Management's Prepared Remarks
Second Quarter 2022 Conference Call
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Hannah True
Manager, Finance and Corporate Strategy
If 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. 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. These risks and uncertainties 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.

Ted Klinck
President, Chief Executive Officer
We had another excellent quarter. Our financial results were strong, our operations were healthy and our robust investment activities set the foundation for our continued long-term growth. This quarter's performance validates the strategy and execution we've deployed for many years: to deliver steady financial growth and strengthening cash flows while driving continuous portfolio improvement and setting the stage for future growth.

As we've stated before, our simple and straightforward investment strategy is to generate attractive and sustainable returns over the long term by developing, acquiring and owning a portfolio of high-quality, differentiated office buildings in the BBDs of our markets. A key ingredient in this strategy is to select markets that consistently outpace national averages on population and employment growth and are affordable and business friendly. North Carolina, which accounts for 35% of our NOI, was recently ranked the #1 state for business by CNBC, with Virginia, Texas, Tennessee, Georgia and Florida all in the top 11. In other words, all of our core markets, where we see the greatest opportunities over the long-term, are ideally situated in the highest-growth, most business-friendly region of our country.

Last week, we announced our entry into Dallas, which has long been at the top of our list for market expansion based on its strong demographic and economic trends. The Dallas metro area leads the nation in overall population growth and has been a premier destination for business relocations, particularly from the West Coast and the Northeast. In Dallas, we are principally focused on building out our presence over the long-run in three submarkets: Uptown Dallas, Frisco/Plano and Preston Center. These are essentially the three BBDs that run the tollway spine from the downtown area up towards Frisco. We are excited to partner with Granite Properties, a prestigious, privately-held commercial real estate investment, development and management company with deep roots in Dallas, to develop best-in-class assets in two of those BBDs.

First is Granite Park Six, a 422,000 square foot office development in the Frisco/Plano BBD, that is 12% pre-leased and is located within the successful Granite Park mixed-use development, where Granite is headquartered and has developed and operates 1.8 million square feet of office that is 96% occupied. Granite Park Six has healthy leasing interest, with more than 3 ½ years until projected stabilization.

Second is 23Springs, a 642,000 square foot office and retail property located in the Uptown BBD that is 17% pre-leased. For those of you familiar with Dallas, 23Springs is across the street from the Crescent in the heart of Uptown. The development has a scheduled completion date in 1Q25 and estimated stabilization date in 1Q28. Given the iconic profile of the property, its location and excellent ingress and egress to and from Uptown, we're confident about the project's long-term outlook.

These two development projects increase our total pipeline to $559 million, at our share, which is 32.7% pre-leased. Midtown West in Tampa and Virginia Springs II in Nashville, our two completed, not stabilized properties, comprise $95 million of investment and are a combined 93.6% leased. As you may recall, we started both of these projects completely spec in late 2019, and we are forecast to bring both properties to stabilization on time and on budget, with all of our lease-up occurring since the onset of the pandemic. The success of these projects illustrates our work-placemaking strategy: that the most talent-supportive workplace options in energized and amenitized BBDs will continue to be highly sought after by customers and their employees. We're excited about our current development pipeline, which will help drive future growth, and the potential for meaningful additional development given our well-situated land bank. In total, our development land can support over $4 billion of future projects, including $2.2 billion of office spread out over nearly 5 million square feet in most of our BBDs.

Given the volume of our investment activity in the quarter, it's easy to forget it was just a little over two months ago when we announced a meaningful expansion in Charlotte. First, we agreed to buy 650 South Tryon, a 367,000 square foot office building located in Uptown, and connected to our BofA Tower. We're scheduled to close on 650 later this quarter. We also acquired a mixed-use development parcel in the heart of Charlotte's dynamic South End submarket that can support at least 300,000 square feet of office and 250 residential units.

We sold $101 million of non-core properties in the quarter. This included $91 million of office and $10 million of land. With these sales, we delivered on our goal of returning our balance sheet metrics by mid-year 2022 to the same levels that existed prior to our 2021 acquisition of $683 million of office assets from PAC.

