Transcript of
Piedmont Office Realty Trust, Inc.
Third Quarter 2020 Earnings Call
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Participants

Edward Guilbert - Executive Vice President, Finance and Treasurer
Brent Smith - President and Chief Executive Officer
Robert Bowers - Chief Financial and Administrative Officer

Analysts

David Rodgers - Robert W. Baird and Co.

Presentation

Operator

Good day, ladies and gentlemen, and welcome to the Piedmont Office Realty Trust, Inc.'s Third Quarter 2020 Earnings Conference Call. All lines have been placed on a listen-only mode and the floor will be open for your questions and comments following the presentation.

At this time, it is my pleasure to turn the floor over to your host for today, Mr. Eddie Guilbert. Sir, the floor is yours.

Edward Guilbert - Executive Vice President, Finance and Treasurer

Thank you, operator. Good morning, everyone. We thank you for joining us today for Piedmont's third quarter 2020 earnings conference call. Last night, we filed our Form 10-Q and an 8-K that includes our earnings release and our unaudited supplemental information for the third quarter. All this information is available on our website at piedmontreit.com under the Investor Relations section.

During this call, we will refer to certain non-GAAP financial measures, such as FFO, core FFO, AFFO and same-store NOI. The definitions and reconciliations of these non-GAAP measures are contained in the earnings release and in the supplemental financial information.

On today's call, the company's prepared remarks and answers to your questions will contain forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. These forward-looking statements address matters which are subject to risks and uncertainties, and therefore, actual results may differ from those we anticipate and discuss today.

The risks and uncertainties of these forward-looking statements are discussed in detail on our press release, as well as our SEC filings. We encourage everyone to review the more detailed discussion related to risks associated with forward-looking statements in our SEC filings.

Examples of forward-looking statements include those related to Piedmont's future revenues and operating income, dividends and financial guidance, future leasing and investment activity, and the impacts of the COVID-19 pandemic on the company's financial and operational results.

You should not place any undue reliance on any of these forward-looking statements and these statements speak as of the date they are made.

At this time, our President and Chief Executive Officer, Brent Smith, will provide some opening comments and discuss our third quarter results and accomplishments. Brent?

Brent Smith - President and Chief Executive Officer

Good morning, everyone, and thank you for joining us on today's call. Despite the challenging operating environment, the third quarter was another solid quarter for Piedmont in terms of operations, financial results and strategic objectives. We saw an increase in new leasing activity and we're very encouraged by the uptick in leasing tours and proposals.

This trend is continuing into the fourth quarter as our leasing pipeline continues to rebuild. But let me be clear, we are not back to levels of pre-pandemic activity. Operationally, we continue to feel very fortunate that most of our tenants are of investment-grade quality and subject to long-term leases with weighted average lease-term remaining for the portfolio over 6 years. We continue to collect substantially all of our build rents 99% for the third quarter.

These collections are net of approximately 60 total lease modification agreements year-to-date that we've entered into with our tenants. A majority of whom are retail related businesses and have experienced disruptions in their operations as a result of the pandemic. As we indicated last quarter, most of these agreements now totaling $6.7 million year to date in cash rent billings are deferrals of 3 to 4 months of rent, the bulk of which are to be paid back in the fourth quarter of this year or in 2021.

I'll remind everyone that during the second quarter, we did establish a $4.9 million general reserve related primarily to those tenants with whom we agreed to some form of rental relief, should these businesses be unable to repay the deferred amounts when they become due or should their operations fail.

As of today, we still have $4.8 million of this reserve in place, and I imagine we will be well into 2021 before we will know how all these tenants will perform. In addition to the availability of general receivables reserve, I will note that we did recognize $700,000 of specific account bad debt expense during the third quarter, bringing our total specific bad debt expense for the year to $2.5 million or about 0.5% of ALR.

While COVID has affected leasing demand, we do feel fortunate to have completed 229,000 square feet of leasing during the third quarter, with over a third related to new tenants. These leasing results exclude the 172,000 square foot lease that is backfilling most of the space related to First Data, which was acquired earlier this year by Fiserv.

