Highwoods PROPERTIES

Management's Prepared Remarks
Second Quarter 2020 Conference Call
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Brendan Maiorana
Executive Vice President, Finance

If any of you have not received yesterday's earnings release or supplemental, they're both available on the Investors section of our website at highwoods.com. On today's call, our review will include non-GAAP measures, such as FFO, NOI and EBITDAre. Also, the release and supplemental include a reconciliation of these non-GAAP measures to the most directly comparable GAAP financial measures.

Forward-looking statements made during today's call are subject to risks and uncertainties, which are discussed at length in our press releases as well as our SEC filings. As you know, actual events and results can differ materially from these forward-looking statements and the Company does not undertake a duty to update any forward-looking statements.

Currently, one of the most significant factors that could cause actual outcomes to differ materially from our forward-looking statements is the potential adverse effect of the COVID-19 pandemic, and federal, state and local regulatory guidelines and private business actions to control it, on our financial condition, operating results and cash flows, our customers, the real estate market in which we operate, the global economy and the financial markets. The extent to which the COVID-19 pandemic impacts us and our customers will depend on future developments, which are highly uncertain and cannot be predicted with confidence, including the scope, severity and duration of the pandemic and the resulting economic recession and potential changes in customer behavior, among others.

Ted Klinck
President, Chief Executive Officer

Let me start by saying I hope you are all well and your families are safe and healthy. We are pleased to report that our employees are healthy and that we have safely returned to all of our offices. To ensure our coworkers feel safe and productive while in the office, we have implemented a rotation schedule, giving everyone ample opportunity to comfortably practice social distancing. This helps us achieve our twin objectives, which are to prioritize the health and safety of our employees and realize the benefits of sharing our Company's unique culture together in the workplace.

Obviously, this has been an incredibly challenging time for our country and our economy. It remains difficult to predict the duration and severity of the COVID-19 pandemic and its overall impact on economic activity. We believe we are well-positioned operationally to handle the near-term effects of this downturn given our lack of large customer expirations over the next few years and our substantially pre-leased development pipeline. Plus, we continue to maintain a fortress balance sheet with ample available liquidity to fund leasing capital expenditures and our development pipeline while having dry powder to capitalize on future growth opportunities.

In addition to having a high-quality portfolio and strong balance sheet, we are well-positioned given our geographic footprint. The southeast continues to benefit from positive demographic trends – both population and job growth. Some notable office using job announcements in our markets have occurred even in the midst of the pandemic. These include the Fortune 50 company, Centene, announcing a 6,000 job, $1 billion, east coast headquarters in Charlotte, Microsoft with 1,500 new jobs in Atlanta, and publicly traded software company, Bandwidth, in Raleigh with 1,200 new jobs and a planned new

headquarters campus. These announcements illustrate the long-term attractiveness of our markets and support the notion that companies still value a collaborative, in-person environment to foster creativity and strengthen company culture.

In the second quarter, we delivered FFO of $0.93 per share, which equals our first quarter results. Further, the second quarter reflected a full quarter of lost NOI from $338 million of properties sold in the first quarter. Our financial results were excellent, especially considering the challenging economic conditions. In addition to strong FFO, our portfolio metrics were solid with occupancy of 91.1%, up 20 basis points sequentially, same property cash NOI growth of 2.4% excluding the impact of temporary rent deferrals, and in-place cash rents up 5.1% year-over-year. We leased 821,000 square feet of second gen office space with GAAP rent growth of 13.6% and cash rent growth of 5.5%, and this was done with limited leasing capex, which drove net effective rents 7.6% higher than our prior five quarter average.

We stated last quarter it was too difficult to predict where the economy would go from here, and we still feel predicting the shape of the economic recovery is speculative, so we're maintaining our focus on the following items that we believe best position us in the near-term:

- maintaining liquidity and a strong balance sheet;
- keeping our buildings fully open and operational;
- keeping our development projects on time and on budget;
- working with customers to maintain occupancy and timely rent payments;
- minimizing operating expenses without sacrificing operating performance or leasing opportunities; and
- capturing as many renewals and re-lets as possible given this uncertain environment.

