H&R REIT

Q2 2024 Conference Call

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9:30 AM

Operator: Good morning, and welcome to H&R Real Estate Investment Trust 2024 Second 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 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 the 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 at www.sedarplus.com. I would now like to introduce Mr. Tom Hofstedter, Chief Executive Officer of H&R REIT. Please go ahead, Mr. Hofstedter.

Thomas Hofstedter: Thank you, and good morning, everybody. Joining me today are Jason Birken, VP of Finance, and Emily Watson, Chief Operating Officer of Lantower. Larry Froom cannot be with us today. He's traveling. On that note, I'll hand it over to Jason.

Jason Birken: Thank you, Tom, and good morning, everyone. I'm very excited to be here today. In my comments to follow, references to growth and increases in operating results are in reference to the three months ended June 30, 2024, compared to the three months ended June 30, 2023. H&R's total same property net operating income on a cash basis increased by 1.7%. Breaking the growth down between our segments, Lantower, our Residential division, recorded a 0.3% increase, which was primarily driven by the stronger U.S. dollar. Emily will provide more details on this shortly.

Industrial same-property NOI on a cash basis increased by 4.7%, driven by rent increases for new and renewed tenants as well as an increase in occupancy. The tenants at our two newly completed industrial properties totaling 336,800 square feet in Mississauga are in occupancy, their free rent period has ended and are now paying rent. We have started construction on three new industrial developments totaling 357,500 square feet at H&R's ownership share. The average rent on our Canadian industrial portfolio at June 30, 2024, was $8.97 per square foot and is well below market rent, which bodes well for our industrial portfolio continuing to deliver strong results. During the quarter, we completed four industrial lease renewals totaling approximately 227,000 square feet at H&R's ownership

share and achieved an average rent increase of $7.73 per square foot.

Office same-property NOI on a cash basis decreased by 1.8%. This decrease was largely attributable to a decrease in occupancy at our properties slated for future redevelopment. Our office properties are in strong urban centers with a weighted average lease term of approximately 6.3 years and leased to strong creditworthy tenants with 88.5% of office revenue coming from tenants with investment-grade ratings.

I would like to draw investors' attention to the 7.9% cap rate on our remaining nine Canadian office properties that are not slated for redevelopment. The cap rate jumped from 7.08% last quarter, primarily due to the sale of Corus. We also increased the cap rates on our remaining three U.S. properties from an average of 7.68% last quarter to an average of 9.02% this quarter. And lastly, retail same property NOI on a cash basis increased by 7.9%, primarily driven by increased occupancy at River Landing Commercial.

In accordance with our strategic plan, we have sold $800 million of property in 2023 and the first six months of 2024. We are very pleased that, despite these property sales and the headwinds facing the real estate sector in general, Q2 2024's FFO was $0.306 per unit compared to $0.297 per unit in Q2 2023. H&R's cash distributions of $0.15 per unit for the quarter

resulted in an FFO payout ratio of 49% and an AFFO payout ratio of 61%.

Net asset value per unit as at June 30, 2024, was $19.94 per unit, a decrease from $21.05 as at March 31, 2024. This was attributable to $427.2 million of fair value adjustments during Q2 2024. Debt to total assets at the REIT's proportionate share at June 30, 2024, was 44.8% and debt-to-EBITDA was a healthy 8.5x. Liquidity at June 30, 2024, was in excess of $900 million with an unencumbered property pool of approximately $4.1 billion. Our unencumbered assets to unsecured debt coverage ratio was 2.2x at June 30, 2024. And with that, I will now turn the call over to Emily.

Emily Watson: Thank you, Jason, and good morning, everyone. Today, I'm pleased to discuss our second quarter same-store results from our multifamily platform and share some operational highlights. Our strategic focus is on positioning our portfolio to drive long-term value through geographic diversification, a robust development pipeline, repositioning opportunities, and technology investments aimed at mitigating costs, delinquency, and associate turnover.

Our markets continue to experience strong demand for household formation driven by population and employment growth, apartment affordability, and positive demographic trends. Move-outs due to home purchases remain at historical lows in our

Sunbelt markets, accounting for just 9% of our total move-outs. Renting an apartment remains an attractive choice being, on average, 60% more affordable than owning a single-family home. Our target renters are high earners with stable employment, which continues to support positive housing performance.

We have seen improvement from our technology innovations with delinquency as one example at pre-pandemic levels and bad debt in the sunbelt returning below the 50 basis points norm. These factors combined contribute to a 58% NOI margin with room for future growth. Given the declining levels of new supply ahead and consistent demand in our markets, combined with the strength of our operating platform, we are well positioned for substantial growth and value creation in the coming years.

