Alexander & Baldwin, Inc. Q2 2017 Earnings Conference Call Edited Transcript
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Participants:
Christopher J. Benjamin - President & Chief Executive Officer
James E. Mead - Chief Financial Officer
Suzy P. Hollinger - Director, Investor Relations
Paul K. Ito - Senior Vice President, Finance & Treasurer
Lance K. Parker - President, A&B Properties

Suzy Hollinger

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Aloha, and welcome to our call today to discuss Alexander & Baldwin's Second Quarter 2017 Earnings. With me today are our President and CEO, Chris Benjamin; Jim Mead, CFO; and Paul Ito, Senior Vice President, Finance. Lance Parker, A&B Properties' President will be joining us as well and will participate in the Q&A portion of the call.

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Before we commence, please note that statements in this call and presentation that are not historical facts are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 that involve a number of risks and uncertainties that could cause actual results to differ materially from those contemplated by the relevant forward-looking statements. These forward-looking statements include, but are not limited to, statements regarding: (i) the potential advantages, benefits and impact of and opportunities created by converting to a REIT; and (ii) expected future dividends to shareholders.

Such forward-looking statements are subject to certain risks, uncertainties and assumptions, including prevailing market conditions. Additional factors that could cause actual results to differ materially from those contemplated in the forward-looking statements include, without limitation, those described on Pages 13 to 24 of the company's 2016 Annual Report on Form 10-K and in other subsequent filings with the SEC, including the Form S-4 for Alexander & Baldwin REIT Holdings, Inc. that was filed with SEC on July 14, 2017. These forward-looking statements are not guarantees of future performance, and we do not undertake any obligation to update our forward-looking statements.

Management will be referring to non-GAAP financial measures during our call today. Included in the appendix of today's presentation slides is a statement regarding our use of these non-GAAP financial measures and reconciliations. Slides from this presentation are available for download at our website, alexanderbaldwin.com. Chris will open up today's presentation with performance highlights, and then turn it over to Jim who will provide some of his initial thoughts about the Company as he takes the reigns as CFO. Jim will be followed by Paul who will discuss financial performance and then we'll open it up for your questions.

With that, let me turn the call over to Chris. Chris?

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Chris Benjamin

Thank you, Suzy.

Good afternoon to our listeners and thanks for being on the call.

On our last quarterly earnings call I discussed our ongoing strategic transformation, including the growth of our commercial real estate portfolio and the increase in recurring income streams it generates. I'm excited about the tremendous progress we've made toward that goal, and we continue to pull levers that add value to the portfolio. We also are building momentum as we monetize more of our development pipeline, through sales of both existing inventory and select development parcels, and we're working to improve the performance of our Materials & Construction business. The Hawaii economy continues to perform well, providing a supportive backdrop for our operations.

In addition, we were excited to announce just a few weeks ago our REIT conversion, an important milestone in our company's evolution. And to help with the transition, we've added great talent to our board and management team.

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While I will defer to Paul to cover the numbers later in the call, our Commercial Real Estate segment had an excellent quarter, with a 4.7% increase in same-store NOI over last year's second quarter. Paul will describe some reallocation of and increases in G&A expenses that occurred as a result of our continuing shift to focus on commercial real estate. These changes impacted the operating profit comparison for the commercial real estate segment, but the underlying performance is excellent.

Our Hawaii retail portfolio performed well, especially Kailua Town, producing strong same-store NOI growth. Hawaii retail re-leasing spreads for the quarter were remarkable at over 35%, thanks in large part to an anchor lease renewal with Regal Cinemas at Pearl Highland Center where we are investing $3 million in Regal's upgrades. Excluding the Regal lease, Hawaii retail re-leasing spreads for the quarter were 10.5%.

Because of the size of the portfolio, large deals have a disproportionate effect on spreads. Although we're pleased with this quarter's result, we wouldn't expect to see these kinds of spreads on a recurring basis. We're probably looking at full-year spreads that are just over 13% achieved in the first quarter.

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Underlying this performance is continued strength in the broader Hawaii market fundamentals.