The new tenant, Deluxe Corporation, will be investing over $10 million to establish a technology innovation center in our 55, 65 Glenridge Highlands II building. And according to the Georgia Governor's office, they will create over 700 new jobs for the Atlanta community. With a significant investment in workforce and the innovation center, we believe it bodes well for a longer-term tenancy at our headquarters location in Glenridge Highlands.

Aside from this lease, the most significant new tenant lease that was executed during the quarter was for approximately 56,000 square feet at 400 Virginia Avenue in Washington, D.C., with the District's Department of Employee Services. A more detailed list of these leases executed during the quarter is included in our quarterly supplemental information that was filed last night.

With regards to leasing activity in our markets, those where we are currently seeing strongest activity taking place are in the Washington, D.C. area, Boston and our Sunbelt markets. We have concerns regarding the pandemic impact on lease rental rates and concessions. But with approximately 1 million square feet of leasing completed through the third quarter of 2020, we are encouraged that rents have held relatively steady with cash rent roll ups for the year increasing approximately 5% and accrual-based rents up over 11%.

Looking at renewals, other than the New York City lease at 60 Broad Street, we have no other significant expirations until the end of 2022. We continue to make progress on the City of New York's 300,000 square foot lease that is currently in holdover, as we are diligently working with them towards executing a renewal.

We still anticipate a short-term renewal to be executed around the end of the year with longer term deals still expected sometime in the latter half of 2021. There are no development projects currently underway in all of our redevelopment projects and tenants build out programs are relatively modest in scale, and are on budget and on schedule.

Our lease occupancy percentage has declined this year largely due to the slowdown and leasing activity attributable to the pandemic. Likewise, our Same Store Cash NOI comparison, which is basically flat on a year-to-date basis, has been impacted approximately 2% by the $6.7 million of tenants lease modification agreements we've entered into.

Turning to capital transactions. Obviously, as the economy slowed from that pandemic transactional activity did as well. We do not complete any acquisitions or dispositions during the third quarter. But after the quarter end, we completed a portfolio sale allowing us to dispose of our final 3 remaining New Jersey properties. The sale consisted of 600 Corporate Drive located in Lebanon, New Jersey; and 200 and 400 Bridgewater Crossing, located in Bridgewater, New Jersey, for approximately $130 million or $176 per square foot. The sale completes our exit from the New Jersey office market and refines our New York portfolio to our position in lower Manhattan.

Also after September 30, Piedmont acquired 222 South Orange Avenue for $20 million, or approximately $157 per square foot. 222 South Orange is approximately 127,000 square foot office building located at what we believe is the [pin-corner] [ph] location for downtown Orlando, Florida, and Orange Avenue in Church Street. And the building is directly connected to our 200 South Orange Avenue asset physically sharing several connection points, including a large atrium lobby, and this actual acquisition provides our property with direct frontage now on Orange Avenue. Piedmont plans to immediately begin a redevelopment of the property to reposition the asset to a standard consistent with 200 South Orange Trophy Tower.

Finally, one of the accomplishments this past quarter that I'm most pleased with, with the issuance of our first green bond, we use the proceeds from the $300 million bond issuance to provide the long-term funding for the LEED-certified acquisition that we completed earlier this year of the Galleria Office Towers in Dallas, Texas. Bobby will talk more specifics about the terms of the bond in a moment.

But at Piedmont, we're dedicated to providing the highest quality office properties, while responsibly managing our impact on the environment. We strive to only manage workplaces that are environmentally conscious, productive and healthy for our tenants and employees.

To that end, I hope you'll take a moment to review our latest environmental, social and governance or ESG report that was also issued during the third quarter and is available on our corporate website. You will see that Piedmont is not only environmentally sensitive, but we're also serious about serving our local communities and schools. And we're committed to treating fairly and equally all individuals who engage including our tenants, employees and vendors.

Furthermore, we are proud of our top social score provided by proxy advisory service. And I will add, we do this all because we believe passionately that this is truly fighting for the right thing to do together, we are all stronger and better.

At this point, I will turn the call over to Bobby to walk you through the financial highlights of the quarter and guidance for 2020. Bobby?