We've reported our rent collection figures each month since the start of the pandemic, which have been strong at 99% every month, including July. Temporary rent deferrals equate to 1.2% of annual revenues, up modestly since our first quarter call. Importantly, new rent relief requests have dropped off significantly since mid-May. We have long emphasized the importance of having significant customer, geographic and industry diversification across our portfolio. No market accounts for more than 20% of revenues, no customer other than the federal government accounts for more than 4% and no industry category accounts for more than 25%. This diversification is serving us well in this uncertain macro-economic environment.

Turning to our updated 2020 FFO outlook. Given the fluidity of the pandemic and its impact on economic activity, potential lost rents from customer defaults and non-cash straight-line write-offs are still too speculative to project. As a result, our updated FFO per share outlook of $3.59 to $3.68, which is up $0.04 per share at the low-end, excludes any such potential losses.

All of our buildings and parking facilities have remained open and available to our customers throughout the pandemic. Obviously, usage of our assets was significantly lower than normal in the second quarter. As expected, parking revenue was negatively impacted, but we were able to offset this with lower operating expenses. We now expect building usage in the third and fourth quarters to remain low, which is reflected in our updated outlook.

In early July we sold two non-core properties in Memphis for $23.3 million. These properties were a combined 89% occupied and were sold at a low-7s% cap rate based on projected 2020 GAAP NOI. We have another $72 million of properties under contract that are scheduled to close later this year. These dispositions comprise the low-end of our outlook of $95 million, and we have other non-core dispositions in various stages of the sale process that could bring us to the high-end of our outlook.

Development continues to be a growth driver for Highwoods. Our 1.2 million square foot development pipeline represents a $503 million investment that is 77% pre-leased and 60% funded. Construction work on our four in-process projects, GlenLake Seven in Raleigh, Virginia Springs II in Nashville, Midtown One in Tampa and Asurion in Nashville, has continued throughout the pandemic. We remain on budget and on schedule with these projects. As a reminder, our pipeline is projected to generate more than $40 million of annual NOI upon completion and stabilization, less than $5 million of which will be generated in 2020.

New build-to-suit and anchor pre-lease conversations have slowed down compared to pre-pandemic levels, but there are still inquiries and activity from prospects. We remain hopeful we'll be able to secure additional highly pre-leased development opportunities during the next several quarters.

Before I turn the call over to Brian, I'd like to say a few words about our incredible teammates here at Highwoods. We greatly appreciate the hard work and dedication that our coworkers have exhibited every day since our normal daily routines and lives were disrupted by the pandemic. Their outstanding performance has shown through in our financial results in the second quarter, but it's also evident in so many other areas also, whether working tirelessly to maintain building operations, adapting to new processes to seamlessly file our 10-Q, adapting to virtual leasing tours or countless other examples, we couldn't be more proud of our team and we sincerely thank them for their efforts.

Brian Leary
Executive Vice President, Chief Operating Officer

I'd like to begin with a quick review of our performance in the second quarter, and then provide an update on what we're seeing real-time across our markets.

As Ted noted, signing 821,000 square feet of second generation leases with GAAP rent spreads of +13.6% and cash rent growth of +5.5% is a testament to the quantity and quality of work put in by our exceptional team across the portfolio. In addition to solid rent growth in the quarter, securing terms on average of 8.8 years, which was driven higher by our renewal with the FBI in Tampa, and with limited leasing capex, is a win for the Company. Our payback ratio, or total capital committed compared to contractual revenue, was 6.7%, well-below our recent average in the mid-teens.

Consistent with the Highwoods playbook, we remain focused on reducing future lease expirations and now only have 21% of revenue expiring through year-end 2022, down from 29% at the end of 2019. The largest lease in the quarter was the 138,000 square foot full-building long-term renewal with the FBI in Tampa. Following this lease and T-Mobile's known July move-out of 116,000 square feet also in Tampa, we have one remaining expiration over 100,000 square feet through the end of 2022 – which is the FAA in Atlanta, who remains in holdover status and with whom we continue renewal discussions.

Our in-place cash rents grew 5.1% year-over-year, driven by higher rents on deals executed in the past 12 months, an improved portfolio mix as a result of the market rotation plan, and as always, in-place annual escalators.

