031 reasons. So, we wouldn't convert otherwise. Just what we're really doing is parking our 1031 if you look at it that way. When we find a replacement, when the market wants us to find a replacement, which again, at this point in time, we're not spending cash, then we'd look ahead to exit.

At this stage of the game, we're just deferring our tax, so to speak, by parking the 1031.

Larry Froom: And, Sam, I should just also add, there are a couple of ones that are not based on that, and those are like the one we just did with the sale of 160 Elgin and we had a VTB of $30 million on the property sold. That and one or two others that are similar.

Tom Hofstedter: --Yeah, they're not really material. This was the most material, and this was just deferring our tax.

Sam Damiani: Got you. And just lastly, on the mezz loans, I guess former mezz loan, any update on the Cove (sp) on the Jersey side?

Tom Hofstedter: That -- the mezz loan over there, my guess is that'll be converted to equity with 80/20 split. We'll have 80, they'll have 20. But the timing on that will probably happen in 2024.

Sam Damiani: Thank you.

Operator: Again, if you would like to ask a question, please press star, one. Thank you.

Our next question comes from the line of Jimmy Shan from RBC Capital Markets. Please go ahead.

Jimmy Shan: Thanks. So maybe just a clarification on the mezz loan you're referring to – this is not relating to the

Brooklyn asset or the development site that you bought, or is that some different?

Tom Hofstedter: It's relating to the Brooklyn assets, correct.

Jimmy Shan: It is. Okay. Yeah, okay. All right, got it. Any update on ECHO portfolio and how you're thinking about the potential of selling your LP interest in that business?

Tom Hofstedter: Yeah, we're making progress. I'm more optimistic that it'll happen. I don't have a date on that, but we're getting the feeling that -- it is a liquid portfolio as far as the quality goes. It's safe, it's fully leased -- 98% leased. 54% of it is the Giant Eagle chain.

It's desirable. It's -- the value of that is in and around 7-ish, 7% to 7.5%. So, because it's the same product as Publix we have in Florida and Publix we trade, and it's 7%, 7.5% because it's Ohio, Pennsylvania, I think it'll be desirable. The markets will be looking for this. And I think we will be able to make an exit within the next 12 months.

Jimmy Shan: Okay. Is it on the market today?

Tom Hofstedter: No.

Jimmy Shan: Okay. Okay.

Tom Hofstedter: It's being underwritten, but it's not on the market at this point in time.

Jimmy Shan: Okay. Maybe just a few modeling type questions, Larry - so the net proceeds from the Telus Tower and the Corus Quay, how do we model the use of proceeds in the quarter?

Larry Froom: I think it would be best to just model a repayment of debt.

Jimmy Shan: Repayment of debt. Okay. All right. And the straight line was $5 million in the quarter. I think it has something to do with the Meadowvale assets. And I guess how do we model that one? Does it run off once the free rent goes away? What's that number look like?

Larry Froom: After the free rent period will drop off, that'll be replaced by actual cash rent. So overall, on an FFO, it won't make a difference because FFO takes both actual rent and non-cash rent into account. So FFO will be the same. AFFO will be higher because it'll be rent instead of noncash rent.

Jimmy Shan: Okay. So out of that $5 million roughly would be like a couple of million from those or--

Larry Froom: **--**Well, you could model it -- I think the easier way to model it is just take a high teens rent on those properties, based on their square footage. And that will give you NOI coming from those properties. Marking rents on the square footage would be the best way.

Jimmy Shan: Okay. Sorry, lastly, the Brampton industrial sale where the tenant exercised the option, do you have a lot of assets that are structured that way where they were able to buy -- I guess they were able to buy at a certain fixed price option?

Tom Hofstedter: We have two -- I wouldn't say a lot of assets, but we have chunky (sp). We have two other assets that have that option by the tenant where we expect, because of the increase in values of the building and land, that the tenant will be exercising their option. That won't happen for another couple of years now.