Robert Bowers - Chief Financial and Administrative Officer

Thanks, Brent. I'll discuss some of our financial highlights for the quarter. I encourage you to please review the earnings release and supplemental financial information, which were filed last night for more complete details.

For the third quarter of 2020, we reported \$0.48 per diluted share of core FFO, a \$0.03 or 6% increase compared to the third quarter of 2019 reflecting rental rate roll ups across the portfolio, as well as the benefits of accretive capital recycling activity since the third quarter of last year.

Company's core FFO earnings have grown year-over-year. However, our top-line revenue growth for the year is a little less than we originally anticipated, due to reduce transit parking and retail revenues since the onset of the pandemic, and slower leasing activity that Brent discussed due to uncertainties, shelter-in-place orders and travel restrictions. There are, however, no unusual income items embedded in our year-to-date revenues such as large termination fees, or settlement income. Although, netted against our total year-to-date revenues are increased totaling \$2.6 million for the write-off of specific tenant receivables, as well as a reserve of \$4.8 million.

Partially offsetting these items, our lower property operating expenses resulting primarily from reduced utility charges and janitorial costs. Daily occupancy at our buildings is slowly recovering, but it varies greatly by location and that type of tenancy usage. With all our buildings remaining open and fully operational throughout 2020, we have some tenants associated with government services or defense related tenancy that are near normal occupancy, while others have active physical use is still in the 10s or 20% range. The buildings located in Sunbelt do tend to have higher overall occupancy today, and shelter-in-place restrictions were lifted earlier than other regions of the country.

Turning into cash flow and financing activity, AFFO was approximately \$38 million for the third quarter well in excess of our third quarter dividend. As Brent mentioned, we did issue \$300 million of 3.15% green bonds during the quarter. They are 10-year senior notes, and we use the proceeds to repay all of the outstanding borrowings under the $300 million unsecured 2020 term loan that we put in place earlier this year to temporarily fund the acquisition of the Galleria Office Towers.

We ended the third quarter with approximately $24 million of cash and have the full $500 million capacity available on our line of credit, with no debt maturities until like 2021. As anticipated our average net debt-to-core EBITDA ratio for the third quarter of 2020 improved to 5.5 times reflecting the sale of 1901 Market Street in June of this year, and the use of proceeds to pay down debt. Also, our debt-to-gross asset ratio was approximately 34% at the end of the third quarter.

Now at this time, I'd like to revisit the topic of guidance for the year. Today, we believe we've identified most of the near-term impacts of COVID-19 on our 2020 operations. This equates to a total impact of approximately $6 million to $8 million for the year, compared to the original 2020 guidance that we provided last February.

The major COVID impacts are as follows. While we began to experience an uptick in leasing tours and proposals during the third and early fourth quarters, overall, we believe new tenant leasing for 2020 will be less than originally expected, modestly lowering 2020 occupancy and lowering net operating income or NOI by approximately $5 million.

Likewise, our transit parking income is estimated to be lower by approximately $2 million to $3 million for the year. Also, overall retail NOI, which comprises approximately 1% of the company's total 2020 revenues, is estimated to be lower by approximately $2 million for the year. In addition, during the 9 months ended September 30, 2020, as I mentioned earlier, we've taken approximately $2.6 million in bad debt charges against rental revenue, as well as a $4.8 million general reserve against billed tenant receivables and straight-line rent receivables.

Offsetting these items, our operating expenses, net of our tenant share that are expected to be lower by $3 million to $4 million for the year. Also, we estimate $5 million of lower interest expense for 2020 due to lower prevailing interest rates.

Then finally, we believe general and administrative expenses will be lower by $1 million to $2 million for the year. Based upon these projections, we're reinstating guidance for the year ended December 31, 2020, with a core FFO range of $1.88 to $1.90 per diluted share, which is at the low end of our original guidance. These estimates include the acquisition and disposition activity in Orlando and New Jersey that we discussed earlier. But no additional capital transactions are included in these projections.

At this time, I'll turn the call back over to Brent for some closing comments.