Occupancy ended the quarter at 94.6%, an increase of 20 basis points from the first quarter and a 50 basis point increase compared to Q2 of 2023. Same-property net operating income on a cash basis from our portfolio in U.S. dollars decreased by 1.2% for the three months ending on June 30, 2024, compared to the respective 2023 period, primarily due to higher property operating costs, including property taxes and insurance costs and a decrease in average rental rates from the sunbelt properties, which was partially offset by rental growth at Jackson Park in Long Island City, New York and River Landing in Miami, Florida.

Lantower's asset management team oversees capital expenditure deployment and one highlight of our repositioning capital is Tortuga Bay in Orlando, Florida. Over half of the units have received kitchen, bath, and flooring renovation with around a 13% return on investment. Other projects include smart home amenity package with a 30% return, washer and dryer additions with a 55% return, and private yards at a 50% return on investment.

Moving to our fair market value, based on recent sales comparison, our fair market value capitalization rate for the residential portfolio is 4.55%. We maintain a 5% cap rate for our sunbelt portfolio, which was further supported by a third-party appraisal received in Q2. Cap rates are expected to remain low, relatively speaking, for institutional quality assets in the sunbelt with capital flows interested and focused on long-term heavy sunbelt multifamily allocation.

Turning to development. Lantower West Love in Dallas, Texas remains on schedule and on budget. We expect to be fully delivered by the end of Q3 with stabilization in Q2 of 2025. Leasing commenced mid-April, and we are currently 31% leased, reflecting strong demand. Our thesis for securing great sites and designing best-in-class products has materialized in a strong initial lease-up at West Love. Our lease-up absorption is

well above what industry reports have stated for our market and is above what is budgeted.

Also in Dallas, Texas, Lantower Midtown is progressing well. The first units are prepared for occupancy with final units expected by the end of the year. We received our first certificate of occupancy earlier this month, and we are encouraged by the high traffic volume of traffic in a short amount of time, a validation of demand for best-in-class product with unparalleled amenities.

On the REDT front, as we discussed last quarter, the investor interest to invest alongside Lantower's existing development pipeline was highlighted by accelerated fundraising results and we feel that this construct will create value for H&R shareholders as well as our REDT investors, while maintaining financial flexibility and taking advantage of a favorable depressed sunbelt supply pipeline in the upcoming years.

We broke ground on both Lantower Sunrise, a 330-unit development in the Orlando market, and Lantower Bayside, a 271-unit development in the Tampa market, in the second quarter, and they are progressing as expected. We expect these developments to reach completion mid 2026, which we believe to be an excellent time to deliver units. Lantower currently has an additional eight development projects in the Sunbelt pipeline

totaling over 2,700 suites at H&R's ownership interest with multiple sites ready and prepared for construction. In summary, the Lantower platform continues to deliver top tier results relative to our multifamily counterparts.

I would like to extend my heartfelt thanks to the entire Lantower team as we proudly celebrate our spot on the 2024 Fortune's best places to work in Texas list. This award is a testament to Lantower being an employer of choice that is adaptive, resilient and innovative. And with that, I will turn the conversation back to Tom.

Thomas Hofstedter: Thanks, Emily. And with that, I'll turn it over to the operator for questions. Operator?

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 prompt that your hand has been raised. Should you wish to decline from the polling process, please press "*" followed by "2." If you are using a speakerphone, please lift the handset before pressing any keys. Your first question comes from Sam Damiani from TD Cowen. Please go ahead.

Sam Damiani: Thanks. Good morning, everyone. Tom, just wondering what your thoughts are on the sort of the acquisition market, disposition market currently versus last quarter? What

change you may have seen and how you see the market unfolding for the balance of the year as it relates to the REIT’s intention to dispose more assets?

Thomas Hofstedter: Sam, good morning. We knew that would be your question. You highlighted that in your report last night. The write-down has really nothing to do with the disposition market. It has to do with the strength of the current value of the asset. There is a very little going on, as you well know, with as far as dispositions as far as being able to target what a price will be or won't be. So, we don't really have, in this market because it's still weak, we don't really have guidance to give you what our future sales are going to look like. But the write-down is really reflective of what's going on in the market today.

And what's going in the market today is really very little. That being said, take an office asset for example, if you evaluate your asset based upon the present value of the cash flow and the terminal value and your terminal value is static, as time marches on, you have to write down the asset for the fact that you're taking in income, and you don't know what the extension is going to look like. Not only do you not know what extension of the lease is going to look like, you don't know what the terminal value at the end of that is going to look like.