The number of jobs in the state has increased over the last 6 years and at the same time unemployment has declined to below 3%. This has driven steady growth in personal income and retail spending, which are not only supporting retail tenant performance, but also performance of our industrial tenants.

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In addition, we benefit from our location in the middle of the Pacific, which helps insulate our retail portfolio from some of the negative impacts that are plaguing the retail sector on the mainland, including internet shopping. Adobe, whose software runs under many retail websites, analyzes data on billions of website visits to create its Digital Price Index, a real-time snapshot of online consumer spending. Analysts there studied digital shopping patterns over the one-year period ended February 2017. At a state level, they measured the growth in total e-commerce spending, as well as the online spending per person, which is depicted on this slide. As you can see, Hawaii is an outlier and we think that's at least partly due to the transit times and costs of shipping to Hawaii and the cost of returns if there's no physical store in the islands. Alaska, which is shown in the pink dot just below Hawaii, is very similar to us in these regards.

This is not to say that we'll never be impacted by these factors, but this chart suggests there may be some structural barriers to internet sales penetration in Hawaii.

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Notwithstanding the tight Hawaii labor market, we have been successful in hiring experienced talent to nearly complete our in-house asset management and leasing teams. We've brought the property management functions for all of our Oahu properties in-house, and are on track for our Neighbor Island properties to be transitioned before year end. We always prided ourselves on the management of our properties and have been supported by strong local third-party property managers. With our expanding scale, however, we felt that bringing these activities in-house made sense, and we're very pleased with the results so far. We've made good hires in building our internal leasing capability as well, and have increased the velocity of leasing since we started migrating the leasing function in-house in the first quarter. We think the direct connection between property management, leasing and tenants will ultimately result in an enhanced and uniform tenant experience, allowing us to attract and retain the best tenants to grow NOI.

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In redevelopment and development for hold, construction of the food court at Pearl Highlands is coming to completion and the space will be turned over to tenants later this month. Regal Cinema will complete their upgrades by year-end. Lau Hala Shops construction remains on track for delivery to tenants early in 2018 with store openings expected by mid-2018. Planning and permitting for Ho'okele Shopping Center advanced during the quarter as did leasing activities. We continue to evaluate and advance planning for new projects to add to this list. These investments will drive direct NOI growth and enhance the overall customer experience.

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Lastly in CRE, we acquired the 73,300-square-foot Honokohau Industrial Center in June for $10.1 million, which was funded entirely with 1031 exchange proceeds from non-income-generating assets. As we said at the time, this quality property currently has tenants in 94 percent of the available space.

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Beyond the progress in CRE, we monetized a few Land Operations assets during the quarter, and more recently, we sold 290 acres of vacant land on Maui for $8 million, or about $28,000 an acre. We've been working on monetization of development units and parcels and have 115 units and a half-acre parcel that are binding and in escrow totaling $115.7 million in gross sales.

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This slide shows the status of sales at Kukui'ula and at Keala o Wailea on Maui. I was at Kukui`ula last week and saw the latest construction progress both in vertical construction on homes and the development of some new lots that we're preparing on the far western end of the property and it looks absolutely spectacular. I think we're in a good position for continued sales there the balance of this year.

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Before leaving development for sale, let me provide a brief update on Kamalani. As you may know, we're building the 170-unit first increment of the project to provide important affordable housing to Maui's workforce. We've noted strong sales activity at the project over the last few months with 21 new bound contracts received since March for a total of 47. Based on the current construction schedule, 34 closings are anticipated by the end of 2017. These closings will not generate significant income due to the affordable nature of the units; however, we will receive affordable housing credits that can be used for development of market units on Maui. Going forward, we may seek partners to develop the market units at the project.

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Switching gears to Materials & Construction…I'm pleased to report improved performance for the quarter. We were able to mobilize our crews to place over 60% more hot mix pavement than last year, despite continued weather impacts. We continue to see margin compression from competitive pricing pressures and expect that it will impact segment results for the remainder of this year, but we're taking actions to improve those business elements we can control and are particularly focused on reducing costs, increasing paving volumes and winning paving bids. We also are implementing performance improvement plans that were developed in conjunction with FMI Group, a leading industry consulting specialist, that we expect will enhance communications, coordination, efficiency and cost-effectiveness, which in turn will help drive EBITDA growth.