Brent Smith - President and Chief Executive Officer
Thank you, Bobby. In April of this year, we will through our annual 2020 guidance due to the vast number of uncertainties created by the pandemic. Still today, the longer-term consequences on the economy and on our tenants continue to be unknown, especially as it relates to the future occupancy trends and tenant usage within the office sector. That said, if we help our clients evaluate the commercial real estate requirements, discussions of densification of office space are virtually non-existent. Instead CEOs are turning their focus towards the impact work-from-home and head on productivity, operating efficiently in

corporate culture, which are being balanced against trends for more flexibility and work schedules.

Notwithstanding these uncertainties and economic ramifications, I believe, Piedmont is well positioned for the future. We have a strong diversified tenant base, a majority of which is investment grade quality, with long-term leases and with little near-term expiration. The company has a prudent balance sheet with excellent liquidity and we consider adequate and appropriate reserves.

We also believe that Piedmont's portfolio of assets will be attractive locations for future tenants located in amenity-rich urban and suburban locations that do not rely on mass transit and are more convenient to workforce housing.

When I became CEO a little over a year ago, I laid out 4 key strategic objectives for Piedmont that I believe would best serve our investors: first, to accelerate transition of our portfolio of properties into targeted high growth amenity-rich office nodes within a few select markets; second, accomplish this portfolio transition while improving the overall quality of our properties and to do so creatively to financial earnings; third, commit to maintain the highest quality of tenant experience and satisfaction through the ongoing redevelopment and repositioning of our properties and amenities.

And finally, the Piedmont further bolster a best-in-class ESG platform, focusing enhancing our market leading social and environmental practices, while maintaining our accountability with the highest governance standards. I could not be more proud of how the Piedmont team has risen to the challenge and continue to execute on these strategic objectives even in the midst of a global pandemic.

This fall, we exited the New Jersey market completed the strategic acquisition of our Orange Avenue asset in Orlando, launched the Piedmont scholarship program for historical Black colleges and universities within our operating communities and accomplished our inaugural green bond offering. With regard to our financial goals, we're pleased to have reinstated 2020 earnings guidance 6% above our 2019 operating results.

With that, I will now ask our operator to provide our listeners with instructions on how they can submit their questions. We will attempt to answer all of your questions now. We'll make appropriate public disclosure later if necessary. Operator?

Operator
Thank you. Ladies and gentlemen, the floor is now open for your questions. [Operator Instructions] We'll go first to Dave Rodgers with Baird.

Q: Hey, good morning, guys. Brent, maybe I'll start with you with a couple of questions. I guess, can you talk about the utilization of the portfolio specifically, maybe by asset type or by metropolitan market? And then, I wanted to dovetail that in with you and talked about the pipeline is beginning to improve. And so, maybe in the utilization comment, also talk about the average tenant size and market with the pipeline as well.

Brent Smith - President and Chief Executive Officer
Okay, good morning, Dave. I appreciate your time today. It's a little bit of a very complex question. We'll try to put some generalities around that. But I think what we're really seeing

from utilization standpoint is continued occupancy from tenants coming back, particularly over the last couple of months and after Labor Day, but still seeing, I would say, diminished levels in the north, probably in the neighborhood of 10% to 20% of the pre-COVID levels; and then the south, a little bit more activity depending again on market, but call it anywhere from 15% to 40%, depending on the building in the market.

I would say though, we also have some mission-critical and government related facilities, indoor spaces and buildings that are 80% to 100%. And so, it's tough to really draw a general conclusion. But for the tenant mix, I'd say we're also seeing larger national tenants generally, as you've read in the headlines, postponed coming back to the market.

But we are seeing smaller tenancy come back faster, particularly in the Sunbelt. And we're also seeing actually a number of our co-working locations actually even achieving well over 50% utilization, in some instances up to 80%-plus at their facilities now.

And so, I think we're seeing it really vary across the board and there's really no way to pinpoint one data point. But hopefully, that gives you a little bit of clarity around what we're seeing. When it comes to leasing pipeline, I'd say, it went to almost non-existent during the pandemic, although we kept a few deals alive.

So really – that really started in earnest to rebuild. We call it midsummer. And we've continued to see that accelerate and rebuild further. And, I'd say that that is generally going to continue to improve, I think if we don't see a meaningful second or third wave, whatever you want to characterize it this fall. And so, I think we're hopeful that we're going to continue that momentum into next year.

