Bluerock Residential Growth REIT

Q4 2017 Earnings

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CORPORATE PARTICIPANTS

Ramin Kamfar - *Chief Executive Officer*

Christopher Vohs - *Chief Financial Officer*

Ryan MacDonald - *Chief Acquisitions Officer*

Jordan Ruddy – *President and Chief Operating Officer*

Jim Babb – *Chief Investment Officer*

PRESENTATION

Operator
Good morning ladies and gentlemen, and welcome to Bluerock Residential Growth REIT's Fourth Quarter 2017 Earnings Conference Call. All participants will be in a listen-only mode. After today's presentation there will be an opportunity to ask questions. Please note this event is being recorded.

I now would like to introduce your host for today's call, Christopher Vohs, Chief Financial Officer of Bluerock Residential. Mr. Vohs, please go ahead.

Christopher Vohs
Thank you, and welcome to Bluerock Residential Growth REIT's Fourth Quarter, 2017 Earnings Conference Call.

This morning, prior to market open, we issued our press release and supplement. The press release can be found on our website at bluerockresidential.com under the Investor Relations' tab. In addition, we anticipate filing our 10k within the next week.

Following the conclusion of our remarks, we'll be pleased to answer any questions you may have. Before we begin, please note that this call may contain forward-looking statements as they are defined under the Securities Litigation Reform Act of 1995. There are a variety of risks and uncertainties associated with forward-looking statements and actual results may differ from those set forth in such statements. For a discussion of these risks and uncertainties, you should review the forward-looking statements disclosure in the earnings press release we issued this morning as well as our SEC filings. With respect to non-GAAP measures we use in this call, including pro forma measures please refer to our earnings supplement for our reconciliation to GAAP, the reasons management uses these non-GAAP measures with the assumptions used with respect to any pro forma measures and their inherent limitations.

With that, I'll turn the call over to Ramin Kamfar, Chairman and CEO of Bluerock Residential Growth REIT, for his remarks.

Ramin Kamfar
Thank you, Chris, and good morning everyone.

In addition to Chris, with me today are several additional team members of our executive team. Jordan Ruddy, our President and Chief Operating Officer; Jim Babb, our Chief Investment Officer; and Ryan MacDonald, our Chief Acquisitions Officer.

I will focus my remarks on our key strategic accomplishments and financial highlights from the quarter and will close with some internalization and capital markets commentary. Afterwards, I will ask Ryan to provide you with additional operational, transactional, and outlook detail.

2017 was a noteworthy year in BRG's evolution with a number of significant accomplishments, but I'd like to highlight the first of these is our internalization, which we completed at the end of October. Internalizing our management was a goal that we had laid out at the time of our IPO and we're pleased to have completed this milestone. We expect the transaction to have a number of benefits, including reducing our G&A growth as we go forward and continue to grow to eliminate any perceived potential for conflicts in terms of alignment of management with our stockholders and to provide us the opportunity to expand our institutional shareholder base.

The second highlight is our ongoing portfolio enhancement and growth during 2017. We deployed approximately $339 million of equity in real estate transactions, and this included $208 million in equity for acquisitions of 12 well-located, high-quality, highly amenitized properties in knowledge-economy growth markets comprising over 4,400 units and $124 million for eight mezzanine and preferred investments in development properties comprising over 2,000 units. With our expertise and relationships, we were able to both source attractive prospects and be opportunistic in our investment strategy. Our activity this year is a good representation of our investment strategy, which is to seek out high-quality operating assets with value creation opportunities as well as selective development deals where we can limit Bluerock's risk exposure about earned compelling returns through our mezzanine and preferred investments.

During the year, we completed approximately $219 million in dispositions, generating IRRs between 22% and 38%. This demonstrates both our ability to create value as well as the discipline to sell at the appropriate time, and to recycle that capital into assets that further enhance our portfolio and growth profile.

Our third highlight is an enhancement to our balance sheet through implementing a $150 million bank line of credit, which provides us with increased flexibility to grow our portfolio and with more efficient cash management abilities. We also continued our opportunistic use of our Series B 6% preferred offering, which offers us access to cost-effective capital.

In terms of operational performance, our fourth quarter results reflect the fact that we were continuing to invest our available cash through late in the quarter. This positions us well as we go into 2018, but also means that investors will see the full earnings capability of our investments starting in the first quarter of '18 versus the current quarter. Furthermore, we anticipate that our performance should accelerate into the back half of the year as we implement our operational expertise and re-stabilization in our recently-purchased assets.

