RPT REALTY
Q3 2018 Earnings Call Transcript

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PRESENTATION

VINCENT CHAO
Vice President of Finance

Good morning and thank you for joining us for RPT's third quarter 2018 earnings conference call. At this time, management would like me to inform you that certain statements made during this conference call, which are not historical, may be deemed forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995.

Additionally, statements made during the call are made as of the date of this call. Listeners to any replay should understand that the passage of time by itself will diminish the quality of the statements made. Although we believe that the expectations reflected in any forward-looking statements are based on reasonable assumptions, factors and risks that could cause actual results to differ from expectations are detailed in the third quarter press release.

I would now like to turn the call over to President and CEO, Brian Harper and CFO, Mike Fitzmaurice for their opening remarks, after which we'll open the call for questions.

BRIAN L. HARPER
President, CEO & Trustee

Good morning and thank you for joining RPT's third quarter 2018 earnings call. This morning, I would like to review highlights from our third quarter results, recent accomplishments and our rebranding. I will then take a few moments to highlight a few of the assets that we believe are significantly undervalued in our portfolio. I will then re-cap our go forward strategy, provide details on our disposition plan, and will close with benchmarks to evaluate our progress as we execute on that strategy. Mike will then discuss our third quarter results in more detail and provide an update on our outlook for the balance of the year.

We are pleased with our third quarter operational results, which represent a strong start as we execute our plan to unlock significant embedded value. We reported same property NOI growth of 2.2%, increased our leased rate by 30 basis points for the quarter and increased our small shop leased rate by 90 basis points. We signed approximately 460 thousand square feet of leases, at releasing spreads on comparable new and renewal leases of 13.1% and 4.3%, respectively. We also continued to simplify our balance sheet by completing the sale of a property held in joint venture and made further progress on our active redevelopment projects as well as our entitlements for planned projects.

We also implemented a number of significant operational and process changes here at RPT, during the quarter. We assembled a first class leadership team and thoughtfully, but quickly developed a short-term strategic plan to capture near-term growth. We improved internal governance to promote interdepartmental collaboration and streamlined the organizational platform resulting in $2 million of annual cash savings that should be fully in the run rate by the fourth quarter of 2018. We mined the portfolio for growth opportunities and identified a half dozen assets where we see substantial redevelopment upside, with relatively limited impacts on current rental streams.

Next, I want to touch on the rebranding of the company that we announced yesterday morning, which we believe marks the start of a new era for this entire organization. The new name of RPT Realty represents a clean start on a new chapter in the company's long history. In conjunction with the rebranding, we have moved our corporate headquarters to New York city, a move that is already paying dividends regarding greater access to our tenant, investor, and banking constituents.

As we noted last quarter, we believe our portfolio is significantly underappreciated and therefore undervalued. Having previously outlined some of our redevelopment opportunities within the portfolio, let me now take a few moments to highlight a few of the key underappreciated operating assets here at RPT. As we look to reshape our portfolio to improve our long term growth profile, we believe these assets provide a strong foundation given their attractive demographics, strong in place tenants and high productivity.

Our Town and Country Crossing asset in Town and Country, Missouri is located in an affluent St Louis suburb with immediate household income of 134k. The center is anchored by Whole Foods, Target and Home Goods and we are re-merchandising the center to fit the adjacent demographics. This will happen as tenants' leases roll but suffice to say we have more demand than we have space. We recently opened Athleta, and they told us that it was one of their best openings in company history.

Let's talk about the Woodbury Lakes asset, located in Minneapolis. This center is anchored by Trader Joes, as well as, a recently opened Alamo Drafthouse and H&M. We are currently 90.6% leased so we have room to drive occupancy with higher productivity tenants given all the recent leasing momentum. One example of this is Sephora, who opened in October of this year.

We also own Market Plaza, located in the higher end Glen Ellyn neighborhood of Chicago. This center is anchored by a Jewel Osco grocer doing north of $800 psf. The center is nearly 97 percent leased today.

At Nagawaukee Center, a 100 percent leased center in suburban Milwaukee, 3-mile HH income is $143k. This center is anchored by a high-volume Sentry Foods as well as Sierra Trading Post, Homegoods and Marshall's. As at Town and Country, this is another center where we have more demand than space.