The investment sales market has been uncertain over the past few months as interest rates have risen and capital has become more scarce. Fortunately, our balance sheet is in excellent shape and we have no need to raise external capital to help fund our acquisition of 650 South Tryon or our current development pipeline. We expect the investment sales market will remain choppy over the next few quarters. However, over the long run, operating with low leverage enables us to be opportunistic in seeking additional investments that improve the quality of our portfolio and increase our long-term growth rate...all the while staying true to our mantra of being disciplined allocators of our shareholders' capital.

We also announced our plan to fund our entry into Dallas by exiting Pittsburgh. Importantly, once completed, the stabilization of our new development projects in Dallas and our Pittsburgh market exit, coupled with anticipated G&A savings, is expected to be roughly leverage-neutral and accretive to our cash flows, while improving the quality of our portfolio and providing higher growth over time. Our two trophy assets in Pittsburgh, PPG Place and EQT Plaza, have consistently maintained among the best occupancies in our entire portfolio. We are grateful for the terrific work our teammates have done on the ground in Pittsburgh, most of whom will continue to lease and care for our assets wearing the jersey of a reputable 3rd party service provider. As we stated in last week's press release, we have no pre-set timetable to sell these properties.

Turning to our results, during the second quarter, we delivered FFO of $1.00 per share, 8% higher than the second quarter of 2021, while simultaneously restoring our balance sheet to pre-PAC acquisition metrics. Plus, as we've often said and can be seen clearly in our financial results, we continue to reap the benefits of strengthening cash flows.

We are proud of our track record of delivering what we believe is the right balance between enhancing our future growth outlook while at the same time delivering current results. Since the beginning of 2021, we have:

- Announced the acquisition of $1 billion of high-quality office assets in the high-growth markets of Raleigh and Charlotte;
- Further bolstered our future development prospects by acquiring land in Atlanta, Nashville and Charlotte that can support an additional 800,000 square feet of office and 2.0 million square feet of mixed-use development;
- Entered Dallas, a high-growth market with significant future upside opportunities, and announced our plan to exit Pittsburgh;
- Sold $494 million of non-core buildings and land;
- Delivered 5.0% core FFO growth in 2021 and 8.0% growth year-to-date in 2022;
- Generated significant growth in free cash flow; and
- All the while maintained a fortress balance sheet and setting the foundation for future growth.

We believe this track record is what sets us apart…the consistent delivery of compounded growth in earnings, cash flow, dividends and NAV per share. Most importantly, with our geographic footprint, BBD selection, portfolio quality, development pipeline, land bank and fortress balance sheet, we firmly believe our best days are ahead.

Brian Leary
Executive Vice President, Chief Operating Officer

For the second quarter, our people and portfolio have once again delivered excellent results. While there is yet to be consensus around what the future of work actually looks like, there does seem to be a general consensus among our customers that their best and brightest are indeed better together and that they are increasingly counting on the workplaces we provide to be the compelling and competitive currency for retaining, recruiting and returning the talent they need to win on whatever playing field they are on.

To that end, our team signed 117 second generation deals for a total of 683,000 square feet, which 243,000 square feet of new deals in the second quarter and expansions outnumbered contractions two to one. We signed 49 new deals in the quarter, exceeding our historical average, and are off to a good start this quarter with more than 350,000 square feet of second generation leases signed in July, including 130,000 square feet of new deals. In the second quarter, we achieved GAAP rent growth of 12.6% and net effective rents of $16.98 per foot, 10% higher than our prior five-quarter average and the highest since the third quarter of 2020. As we have long stated, we pay closest attention to net effective rents when assessing our leasing economics.

Turning to our markets, where in-migration continues across the Sunbelt and unemployment rates are lower than the national average. Utilization continues to increase with Tuesday-through-Thursdays generating the greatest physical occupancy, with multiple BBDs and assets at or approaching pre-pandemic levels. Most of the second quarter's activity occurred among smaller users and predominantly in our suburban BBDs.

Raleigh ended the quarter at 91.9% occupied and achieved the greatest leasing volume with 199,000 square feet signed. Raleigh rents have increased 6% year-over-year and the market posted positive net absorption for the third consecutive quarter.