Now turning to our fourth-quarter results. On the revenue front, we are continuing to achieve meaningful growth. Our top line revenue for the fourth quarter was $36.5 million, which is a 54% increase from $23.7 million in the prior year quarter largely as a result of our significant investment activity since Q4 of 2016. I should note that our revenue growth was impacted by our asset sales in the second quarter and expect a reinvestment of those proceeds will produce a full-run rate starting in the first quarter of 2018.

Net loss attributable to common stockholders for the quarter was $1.87 per share as compared to our net loss of $0.34 per share for the prior year quarter.

For the quarter, our adjusted funds from operations attributable to common stockholders or AFFO was $3.1 million compared to $3.7 million in the prior year quarter. On a per share basis, AFFO came in at $0.13, which exceeded our guidance of $.03-$.06 per share.

Moving on to property operations, property NOI grew to $20.2 million in the quarter, which is a 37.6% increase from $14.7 million in the prior year quarter. Same store NOI was down 60 basis points for the quarter versus the prior year quarter. This was impacted by the asset mix in our same-store pool changing due to recent asset sales and also by market challenges at two assets in Frisco and Fort Worth. Ryan is going to provide you with additional detail on that.

Our asset base continues to grow. Our gross assets are over $1.6 billion, which is up 10% on a quarter-to-quarter and 36% on a year-over-year basis.

On the acquisition front, during the fourth quarter, we closed on four operating properties totaling over 1,600 units for approximately $96 million in BRG equity and made mezzanine loan investments in three development properties totaling over 700 units for approximately $84 million in BRG equity. And finally, on the investment front, we consolidated our ownership in five assets during the quarter by buying out minority interests with an $8 million investment. Again, Ryan will provide additional detail for you.

Shifting to capital markets, during the fourth quarter, we completed sales totaling $46.7 million of our Series B 6% preferred shares. This preferred offering is an important part of our growth strategy, because it continues to offer us access to cost-effective, accretive capital, while at the same time minimizing potential dilution because it is convertible into common stock at a future price after two-years. So it enables us to access the markets without dilution at current equity prices. Our series B raise will be lower in the first quarter of '18, because our primary offering expired at the end of December and we are kicking off the follow-on offering, which takes time to build momentum. We expect that the quarterly run rate will be accelerate back to a steady-state level in the $45 to $50 million a quarter range over the next couple of quarters.

Moving onto the internalization, on October 31st, following the approval of stockholders at our annual meeting, we closed the internalization of the external management function previously performed by our manager to further align the interest of our management team with those of our stockholders; 99.9% of the consideration was paid in equity.

In December, the board approved an adjusted common stock dividend policy with an annual dividend rate to be set at $0.65 a share, which we expect to be covered on a run rate basis in 2018.

Finally, I'm pleased to announce that the board has authorized a share repurchase program of up to $25 million. This share repurchase authorization is an important component of our capital allocation plan, as it is accretive both from an NAV and AFFO point of view and underscores our conviction in the value of the equity and our commitment to creating value for our shareholders. We intend to use this program opportunistically and with consideration of a number of factors, including prudently managing our leverage, stock price and other investment alternatives.

On a personal level, given my unwavering belief in the value of the company's equity and its outlook, I recently purchased a significant amount of additional shares and units, as you can see detailed in a Form 4 filing that occurred last week, increasing, again, my personal ownership of BRG.

With that, I'd like to turn the call to Ryan. Ryan?

Ryan MacDonald
Thank you, Ramin, and good morning everyone.

I'd like to start off by noting that from the same-store perspective, this quarter continued to be a transitionary period for us, as we finished reinvesting the substantial capital on our balance sheet into growth-oriented assets whose performance will not be captured in the same-store pool for some time. Today, our same-store pool consists of 11 properties versus the total operating asset base of 28 communities.

Portfolio-wide, across BRG's assets, average occupancy for the fourth quarter of 2017 was 94%.

Same-store revenue increased 2.8% over the prior year period, driven by a 2.7% increase in average rental rates versus the prior year period and a 20 basis point decrease in occupancy. Same-store expenses increased by 8.6%, of which almost half stem from increased real estate tax accruals, and the remaining from an increase in R&M and turnover costs. I would like to point out, however, the nominal gross dollar change was fairly limited at approximately $430,000, given the smaller subset of the same store pool versus our total operating portfolio. And as a result, NOI in the fourth quarter decreased by 60 basis points.