Larry Froom: And just a note on that - when that does happen and a tenant has an option to purchase, we limit the fair market value, our IFRS value to the asset purchase option even if the IFRS market value may be higher.

Tom Hofstedter: Right.

Jimmy Shan: Understood. Okay. Thank you.

Larry Froom: Thanks.

Operator: Our next question comes from the line of Sumayya Syed from CIBC. Please go ahead.

Sumayya Syed: Thanks. Good morning. Just firstly, on 69 Yonge, so now you have the amendment to convert it to residential. Just wondering what would be maybe the construction cost per square footage for an asset like that today?

Matt Kingston: Good morning, Sumayya. It's Matt Kingston. The construction cost for 69 Yonge is a bit higher than standard. It probably is going to be somewhere $100 to $150 a square foot higher than a traditional project just because of the heritage nature of it and the fact that it's a retention project. So it has an inherent premium.

Sumayya Syed: Okay. That's helpful. And then I guess, switching to the balance sheet, debt-to-EBITDA did tick up a little bit higher. Just wondering, Larry, where do you expect that to settle over the course of the year?

Larry Froom: Proceeds from Corus that happened post March 31st will be used to pay back debt, you should see that drop again. But overall, that's a short-term drop. And I think you should expect to see it stabilize at around 9.2x, 9.3x.

Okay. And also just wanted to confirm that the decline in occupancy and office, that was primarily all related to Kingsway?

Larry Froom: Primarily related to Kingsway but not solely related to Kingsway. There were other drops in occupancy, some tenants did vacate, some other properties. We had a 30,000 square foot tenant leave one of our other properties to be redeveloped. But it was mostly -- most of it came from Kingsway.

Sumayya Syed: Okay. Great. Thank you,

Operator: Our next question comes from the line of from Romel Sabat from Scotia Bank. Please go ahead.

Romel Sabat: Hey, good morning. So we noticed that we haven't done any buybacks over the last two quarters, and following the recent announcement of the dispositions, how do you view the appeal to restart NCIB versus paying down debt?

Tom Hofstedter: We're open to the NCIB, but at this point in time, we're protecting our balance sheet, so we don't expect to be engaging in the NCIB.

Romel Sabat: All right. Makes sense. Thank you. My next question is related to the new Lantower, the new disclosures on the residential portfolio. So is there -- is it possible to provide a little bit more color on the leasing spreads that you're seeing right now?

Emily Watson: Sure. What in particular questions do you have - in between renewals or--

Romel Sabat: --Yeah, like the renewal, new leasing spreads, mark-to-market?

Emily Watson: Sure. We -- pretty stable. We had about a 60% basis point improvement over Q4, which is really seasonality. And Q2 is off to a much better start. Actually, where we're seeing flat.

So Q1 was down around 2% of our lease spreads, but flat for Q2. So we're getting a little bit closer into our leasing peak season and moving into kind of where we see the height of our traffic. So I expect that to really be about the same in Q2, Q3. About the same deliveries every single quarter. There's some volatility to there, but it's pretty stable across the four quarters. So come back down in maybe Q4, but Q2 and Q3, expect them to be pretty flat.

Romel Sabat: Okay, makes sense. Thank you for this. My last question is related to the residential portfolio, too, and also the whole portfolio. So we just wanted to know if it's possible to give us your expectations on SPNOI growth for this year.

Larry Froom: This is Larry. We haven't given any guidance, and we want to kind of stay away from giving guidance. Some other issuers have been caught giving guidance which landed them in all sorts of trouble, and we just don't want to go there.

Romel Sabat: Perfect. No worries. Thanks, Larry. Appreciate it. That's it for me. I'll turn it back.

Larry Froom: Thank you.

Operator: There are no questions at this time. Mr. Tom Hofstedter, please go ahead.

Tom Hofstedter: Thanks, everybody, for joining us. Have a great day.

Operator: Ladies and gentlemen, this concludes today's conference call. Thank you for your participation. You may now disconnect.