In Charlotte, where we ended the quarter 94% occupied, we signed 33,000 square feet, including 22,000 square feet of new deals at our Bank of America Tower and are seeing good leasing momentum at 650 South Tryon, which we expect to close on later this summer.

This quarter in Nashville, our team signed 95,000 square feet, including 17 new deals, occupancy held steady at 95% and our Virginia Springs II development is now 100% leased. Nashville market rents are up 6% year-over-year and employment growth exceeds the national average at 5.5%.

As Ted mentioned earlier, our development pipeline is strong. Our two completed, not-yet-stabilized properties are a combined 93.6% leased, with 27,000 square feet signed at our Midtown West development in Tampa since last quarter and the last 11,000 square feet of remaining availability at Virginia Springs II in Nashville was signed as well. Our team's track record of success in delivering on-time and on-budget gives us confidence looking ahead at both our development current pipeline and the opportunities before us, including the over $4 billion of future potential development supported by our current land bank.

I'd like to close with an additional outlook on near and long-term growth. Since our last call in April, we've announced the pending acquisition of 650 South Tryon, a 367,000 square foot multi-customer office tower of the highest quality at the pin corner of where Charlotte's Uptown and South End BBDs meet. 650 joins our 841,000 square foot Bank of America Tower as the second Highwoods asset amid the dynamic Legacy Union mixed-use development. Legacy Union's location represents the redefined "main-and-main" address in Uptown with unparalleled access to the interstate and Charlotte's light rail system amid a mixed-use district served by a Whole Foods, a new JW Marriott hotel and a variety of restaurants. Also in the second quarter, and a half-mile to the south in the heart of Charlotte's South End business district, we closed on a land parcel off-market that provides a tremendous opportunity for office and mixed-use development, and where we've already received a healthy dose of inbound interest from retail, residential and hotel developers looking to be part of our plans there. With this development site, along with the 2 million square feet of best-in-class office space our Charlotte portfolio represents, in just three years we've established a formidable presence in the Queen City with growth opportunities in all three of the BBDs we targeted when we entered the market in 2019.

Growth into Dallas via joint venture development is a very effective and efficient way to enter this high-growth market in two of the three BBDs we've long had our eye on. Our partnership with Granite Properties at Granite Park Six and 23 Springs provides a bedrock foundation from which to build and gives Highwoods visibility into a long-term and productive presence in Big D. The Dallas economy is home to the 2nd most Fortune 500 HQs in the United States and leads the nation in three-year job growth. We believe Dallas' robust and diversified economy, coupled with best-in-class BBD positions in Uptown and Frisco/Plano provides fertile ground from which to grow.

This is consistent with our long-term and simple strategy of owning the best workplaces in the best business districts of markets that are outperforming the nation on a variety of factors. Our urban and suburban BBD focus, portfolio quality and robust development pipeline serve as a strong foundation from which we will continue to deliver for our customers and shareholders in the years ahead.

Brendan Maiorana
Executive Vice President, Chief Financial Officer

In the second quarter, we reported net income of $50.5 million, or $0.48 per share, and FFO of $108.1 million, or $1.00 per share. The quarter included a land sale gain of 2 cents and losses of 2 cents related to a single customer's lost rental revenues and non-cash credit losses of straight-line rents receivable. Neither of these items were included in our prior FFO outlook and essentially offset one another. Adjusting for the quarter-to-quarter fluctuations in land sale gains, term fees, credit reserves and seasonal G&A changes, core operations in the second quarter were similar to the first quarter. The main difference was modestly lower operating margins in 2Q, which we forecast when we provided our original outlook in February.

Our strong start to the year and upbeat outlook for the second half of the year give us confidence to increase our FFO outlook again this quarter. Our updated range is $3.92 to $4.00 per share, up $0.06 at the mid-point, which is on top of the $0.06 increase at the mid-point we provided last quarter. In total, we've increased the mid-point of our FFO outlook more than 3% since we introduced our 2022 outlook in February.