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So, generally good performance so far in 2017 and I feel very positive about our continued strategic momentum. While this slide is a repeat of information we shared on the REIT call last month, I think the information bears repeating. We take seriously the challenges and opportunities of becoming a REIT and we recognized that there were a few steps we could take to best position ourselves for success. The addition of Jim Mead as CFO, Tom Lewis as a director and the shareholder friendly changes we are making to our governance practices all reflect our commitment to creating and realizing shareholder value. I want to welcome Jim to his first quarterly conference call and say that we are already benefiting from his extensive REIT experience.

With that let me turn the call over to Jim to provide some of his thoughts as a newcomer to A&B. Jim?

James Mead

Thank you, Chris, and hello everyone.

I'm really excited to be here and I'd like to spend my time today to tell you why.

But first, for those of you who don't know me, I've been a REIT CFO for quite a while and in a few sectors: multifamily, hotels, office, street retail and mezzanine lending. I've been fortunate that each of these experiences were with companies that had a special skill set and uniqueness to fill a complementary spot for investors.

I think A&B is equally special and unique; we have great assets and a home field advantage that no one else can replicate.

That's why I am here today.

As you might imagine, I've been drinking from a fire hose over the past three weeks. Nevertheless, I've been able to focus on a few strategically important things that I'd like to give you some thoughts on:

- First, given the transition the company is making, it is important that we maintain a low risk approach to the balance sheet. Thanks to Paul Ito, the balance sheet is in great shape and today gives me the advantage of mostly long-term fixed rate debt, a smooth maturity schedule, low leverage, and strong long-term lending relationships.
- Next, Chris has asked me to really drill down on G&A. I'll have more to speak about in coming quarters, but at first glance, if you look at the REIT side of our business as the growth area, I would expect our G&A to evolve and become comparable with our REIT peers. More to come on this very important topic.
- I am now well integrated into the investment side of the business here - and by way of comparison, I've had experience in very complex capital allocation processes at other REITs.
- I can tell you that our acquisition team, led by Jeff Pauker, is well founded in judgment and analytical capability. I know we will be able to show off our capabilities in upcoming quarters as we grow the commercial real estate side of our business in Hawaii.
- And not to peek too far into the future, but one of our distinctive advantages is our personal relationships in this marketplace. So now with the UPREIT structure, Jeff and his team have an entirely new set of tools to make deals happen.
- And finally, the REIT announcement was more than a tax strategy. I've seen an energetic focus on activities that create value in a way that REIT investors will appreciate and which we are doing to drive total shareholder return for a broader investor base. So, much more to come here.

Over the next few months, I will be reaching out to many of my friends who were investors in my prior lives. And what I'd like to ask is that you please watch us closely, because at some point in this REIT transformation, either now, after our E&P purge, when we are in a REIT index, or as we execute our capital allocation strategy, you will find a time when it becomes important to take a position in us.

I want to thank Paul Ito for helping me in this transition. Paul has really left me in a strong position and I appreciate his support. So now I'll turn the call to Paul.

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Paul Ito

Thanks, Jim.

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Turning to slide 16, all segments contributed to improved financial performance this quarter as compared to last year. Diluted EPS from continuing operations available to A&B shareholders was $0.07 per share compared to $0.06 per share last year. Including after-tax earnings from discontinued HC&S operations, EPS available to A&B shareholders was $0.09 per share, compared to a $0.01 loss per share last year.

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The next slide shows segment operating profit and other income and expense items compared to last year. The reasons for the variances are included in our earnings release and will be detailed in Management's Discussion & Analysis, which is included in the second quarter 10-Q that we'll file tomorrow. As a result, I'll focus my remarks on some of the key commercial real estate performance metrics for the quarter. I'll then update you on our capital structure and our capital plans.