And finally, at River City Marketplace, a super-regional center in Northern Jacksonville, tenants range from Walmart, Lowe's, Old Navy and Regal Theaters. Volumes are high here as is the daily traffic. This is a center that will just continue to get stronger and stronger as the growth in the market is headed north.

Turning to our strategy as we look ahead. On a go-forward basis, our strategic focus is,

- executing on our disposition plans
- de-levering the balance sheet
- leasing up our small shop occupancy
- preparing our redevelopment pipeline

The key to our broader plan is the disposition program that will fortify our balance sheet for the first wave of redevelopments that we expect will start sometime in late 2019 as our redevelopments take form, these disposition proceeds will ultimately be redeployed into the accretive projects that will be a combination of densification, mixed-used, and outparcel developments, where we believe we can earn attractive current returns with higher long-term growth profiles. Throughout this process, Tim Collier, our new EVP of leasing, and his team will be laser-focused on driving small shop occupancy.

In order to hit our 5.5 to 6.0x net debt to EBITDA target, we are planning to sell between $150 to $200 million of assets located in secondary and tertiary markets where we currently do not have scale. We continue to expect to complete the process by the end of 2019. In addition to reducing our leverage, these sales will improve our tenant credit, strengthen our geographic profile, and reduce portfolio management inefficiencies.

We expect pricing to be in the 8-9% range for the open-air centers that we plan to sell. We are already active on the marketing front, and based on early interest, we hope to complete our first wave of sales in early 2019. While we won't fire sale the assets, we are working on the dispositions with the same sense of urgency that pervades the rest of our business.

It is important to keep in mind that these sales will be dilutive to our 2019 and 2020 earnings as proceeds will initially be used to repay debt, before being redeployed into much more accretive redevelopments. Though our focus will be on value creation, we are sensitive to near term earnings impacts and we will thoroughly vet every penny of dilution to understand what we are getting in return.

On this front, the assets that we expect to sell have an average ABR per square foot of over $11.50, an average HH income of $74,000 and average population density of 60,000 within a 3-mile radius, and have produced an NOI CAGR of 0.8% over the past 3 years. This contrasts sharply with a nearly $16 ABR per square foot, household income of nearly $100,000, population density of 78,000 people and annualized NOI growth of 3% for the remaining portfolio. As you can see, the sale of these assets will improve the risk profile of the remaining portfolio's cash flows and will ultimately fund attractive redevelopments where we believe we can further strengthen the growth and risk profiles of the future earnings stream.

Turning to benchmarking, I wanted to provide you with several of our own internal benchmarks that we are tracking closely to measure progress against our initiatives.

1) Our leverage level: As we sell assets, our leverage level should fall to the 5.5x to 6.0x range, a clear indication of our success on the disposition front.

2) Small shop leased rate: Clearly, this will be an internal focus that provides us with the best risk-adjusted return on capital. Look for us to drive small shop occupancy from the 88.1% on a signed basis in the 3rd quarter to the 91-92% level over the next 2-3 years. We continue to expect to end 2018 in the mid-to-high 88% range. Keep in mind that every 100bps increase in shop occupancy equates to about $800K of additional NOI or about 50bps of SS NOI growth.

3) SS NOI growth: As we sell lower growth assets, drive shop occupancy, and increase our average contractual rent bumps, this should translate into higher and less volatile same store NOI growth.

4) Redevelopment updates: We will keep you posted as we move through the entitlement process at our key redevelopment assets, and will share both project scope, size, and return expectations as they are formalized.
Something that is important to share is that these are redevelopments that will have minimal NOI disruption during construction with attractive spreads between our expected development yields and current cap rates that will create significant value for our shareholders.

To be clear, all the initiatives support our strategic plan, and are designed to improve both the sustainability and growth of our cash flows, which will ultimately be evident in our NAV, FFO, and AFFO performance. Though our quarterly results will not always reflect the progress being made in real time, given our portfolio size and lead times for our initiatives to take hold, we believe the fruits of our initial labor should be more visible in 2019. If we execute on our plans and communicate our progress effectively, we believe this should translate to both a higher multiple and better long run growth supporting an attractive shareholder return.