As you may have seen in our press release last night, other than including the expected impact of acquiring 650 South Tryon, which we expect to close later this quarter, we've returned to our customary practice of excluding the impact of any potential acquisitions or dispositions from our FFO outlook. Besides the updated investment items, which provide you some context of what we could announce for the remainder of the year, there were minimal changes to the other line items in our 2022 outlook.

Now, to our balance sheet. Our leverage remains relatively low and we have limited debt maturities, which creates optionality with our financing plans. During the quarter, we recast the Company's $200 million unsecured bank term loan by extending the maturity date from November 2022 to May 2026, and lowering the borrowing rate approximately 15 basis points. We also obtained a $150 million delayed-draw unsecured bank term loan, which must be drawn by August 2022, and is scheduled to mature in May 2027. Our only debt maturity prior to 2026 is a $250 million unsecured bond that matures in January 2023 that we can repay without penalty in October of this year. We plan to satisfy this maturity with a combination of proceeds from the delayed-draw term loan, borrowings on our revolving credit facility, retained cash flow and non-core dispositions.

We have approximately $600 million left to spend to complete the acquisition of 650 South Tryon and finish our share of the current development pipeline. We have ample existing liquidity, including 60% loan-to-cost construction loans for our Dallas joint venture developments, to satisfy these long-term obligations and repay the $250 million bond due in January 2023. We believe we can fund these growth opportunities without the prerequisite of selling any assets or raising equity, and still maintain a net debt-to-EBITDAre ratio under 6x.

As Ted mentioned, we've returned our metrics to pre-PAC acquisition levels by mid-2022, which satisfies the timeline we set a year ago, with our debt-to-EBITDAre ratio of 5.2x at June 30th. We sold $463 million of non-core assets following our announcement to acquire the portfolio of high growth office assets from PAC, slightly below our original forecast of $500 to $600 million. However, we were still able to achieve our balance sheet target by growing EBITDA more than our original expectations, increasing retained cash flow and raising a modest amount of equity through our ATM program, albeit none in the second quarter.

To provide context, since we announced our planned acquisition from PAC, we've completed net investments of over $350 million, grew year-over-year FFO 8%, increased our annual dividend 4% and retained over $80 million of operating cash flow in excess of our dividend payments…all while returning our balance sheet to pre-PAC acquisition levels. As we've stated for several years, our cash flows continue to strengthen which, combined with solid organic EBITDA growth, gives us the platform to be a net investor on a leverage-neutral basis without the prerequisite of issuing new equity. Importantly, we have replenished our balance sheet's dry powder, which enabled us over the past 2+ months to commit $530 million of future investments knowing that we can fund these commitments without significantly increasing leverage or jeopardizing our fortress balance sheet.

Finally, I want touch on our announcement last week about our entry into Dallas and planned exit from Pittsburgh. As many of you know, we have completed two similar market rotations over the past 3 years. In 2019, when we announced our plan to enter Charlotte and exit Memphis and Greensboro, we stated Phase I of that plan would be FFO neutral, leverage neutral and cash flow accretive. We completed that plan within our 12-month timeline and, in the first quarter following completion of Phase I, our FFO was 7% higher than the prior year and our balance sheet was returned to pre-plan metrics. Similarly, we announced the planned acquisition of office assets from PAC last year with a corresponding plan to accelerate non-core dispositions. We also stated we expected this planned recycling to be FFO neutral, leverage neutral and cash flow accretive upon completion. As I stated earlier, we've returned our balance sheet to pre-announcement levels, our FFO is 8% higher than a year ago, and our cash flow has strengthened with more than $80 million of retained cash flow in the last 4 quarters.

Our entry into Dallas, combined with our planned exit from Pittsburgh, has many of the same financial benefits as our prior capital recycling plans – namely leverage neutrality and cash flow accretion upon completion. Given the construction timetable for the Dallas developments, the primary difference this time is that we may not be able to match-up the timing of the dispositions with the commencement of NOI from our investments as seamlessly as we've done in the past. While this could create some choppiness in short-term earnings, over the long-term we are confident that our latest capital recycling plan will result in higher cash flows and an enhanced long-term growth rate without compromising our fortress balance sheet.