So, bottom line is, if the market doesn't improve, in office, you have to take down or write-down, periodically, unless you see some form of a turn in the market. That can happen also because of interest rates and interest rates, hopefully, will come down by the inflation and tackle to a great extent. But until that does, they warrant a write-down.

The land value, which involves our intensification properties, the Cove & Gowanus also reflect the current market where nothing is going on. And as you all know in downtown Toronto, there was supposedly going to be a deal for 212 King that never happened, never materialized. We're hoping that was going to be the $160 a foot and nothing happened there. We have no visibility as to what the trade looks like. But just to be conservative, we took everything down by $10 a foot in Canada, $10,000 a door in the United States to reflect the fact that there's very little going on.

The reason there's nothing going on is because everyone is building to a 7-yield return on cost. In order to achieve that with the construction costs and interest rates where they are today, something has to give. And what gives, obviously, is the one element that has to give is the value of land. So, you have to take the value of land to reflect the fact that people are going to ultimately have to get to 6.75% to 7% deal, and the only way to do that is through land reduction. So, this doesn’t

reflect our desire necessarily to change the fact that it's easier for us to sell down the road. It reflects regretfully reflects the modest current conditions and what--where we see the world today.

Sam Damiani: Thank you for that. And just with what you said and the REIT's overall strategic objectives over the sort of medium term, does it pivot your attention more towards the retail portfolio as a source for dispositions at this time?

Thomas Hofstedter: So, I don't think so. I think that's like--I don't know, something in the market that I can't understand, to be honest with you. The REIT, our portfolio, unlike many other portfolios, it's not speculative, it's not dangerous. There's nothing--it's almost irrelevant what the expiry schedule is. We have total visibility into ECHO as to what stores are doing well, the lease term to that sister company to the real estate arm where we own a piece of.

And as far as the Canadian retail portfolio, that's as good as you're going to get as far as getting a clipping with solid real estate. And really, you don't have to worry about lease expirations. That being said, there's no urgency to sell those. And that's highly liquid to sell any time you want, giving us those assets in today's environment, which those assets are all really reflection out of the economy, a reflection on interest

rate doesn't make a whole lot of sense. We'll wait until interest rates come down a bit.

So, in the case of ECHO, we have someone looking at it, but if the prices are not going to be to our expectation and on the Canadian side, if someone comes forward with an offer that reflects tomorrow's value, not today, and again, today's Capex are elevated because of interest rates, then we'd look at selling it. There's no burning issue to sell these assets at this point in time, not when you're giving up good cash flow, good FFO in return for what? For selling at a high cap rate, because interest rates are high? Doesn't make a ton of sense. We don't feel the pressure to sell, in other words.

Sam Damiani: Okay. Last one for me. I think last quarter, there was a comment probably from Larry that the debt-to-EBITDA would stabilize around the 9.25% level before any additional disposition announcements. Is that still the outlook for the end of the year?

Jason Birken: Hi, Sam. As you know, in the MD&A, we use the trailing 12-month EBITDA. But if you annualize Q2, that ratio would be around 9.2x.

Sam Damiani: Perfect. Thank you.

Jason Birken: Thanks, Sam.

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

Jimmy Shan: Thanks. So, when it comes to portfolio trades, there are trades happening in the multi-res--U.S. multi-res sector. I was wondering if you guys looked at those the KKR, Quarterra deal and Blackstone and wondering how comparable would those portfolios be to the Lantower portfolio?

Thomas Hofstedter: Good morning. Hi, Jimmy. So, let's take KKR as an example. They reported last quarter just now, I think a week ago or something that they sold that--that they pitched that portfolio, 5,000 units, call it, $1 billion, if I recall correctly, and they reported it a low 4s cap. That put a little question to the market, why that 4 cap and how does it compare to Lantower?

The answer to the question is very similar in geography, very similar in age, but let's call it, 18 stories instead of our stick build 3 stories. But that's not a huge difference. The explanation needs to explain why they are a low-4 cap and why we're a 5 cap. And the answer lies in the fact that KKR didn't buy their assets for their portfolio. They bought them on behalf of an insurance company, whereby the money that has to be spent by the end of June, otherwise, they would have lost that allocation.

So, they were kind of anxious to spend it. They actually bought it at a 5.2 cap and if you asked the question, well, leverage is at 5, therefore, it should be neutral to their

overall return initiatives return on cash around 5, why is it low 4s? And the answer is to the asset management fee is embedded in the KKR’s charging of that portfolio for asset management fee maybe down to low 4s.