With that I will now turn the call over to Mike Fitzmaurice, our CFO, to discuss our third quarter results and provide an update on our outlook for the balance of the year.

MICHAEL P. FITZMAURICE
Executive VP, CFO & Secretary

Good morning. Before I discuss our third quarter results, I'd like to take a moment to thank our sell-side research and current and prospective investors for taking the time over the last several weeks to meet with Brian, Vin and me to discuss RPT's new strategic direction. Your support and insight have been invaluable, and we look forward to continuing our dialogue over time.

Now let's turn to our third quarter results. Operating FFO for the quarter was $0.32 per share compared to $0.34 per share in the same period in 2017. The decrease in operating FFO was driven by a decrease in NOI from other investments of $0.03 per share primarily related to our 2017 asset sales, partially offset by a decrease in interest expense of $0.01 per share. Nonoperating items this quarter were related to non-recurring charges largely associated with the former executive management team of $1.6 million and severance costs of $850,000 related to our previously communicated reduction in force that we experienced in late July.

Same property NOI growth with redevelopment was 2.2% in the third quarter. This was driven by a contribution of 210 basis points from minimum rent and 30 basis points from recovery income, net of recoverable and non-recoverable expenses. These items were partially offset by 20 basis points from higher bad debt expense. As expected, our growth was negatively impacted by 110 basis points, or $500,000, due to the termination of our two Toys "R" Us leases. We have already backfilled one of our locations, which is expected to come into occupancy in mid-2019, and the remaining site is at an asset that we expect to sell over the next year.

Turning to 2018 guidance and related assumptions. Similar to last quarter, we have excluded asset sales from our guidance assumptions. If we were successful on closing a portion of the $150 - $200 million of identified dispositions by the end of the year, it will be negligible to 2018 earnings. We are lowering the high end of our operating FFO guidance range by two pennies; our new range for 2018 operating FFO guidance is $1.35 to $1.37. This one penny reduction at the mid-point was primarily the result of a higher estimated weighted average share count attributable to an assumed above-target payout ratio for 2018 equity-based performance awards. This was largely based on our relative stock outperformance during the third quarter. Also, we tightened our assumption on our same property NOI with redevelopment growth to a range of 2.25% to 2.75%, up 25 basis points at the midpoint, or approximately a half penny. This was offset by a modest increase in G & A expense as we also tightened up our G & A expense range up roughly a half penny at the midpoint. As for the cadence of same property NOI with redevelopment, we expect to accelerate into the fourth quarter, which is largely driven by the lease-up of vacant anchor locations. Of note, at quarter end, we had approximately 340 basis points of signed not commenced space, representing $6.3 million in economic ABR, of which $2.5 million will be commencing rent during the fourth quarter. The remaining amount of $3.8 million will commence ratably over the course of 2019. And to touch on Mattress Firm, three of our nine leases have been rejected, which will impact our same property NOI with redevelopment growth by 20 basis points in the fourth quarter, or $80,000.

As you begin to model 2019 earnings, I'd like to point out a couple items. First, the mid-point of our updated 2018 OFFO guidance range implies a fourth quarter run rate of $0.32 per share. Second, as Brian mentioned earlier, we expect to utilize the asset sales proceeds of $150 to $200 million to lower leverage. The weighted average cap rate for the open-air centers that we sell will be between 8.0% to 9.0% and the debt we expect to prepay will have a weighted average interest rate of between 3.00% to 3.50%. By the end of 2019, we expect our net debt to EBITDA to be 5.5x – 6.0x and our floating rate interest rate exposure will be close to zero percent. Our balance sheet will be well positioned to support our growth initiatives. As an update to the new lease accounting standard that is set to take effect on January 1 of next year, we are still evaluating how this expense will be allocated between G&A and operating expense within NOI. Though, we continue to expect to have an approximately four cent impact to FFO in 2019.

As indicated on our second quarter conference call, one of RPT's mandates is to provide best-in-class transparency and disclosures. On this front, we have made several updates to our supplemental disclosure. Our occupancy rate now represents economic occupancy versus physical occupancy as reported historically. A five-quarter look back will be provided in our third quarter 2018 investor presentation that will be posted to our website. On pages 23-26 of our supplemental, we added property categories to the portfolio detail report to help you understand how we categorize our assets. Also, on the bottom of page 8 of the supplemental, we consolidated our capital expenditure information to help our sell side research and investors model AFFO. And finally, we removed ABR per square foot excluding ground lease disclosures to simplify and focus attention on total company economics that include ground leases. There are a number of other smaller changes in the supplemental that will help facilitate your analysis of our results. As always, we welcome any feedback you have on how we can continue to improve our disclosures.