As you know, all of our buildings and parking facilities remain open and available for our customers who are returning to the workplace in varying degrees with any return at scale still ahead of us. As Ted mentioned, this reduced utilization has impacted our parking revenues – with transient revenue nearly non-existent and some reduction from contractual monthly parkers. We've been able to offset the parking revenue delta with lower operating expenses. Moving forward we expect parking revenues to remain tied to building occupancy while we expect a sequential increase in op-ex as customers slowly return to their offices.

The volume of rent relief requests received has slowed significantly. We continue to work with those customers with a demonstrated financial need created by the COVID-19 pandemic. These customers account for 7.8% of our total annual revenues and the temporary deferrals we've provided them represents approximately 1.2% of annual revenues. We continue to see most of the requests fall into a few broad categories: our amenity retail and restaurants, flexible office providers, elective medical practices, and other businesses impacted by social distancing measures. While there are no silver linings to a global pandemic and near shutdown of the economy, the second quarter has given us an opportunity to get even closer to our customers. Whether it's administering the protocols of a socially-distanced and CDC-guided workplace, receiving inbound requests for help or structuring win-win extensions, we believe these strengthened relationships will benefit us in the years to come.

To that end, our rent collections have been strong throughout the pandemic with 99% collected each month through July. We believe we have a unique opportunity and responsibility to create desirable workplaces for our customers, and we remain committed to working collaboratively and constructively with them during these unprecedented times.

As expected, in-bound inquiries and new leasing activity has clearly slowed, with only 91,000 square feet of new leases and 48,000 square feet of expansions signed in the second quarter. For perspective, we have little revenue at risk in 2020 attributable to speculative new leasing and we've already completed the majority of spec renewals we forecasted for the year. At this point, and in response to the altered landscape, we've shifted most of the spec leasing in our outlook into 2021. However, we did see solid renewal activity with favorable economics in the second quarter.

Recognizing the challenge before us was also an opportunity, our leasing teams have quickly pivoted to the challenging dynamics on the ground. This includes showing our available space virtually and bringing a level of flexibility and creativity to leases as we navigate these uncertain times with our customers and prospects.

Now, turning to our markets.

Already the second largest financial center in the United States and having passed the city of San Francisco this quarter with regard to population, Charlotte continues to benefit from the Great Affordability Migration already underway prior to the pandemic, and, consistent with all of our markets, continues to see strong inbound interest. This was illustrated most clearly and most recently by Centene's 6,000 new job announcement in July that they will build their own 1 million square foot campus in University City adjacent to UNC-Charlotte. The continued economic attractiveness and diversification of our markets is a testament to having a:

- low cost of doing business;
- highly-educated and diverse workforce;
- strong transportation infrastructure;
- low cost of living; and
- higher quality of life.

Across the board, market rents are holding steady for the moment, while vacancy is marginally increasing, and the level of sublease activity is consistent with the onset of a recession. We continue to pay close attention to sublet availability across our markets. The wave of development projects launched pre-COVID continue to advance through various stages of construction and varying degrees of preleasing. Charlotte's 1.2 million square feet is 30% preleased, Atlanta's 5 million square feet is 60% preleased, Raleigh's 3 million square feet is 40% preleased, and Nashville's 2.8 million square feet is 28% preleased. Most of these projects don't deliver until 2021 or beyond which grants them the benefit of time.

As Ted mentioned, our development pipeline will deliver over $40 million of annual GAAP NOI upon stabilization. This includes $32 million from three projects that are fully pre-leased, on schedule and on budget.

In closing, I couldn't be prouder of the effort and results our teammates delivered for Highwoods in the second quarter. Their support of our customers' short-term needs has positioned us favorably in our markets, while our long-term perspective and presence across the southeast should benefit us in the changing landscape.

Mark Mulhern
Executive Vice President, Chief Financial Officer

In the second quarter, we delivered net income of $37.0 million, or $0.36 per share, and FFO of $99.2 million, or $0.93 per share. As Ted mentioned and we discussed last quarter, the $338 million of dispositions completed in the first quarter had a dilutive impact of $0.02 per share in the second quarter compared to the first quarter. Additionally, the second quarter was negatively impacted by lower parking revenue, which also had an approximate $0.02 per share drag compared to the first quarter. Offsetting these items was a significant reduction in net operating expenses and lower G&A. Given the challenging economic environment, we are pleased with our performance.