So that's not a reflection of--that's a reflection endorsement of H&R's--Lantower's cap rate overall to 5 and the noncompetitive nature of asset managers, because of their fee structure, that brings it down so low. But again, KKR just really didn't care. They're managing that money on behalf of an insurance company. And the insurance company agreed to pay their fees. Therefore, that insurance company is getting a lower yield, not reflective of the market, which is at 5.

So those trades really endorsed a low 5s cap, and I think it's pretty solid and Emily can tell you trades that have gone on--there's around 6 of them in our markets that all were around 5.1, maximum 5.2 in and around that. So, all those trades confirm--validate, rather, our 5 cap.

Jimmy Shan: Okay. No, that’s helpful. And I mean, low fives, that sounds like good pricing. And so I know it's not in your strategic plan, but given these type of prices and what appears to be some level of interest, does it make you kind of rethink about Lantower? And could that be a candidate for sale down the road? And how are you thinking about Lantower here?

Thomas Hofstedter: So Lantower is a very, very solid asset, very, very solid platform, very solid management group. It really doesn't change anything. The markets all concerned about the fact that there's a whole bunch of units going to be ready. The 100,000 units that have been built in our market and sunbelt markets and the cost pressure on rent. We look at it completely differently.

We look at the fact that right now, there is some pressure on rent. Those units are going to get absorbed in our markets sometime mid to end in 2025, 2026, the rents are going to go way up against the supply and demand. Good balance, but you're not--no one's building anything. And as I mentioned before, no one's building anymore because they have to build to a 6.75% to 7% yield return on cost, and that's not really doable in today's market very easily. Your land cost really has to be brought down. You have to buy your land well, and your land has to be ready to go.

Lantower is a solid company, and it's a keeper. So, it doesn't make sense to go ahead and increase your exposure to office by spinning off Lantower. You may get a good price for Lantower, but again, the remaining--what's behind is going to suffer. I think we're going to more prudently stick to our original strategy, which is slowly, but surely to deal with our office, which, in our opinion, have value when the residential

market returns as an ulterior user for the intensification properties. And for our three or four core office buildings, they're sticky tenants, and we expect to renew them and be able to sell the properties at that time. So, we'll stay the course and Lantower is, therefore, going to be one of our keepers and ultimately, we're going to we achieve the result of having an industrial/residential REIT.

Jimmy Shan: Okay. Last one for me. Chevron made an announcement that they will move their headquarters to Houston. I just wondered, does that mean anything at all for Hess Tower? Does that mean anything at all for potential sale of Hess Tower?

Thomas Hofstedter: So, it just adds more confusion to what's going on over there. The courts haven't put down their ruling what's with the Hess sale at all. So that--we expect this coming in November, but my guess is that it will drag, as these things usually do. If Chevron buys Hess and is successful, then Chevron has to make the decision where they want to be located. They have space within their existing tower.

They have made the announcement they're moving headquarters to Houston, which means they probably roll space into Hess and keep Hess. Until this is all resolved, we have no idea what's going on. If the court case goes against them, Hess does not have saleable asset anymore. Hess can't be sold to Exxon and

Hess can't be sold to Chevron. Hess will remain a going concern as it will remain in the building the way it is.

In either event, it really doesn't have any impact at all on us and our strategy for Hess Tower. We are currently dealing with one-third of the role that--building roles for 2026. I think successfully, we're very confident that we'll achieve our objective to have that lease and then we have another 12 years to go with Hess.

We are very confident with that building. We're very confident with our TransCanada joint venture, TransCanada tower, TC Tower in Calgary with HOOPP and 2 Gotham. Those are all sticky tenants. We expect the tenants to renew. We expect them to be there long term. We just don't know what the rental rates will be.

So again, the Hess situation with Chevron is, I guess, good news that Chevron is consolidating in Houston. It can't be bad news. We just don't know the final outcome. Until you know the final outcome, you can't rally sell the asset, because every buyer is going to be asking the same question as you did, where is Hess going to be located? It has a strong impact on the long-term value of the asset. And so therefore, right now, it's re-leasing the space that will come up in 2026, and I think successfully so. And then we'll see what happens in the next few months with the Chevron-Hess situation.

Jimmy Shan: Okay. Thank you.

Thomas Hofstedter: Thanks.

Operator: Thank you. There are no further questions. I'll turn the call back over for closing comments.

Thomas Hofstedter: Thank you, everybody, and enjoy the summer.

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