With that operator, please open the line for questions.

QUESTION & ANSWER

OPERATOR

[Operator Instructions] Our first question comes from Derek Johnston with Deutsche Bank.

DEREK CHARLES JOHNSTON
Deutsche Bank AG, Research Division

Could you share some more details on the small shop leasing efforts? With a 90 basis point increase to the lease rate in the quarter, what do you think is driving success there? And are there any notable leasing trends that you're seeing on the ground that you can share?

BRIAN L. HARPER
President, CEO & Trustee

Derek, thanks for your question. We do believe we can get to 91% to 92% on the 88%. We have put governors in place such as lease committees that meets every Monday at 9:00 a.m. We have a legal tracking call going suite by suite. We also have pipeline calls going space by space. The sense of urgency has been felt through all disciplines within the organization, as well as the retailers. From -- I am seeing some good tailwind with -- among the retailer mix. We mentioned Athleta, we're doing a number of deals with them. We opened a Sephora in Minneapolis. We're doing a lot of business with the TJ folks as well as Ross as well as a number of restaurants, both national and regional, and fitness users as well. So I've been very, very pleased with the effort that's been implemented here.

DEREK CHARLES JOHNSTON
Deutsche Bank AG, Research Division

Great. And as a follow-on for me, can you just discuss the new leasing statistics in the quarter, specifically that the TIs per square foot cost were, I think, over $44. Some color on the previous and new tenant. It does look like the previous rent for the space was pretty high, so seems like a newer lease that was being replaced. So I'm just wondering if that space would need so much work, and if this is a one-off or a trend that may continue into 2019.

BRIAN L. HARPER
President, CEO & Trustee

There's good in this number. Yes, it was the elevated high TA but the average rent on these deals was a little over $34. We even had one north of $50. Some were fitness, some were small restaurant users. But the key thing on this, Derek, is the payback was less than 2 years. So it was a good investment and right merchandising strategy for each center.

MICHAEL P. FITZMAURICE
Executive VP, CFO & Secretary

Yes, and the only thing I would add, Derek, is that I would also note that we did see an increase in our cost for tenant improvement and leasing-related costs during the quarter, which is related to formerly occupied, bankrupt tenants such as Gander, Toys, Kmart, and Sports Authority. And we'll continue to see the same dynamic as we move into remaining part of this year. And then in 2019, we'll continue to have a transitional outsized CapEx year, and then we'll begin to moderate in 2020. And the only other point that I would make is, this also underscores the importance of reducing our leverage, down to 5.5x to 6x to put us in an offensive position as we continue to put accretive capital into leasing where we can achieve our highest returns.

OPERATOR

Our next question comes from Craig Schmidt with Bank of America.

CRAIG RICHARD SCHMIDT
BofA Merrill Lynch, Research Division

What would be a normalized projected cost for your redevelopment pipeline as you work your way through 2019?

BRIAN L. HARPER
President, CEO & Trustee

I think, Craig, we're going to get back -- go to that number on the development spend -- already, we've been -- we act with urgency. I've seen 95% of assets. We've identified 6 assets for, really, marquee densification properties. We've worked with premier and are working with premier architects. We're finalizing those plans. And we're going to start the entitlement process maybe even as soon as the end of this year. We'll keep everybody updated on the spend as we finalize the plan.

MICHAEL P. FITZMAURICE
Executive VP, CFO & Secretary

Yes. And as you move into '19 and we prep for these bigger densification properties for redevelopment, the spend in '19 will be muted as it relates to 2018, maybe up to $10 million. But again, as Brian noted, we'll share more details on our long-term vision for redevelopment cost on the fourth quarter call.

CRAIG RICHARD SCHMIDT
BofA Merrill Lynch, Research Division

Great. And then how many shares were awarded for the 2018 equity base performance?