I will say when it comes to renewals, we are seeing – many tenants decide to try to do a shorter-term renewal. We're fighting for longer terms and that's generally playing itself out. But I would say we have a few larger national tenants that know their business very well, consider this an opportunity maybe to extend our term on a larger lease and capture a favorable rate.

And so, we're also seeing some of those larger potential renewals start to take shape at the moment. So we're hopeful, but I think I think the main message there is the pipeline is continuing to rebuild off of what was a very low level in the summer.

Q: Great. Thank you for that color. I wanted to turn to the asset sales in New Jersey subsequent to the end of the quarter. Can you talk about the pricing, the discussions, any re-trade on that, the kind of why the timing was right now and any cap rate color that you can provide on kind of the discussions and the ultimate disposition of those assets?

Brent Smith - President and Chief Executive Officer
Yes, thanks, Dave. I think when we began the year. It was really our objective to clean up what I would consider the mid-Atlantic/Northeast portfolio in terms of getting out of what we consider non-core assets. And, of course, I think everybody knew, and we were pretty vocal around our Philly execution and wanting to get that off of the portfolio, and it being non-core.

We were less vocal around New Jersey, but it's always been a goal of ours to continue to refine our New York City holdings to just the lower Manhattan position. And so, it was really the strategic objective overall. And then, we had had dialog with a number of parties pre-pandemic, and really had anticipated to actually dispose the asset maybe a little sooner in the year than what actually transpired.

But we felt like we were able to achieve a pricing level that was reasonable relative to where we thought the value was pre-pandemic and where those discussions were. And overall, generating a cash and cap rate caught in the high 7s to 8 zip code, felt pretty good given where we want to focus the rest of the business on and be more strategic longer term.

And so, we did reach a transaction level – sorry, transaction with one of the interested parties. We did discuss the deal with a number of parties, but went with one that we were comfortable with. And got a few burnouts into our other leasing components, still to play out here over the next, call it, few months. But we look forward to sharing all the final details on the next call.

Overall, though, I'd say, I'd also point out, we think this is a good example of pricing within our portfolio itself, but you're going to continue to see private market transactions that I think will be well inside on a cap rate basis to where some of either us or our peers trade from an implied cap rate basis. And I think that's just one example. And frankly, I would consider these probably one of our toughest markets and one of our highest cap rates. And I point out that we did trade it inside of, frankly, where our stock trades today.

Q: Last for me, on the city of New York, what's the risk that they just pick up and move somewhere else?

<u>Brent Smith - President and Chief Executive Officer</u>
We feel like that risk is very low. We've talked about in the past. It's a pretty unique building. It fits their needs very well from a user group, size of the space. And it acts as being as a dedicated lobby and elevator bank.

Obviously, we recognize the issues with the municipality, but everything from a leasing process continues to kind of go as we would expect it to in the process. It's slow. It's always slow dealing with government tenants, but nothing's really changed from what we've talked about in the past. We do anticipate having a shorter-term renewal signs, somewhere around the end of the year. And then the longer-term deals still going to take some time to play out and finalize [swing] [ph], et cetera. Very similar to what we did with the state last year in 2019, and we'll do that again. And that longer-term lease is still tracking to the end of next year.

Q: Ok, thank you.

<u>Brent Smith - President and Chief Executive Officer</u>
Thanks, Dave.

<u>Operator</u>
[Operator Instructions] With no other questions holding, I'd like to turn the conference back to Mr. Brent Smith for any additional or closing comments.

<u>Brent Smith - President and Chief Executive Officer</u>
Thank you. We appreciate everybody joining us on today's call. I would remind you we've got NAREIT virtually coming up in a few weeks. We've got a tight schedule, but we'd love to include anybody else that is interested in meeting with management.

We're excited about the prospects that we have in leasing pipeline. As we mentioned before, I think we continue to see that grow. And we look forward to discussing that more at NAREIT. And then, of course, in January, on our fourth quarter call. Everyone have a great Halloween weekend and thank you for your time.

Operator

Ladies and gentlemen, that will conclude today's presentation. We thank you for your participation. You may disconnect at this time and have a great day.