One thing to note on this slide that might seem unusual is that its operating profit for the quarter declined compared to last year despite the strong CRE segment operational performance. The reason operating profit declined was primarily due to some changes in cost allocations as a result of the strategic realignment to focus on the growth of our commercial real estate portfolio and earnings, as well as the doubling up of certain costs that will continue while we transition property management and leasing in house and exit existing third-party management contracts.

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On slide 18 are some of the key commercial real estate performance metrics for the quarter. Segment performance was largely driven by a 4.7% increase in same-store NOI. Notably, same-store NOI from the Hawaii retail portfolio was up 5.1%. Strong same-store performance in the quarter helped drive year-to-date overall same-store NOI growth to 3.3%, in line with the Company's guidance of a 3-4% increase in same-store NOI for the full-year 2017.

Chris already discussed leasing spreads, which were exceptional at 19.8% for the quarter.

With respect to occupancy, overall portfolio occupancy increased 70 basis points to 94.1%, driven by a 140 basis point increase in Hawaii occupancy to 93.8%. And, Hawaii portfolio ABRs remained stable at $27 a foot for retail, $13 a foot for industrial, and $28 a foot for office.

As a reminder, our second quarter supplement was posted on our website earlier today and includes more detailed information.

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Let me move on to our capital structure, which remains strong. Debt to debt plus equity was 32.1% and we had $239 million of liquidity available on our revolver at the end of the quarter.

Net debt-to-EBITDA was 4.6 turns, reflecting relatively low leverage. Our debt metrics for the quarter have been generally consistent over the last two quarters. That, of course, will change in January 2018 with the payment of the Special Distribution that we discussed at length on our REIT conversion announcement call. We expect to draw on our revolving credit facility to fund the cash portion of the Special Distribution. We are also currently working on upsizing our revolver by an additional $100 million and terming out some of our short-term debt on a long-term basis. Both actions will comfortably allow us to accommodate the Special Distribution using our revolving credit facility.

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Slide 20 summarizes our capital expenditures, breaks out growth and maintenance capital spending by segment, and provides our full year budget. We invested $49 million of gross growth investment capital in the first half of the year, including $15 million for the acquisition of the Honokohau Industrial Center and repositioning and development-for-hold opportunities in the commercial portfolio. Additionally, $34 million went to Land Operations growth capital, including active real estate projects and joint ventures, which included funding draws under the Keauhou B-Note and capital for Kamalani. In addition to this growth capital, $6 million was for maintenance capital.

Let me now turn the call back to Chris for closing remarks.

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Chris Benjamin

Thanks, Paul.

I'm very pleased with all that we have been able to accomplish so far this year and the momentum we've created going into the second half of 2017. Our CRE portfolio continues to perform well and we have done a lot of work to position our portfolio for future growth-from migrating leasing and property management in-house, and evaluating and unearthing acquisition opportunities, to advancing redevelopment and development for hold projects. Importantly, we have taken the necessary steps to convert to a REIT for the 2017 taxable year, which will have multiple benefits to the Company on the acquisition front, as well as in expanding the investor audience for the stock, which in turn will create more trading liquidity and lower our cost of capital.

We've also taken steps in our Land Operations and Materials & Construction businesses to increase cash flow and value for investors. We've positioned several development assets for retail and wholesale monetization and look forward to strategic closings. We also continue to expand diversified agriculture on our former plantation lands, and have issued several press releases detailing progress that we're making on that front. And, finally in Materials & Construction we are taking several steps to enhance performance and drive cash flow.

Going forward we'll continue to advance implementation of our Hawaii commercial real estate growth strategy and work through the remaining conversion steps and related events we detailed in our REIT conversion announcement presentation, including the holding company merger vote, Special Distribution, and electing to be taxed as a REIT on our 2017 tax returns.

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Since we announced the REIT decision, many of you have been calling with questions about how to model NAV for the Company. We appreciate that some of our assets are more difficult to value than with other REITs. To help your analysis and to better define our priorities and the initiatives underway, we'll be holding an analyst day, including a deep dive NAV session, in New York City on the morning of September 14. We'll webcast the session, but we'd love to have you in person if you can make it. Please contact Suzy if you would like to attend and haven't received a save-the-date email.

That concludes our formal remarks and I'll now open it up for your questions.