MICHAEL P. FITZMAURICE
Executive VP, CFO & Secretary

The increase in the share count, as you probably saw in the press release last night, Craig, was due to the reevaluation of those 2018 inducement awards. The increase in share count was about 500,000 shares. Now you should not see the share count increase because the payout ratio associated with that is now capped at about 200%. But it could ratchet down, of course, but it is capped. Right now, you shouldn't see that number increase going forward because of those awards.

OPERATOR

Our next question comes from Collin Mings with Raymond James.

COLLIN PHILIP MINGS
Raymond James & Associates, Inc., Research Division

First question for me. You discussed in the press release the difference between signed, but not commenced rent. Just other landlords have discussed some of the delays of actually getting tenants into the space and paying rent. Can you maybe just touch on what you're seeing on that front?

BRIAN L. HARPER
President, CEO & Trustee

I have been very, very pleased with our TC and construction team existing both predating me and with Jonathan's background in construction TC and development. We haven't had any snafus. And the speed has been, again, felt in this area and this department as well. And I mean, we've even seen tenants opening up a lot sooner. Hence, the hockey stick in fourth quarter.

COLLIN PHILIP MINGS
Raymond James & Associates, Inc., Research Division

Okay. And then moving -- just going back to the disposition guidance and appreciate again the detail there. But just on expecting kind of 8 to 9 cap. Just can you talk about how you view the cap rate spread between those assets and kind of what -- kind of what you're viewing as kind of the remaining core portfolio going forward?

BRIAN L. HARPER
President, CEO & Trustee

If you look at the non top 40 MSAs and look at the average deal size, let's say, of $20 million, and if they've talked about -- in my script -- just the demographics alone, that speaks volumes of the cap rates, right? And the average per square foot, ABR is drastically different than what's remaining on the portfolio. This is bottom of the barrel, if you will, of these dispositions and doesn't relate -- doesn't reflect at all of what's left.

COLLIN PHILIP MINGS
Raymond James & Associates, Inc., Research Division

Okay. And then just one other follow-up for me going back to the -- on Derek's question just on the small shop occupancy gain. Can you maybe just talk a little bit more? Kind of, internally is there incentive plan or things like that do you're using to motivate the team to hit some of those targets you've thrown out there? Are there some organizational changes that you've implemented to help drive that statistic higher? Just again, other details on that front would be helpful.

BRIAN L. HARPER
President, CEO & Trustee

Yes, Collin, I believe in just boots on the ground leasing; I believe in canvassing; I believe in just knocking on doors, not only for regionals, but for national tenants as well. Tim and I have hit the road and met -- have met with a lot -- a number of the larger national tenants, which has provided a lot of fruit. But also, as far as compensation, we're evaluating that currently and really wanted to be reflective of true appreciation of the asset, as opposed to just the deal itself. So boots on the ground, decentralized leasing and a really stronger emphasis on national portfolio reviews.

OPERATOR

Our next question comes from Todd Thomas with KeyBanc Capital Markets.

TODD MICHAEL THOMAS
KeyBanc Capital Markets Inc., Research Division

Just following up on the dispositions. I was just wondering if you could just talk about the depths of the buyer pool that you're talking to and working with here. And is it the expectation that you're going to transact on a one-off basis? Or is there an opportunity to do a little bit of a larger transaction and maybe sort of clear the deck a little bit?

BRIAN L. HARPER
President, CEO & Trustee

That -- right now, we're going through a one-off basis to just really maximize pricing. And we have seen -- I mean, while the assets -- it varies between asset. I mean, at the -- one asset was over 50 CAs. Another asset would be in the 20s from CAs. So that capital or those operators range from private equity to even some REITs, to even some regional and smaller private operators, just really depending on the deal size ranging from $20 million and higher.

TODD MICHAEL THOMAS
KeyBanc Capital Markets Inc., Research Division

Got it. And then the signed but not commenced bucket. So $6.3 million at the end of the third quarter. You have about $2.5 million of ABR expected to kick in, in the fourth quarter. I was just wondering if you could sort of decompose that in terms of what's incremental from an occupancy standpoint in terms of occupancy gains versus what's sort of captured in the renewal leasing activity, and sort of the spreads that we might be modeling.