The quarter was relatively clean from an FFO perspective except for a $0.5 million charge to straight-line rents receivable. Excluded from FFO, but included in net income, is a $1.8 million impairment on a non-core building in Memphis.

Our balance sheet is in excellent shape. At quarter-end, we had $586 million of liquidity, which has now increased to over $600 million following the receipt of proceeds in early July from the sale of two non-core properties in Memphis. Our net debt-to-adjusted EBITDAre ratio held steady in the quarter at 4.9x and our leverage ratio, including preferred stock, is 36.8%. We have no debt maturities until June 2021 and expect to fund approximately $90 million on our development pipeline during the remainder of the year. As we discussed last quarter, we expect lower leasing capex than our original 2020 projections, which should drive higher free cash flow and dividend coverage. The combination of ample current liquidity, improving cash flows and projected disposition proceeds later in the year puts us in a strong position to fund the remaining $201 million to complete our development pipeline and repay our June 2021 bond maturity without the prerequisite of raising additional capital.

Turning to our outlook, we've updated our FFO range to $3.59 to $3.68 per share, which is up $0.04 per share at the low-end. Adjusting for the dilutive impact from the $23.3 million non-core disposition completed in July and the second quarter straight-line rent credit loss, neither of which was included in our previous range, our outlook is up $0.05 per share at the low-end and $0.01 per share at the high-end, on an apples-to-apples basis.

Last quarter, we provided a list of projected impacts from the COVID-19 induced economic slowdown. We updated these items and included a table in last evening's press release, and I'd like to provide a little more color:

- We lowered our parking forecast by an additional 1 to 2 cents per share for a total reduction of 5 to 9 cents per share compared to our original February 4th outlook. We previously expected improved utilization of our garages in the third and fourth quarters, but we now expect parking income will approximate the 2nd quarter level in the third and fourth quarters.
- Op-ex, net of recoveries, is now expected to be 6 to 8 cents per share lower than our original February 4th outlook, which mostly offsets the reduction in parking income.

- The dilutive impact from the $23.3 million non-core disposition and straight-line rent credit loss has lowered our outlook by 1 cent per share.

In addition to these specified COVID-19 induced changes to our outlook, we increased the low end of the prior range 3 cents per share. The result is an updated range of $3.59 to $3.68 per share. In total, the mid-point of our range is down 2.5 cents, or less than 1%, from our original February outlook. As we stated in the press release, our updated outlook excludes the potential impact of customers that file bankruptcy or otherwise irrevocably default on their leases and non-cash credit losses of straight-line rent receivables. Given the fluidity of the pandemic and its effect on the collectability of rents over the remainder of existing lease terms, such losses are still too speculative to project at this time.

Our year-end occupancy assumption is 89.0% to 91.0%, which we lowered 100 basis points at the high-end due to slower new leasing activity.

Our same property cash NOI growth outlook is 1.0% to 2.0%, excluding potential lost rental revenues attributable to COVID-19, but inclusive of the negative impact of temporary rent deferrals. Our prior range was 1.5% to 3.0%. The change from our prior outlook is driven primarily by the negative impact of temporary rent deferrals and free rent associated with early lease extensions. These items reduce 2020 cash NOI but will benefit cash flow in future years, while they have no impact on current year GAAP NOI or FFO.

As is our custom, we don't include the effect of future acquisitions, dispositions or development announcements in our FFO outlook. Ted mentioned we have $72 million of dispositions under contract that are scheduled to close later this year, and these have NOT been included in our updated FFO range. The low-end of our disposition range is $95 million and upper end is $150 million. We have maintained the original upper-end of our acquisition and development announcement categories as a placeholder in our current outlook, with a low-end of zero given the current uncertain economic environment.

To wrap up, we believe we are well-positioned to weather the uncertain economic environment given our balance sheet, portfolio, development pipeline and geographic diversification.