MICHAEL P. FITZMAURICE
Executive VP, CFO & Secretary

Todd, this is Mike. I can give you some color on what the occupancy is for the remaining part of this year. Today, we're at -- on an economic business, we're at 90.8%. At the end of the fourth quarter we should be about 91.5%. If you look at the 250 midpoint that we have for same-store or same property NOI with redevelopment growth in '18, it is top line driven. Base rent contributes about 230 basis points, which is a combination of bump spreads and average occupancy gain. And then you also have a more modest decrease in bad debt expense of about 20 basis points. You add those 2 factors up, you're about 250.

TODD MICHAEL THOMAS
KeyBanc Capital Markets Inc., Research Division

Okay, that's helpful. And how much annualized base rent commence during the quarter? Was there anything sizable that we should think about making an adjustment for in terms of the run rate?

MICHAEL P. FITZMAURICE
Executive VP, CFO & Secretary

No, nothing sizable there. The only thing I would repeat from my prepared remarks is that Toys did cause some disruption during the quarter of about 110 basis points or $500,000. So that was a net detractor during the quarter.

TODD MICHAEL THOMAS
KeyBanc Capital Markets Inc., Research Division

Right. And what was the timing of that move out during -- that occurred during the third quarter?

MICHAEL P. FITZMAURICE
Executive VP, CFO & Secretary

Yes, it occurred during July. So the front end of the quarter.

TODD MICHAEL THOMAS
KeyBanc Capital Markets Inc., Research Division

Okay, got it. And then in terms of Toys and apologies if I missed this earlier. But can you talk about where you're at, the backfill opportunities and some of the details around the timing and rent spreads that you're looking at on those replacements?

BRIAN L. HARPER
President, CEO & Trustee

So one in Front Range is we replaced the Toys box with Urban Air, which was a flat renewal. We think timing on that will be a mid-'19. Jackson Crossing is our other Toys box. We're negotiating LOI's with a number of tenants and hope to have -- the goal is to have something papered within the next month or 2.

OPERATOR

[Operator Instructions] Our next question comes from Mike Mueller with JPMorgan.

MICHAEL WILLIAM MUELLER
JP Morgan Chase & Co, Research Division

Brian, when you were talking about the portfolio on a bunch of assets that you thought were underappreciated by the market. Curious what portion of the company do you think those assets that you flag represent? And then when you were making those comments, is it more along the lines of you think these are the lowest cap rate assets in the portfolio and folks are missing that? Or is it there is upside that people are missing? Just curious as to why those 5 or so were over flagged.

BRIAN L. HARPER
President, CEO & Trustee

I think there's just a number of factors here where -- as I'm spending a lot of time on the ground at these assets, one area that I love and is kind of misunderstood and underappreciated is Oakland County. I mean, this is 98% leased. Even in the depths of the recession, I think it just dropped to 94%. Monster Nordstrom Rack volumes in 2 centers, a grocery anchor in 1 center, major volumes. Then you go down to Florida, in Southeast Florida, particularly in Miami, every single center down there we have is grocery anchored. And we're seeing great rental spreads in there. Shops At Lane, which might be one of my favorite assets in Columbus, Ohio, very high-performing Whole Foods. And that's where we're looking at densification opportunities where either office or residential. I think that is the lion share of where these opportunities are and the Nagawaukees of the world, I wish I had more real estate to do more redevelopment there.

MICHAEL WILLIAM MUELLER
JP Morgan Chase & Co, Research Division

Got it, okay. And then, Mike, just a quick question. For your assumptions, are you assuming that dispositions occur ratably throughout 2019? Or should we be thinking front-end loaded or back-end loaded?

MICHAEL P. FITZMAURICE
Executive VP, CFO & Secretary

At this point, Mike, I would say it's more front-end loaded. It's the first half of the year.

OPERATOR

There are no further questions. I would like to turn the call over to Brian Harper for closing comments.

BRIAN L. HARPER
President, CEO & Trustee

I am extremely proud of what the organization has accomplished in a little over 4 months. And I'm excited about RPT's future. I want to end the call with a thank you to every RPT team member for their hard work and their dedication. Have a great rest of the day, and we look forward to seeing many of you at next week's NAREIT conference.

OPERATOR

This concludes today's teleconference. You may disconnect your lines at this time and thank you for your participation.