Like the prior quarter, I want to note that our same-store performance was disproportionately impacted by negative performance from two assets in the DFW MSA, and particularly our Frisco asset, which remains a challenge with new supply and where we expect the operational volatility to persist through 2018. Starting in 2019, we are forecasting a dramatic drop in the number of new deliveries within the Frisco submarket and we should benefit from more favorable supply/demand characteristics. Excluding the two DFW assets, year-over-year same-store revenue and NOI increased 4.6% and 1.4% respectively.

On the operational margin front, we experienced a 310 basis point decline in our margin to 59%. This decline is primarily attributable to our 2017 disposition and reinvestment activity, which will establish an attractive longer-term growth profile for the company. We exited mature cash flowing assets and recycled the capital into higher growth opportunities that typically take a couple of quarters to stabilize into a steady operational state. During a period of high investment activity, elevated turnover during an asset takeover is typical, and one-time upfront expenses can further disproportionately distort margins.

Shifting to the investment front, in the fourth quarter we closed on four operating property investments totaling over 1,600 units and approximately $260 million in gross asset value and $96 million in BRG equity. The business plans focused on executing our core plus renovation strategy, which includes targeted capital improvements to the interior units and amenity areas, so that we can migrate the assets to our standard, highly amenitized live/work/play lifestyle products. Two of the investments were partially funded withdrawals from our new line of credit totaling $54 million. Our Hunters Creek purchase was funded with a $72 million fixed-rate loan from Freddie Mac at 3.65%. The assets are projected to yield a year one cap rate of 5.3% and grow to a stabilized cap rate of approximately 6.5% versus the market cap rates ranging from 5% to 5.25%.

In addition to the four property acquisitions, we close on the buyouts of minority ownership interest in five assets totaling $8 million in BRG equity and originated three development mezzanine loans with a combined BRG investment totaling $84 million.

In terms of development commitments, the $84 million in originated mezzanine loans included the conversion of three common equity development investments to mezzanine loans. Prior to the conversion, we had funded approximately $50 million in common equity for investments in Crescent Perimeter and Vickers Village in Atlanta, Georgia, and the Metropolitan in Fort Lauderdale, Florida. As part of the conversion to mezzanine loans, we invested an additional $34 million in order to fully fund the $84 million commitment, all of which is earning a 15% annualized cash AFFO. Following the conversion of existing development common equity and additional investment in the three projects outlined, the total BRG investment and development preferred equity and mezzanine loans is projected to be approximately $212 million.

At year-end, BRG had $39 million available for investment through a combination of cash and availability on our bank line of credit.

Finally, let's turn to our outlook. We are optimistic about the year ahead and have an attractive portfolio which should continue to deliver solid growth as the properties stabilize.

We are introducing a full-year AFFO per share guidance for the first time, and for 2018, we expect AFFO per share to be in the range of $0.65-$0.70 per share.

These guidance numbers reflect the benefits of realizing the earnings power from investing approximately $218 million in BRG equity throughout the last half of 2017. The ramp in NOI should continue throughout the year as we begin to realize the value creation opportunities through stabilization of properties, operations during acquisition takeover and the benefits of our core plus renovation strategies. For additional detail on our underlying assumptions, please refer to our earnings release and supplement.

And with that, I will now return the call to Ramin to conclude.

Ramin Kamfar
Thank you, Ryan. That's the end of our prepared remarks, and with that I'm happy to open it up for Q&A.

QUESTION AND ANSWER

Operator
Thank you. We will now begin the question-and-answer session. To ask a question, you may press star, then one on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star, then two.

Our first question comes from Rob Stevenson of Janney. Please go ahead.

Rob Stevenson
Good morning, guys. Can you talk a little bit about how you guys are expecting to fund any stock repurchase is that you wind up doing? So they're going to be some corresponding dispositions? Are you guys willing to use the line or other stuff to--other capital, the Series B preferreds, etc., to buy back common?

Ramin Kamfar
How are you, Rob? It's a good question. We have cash availability on hand. Between what we have on hand, between the line, and between the Series B to fund the $25 million and more. We think that, obviously, if it gets to a point you can always sell assets and buy back stock because what we can get for our assets in the market today at a 5% or 5.25% cap is significantly higher than our market-implied cap rate.

So it would be accretive to us, but we don't plan to do dispositions at this point. I think part of our migration, we had a lot of movement in terms of our income statement and balance sheet in 2017 to set ourselves up with a go forward portfolio that's core for us. So we exited markets that weren't core assets, that weren't core assets where we didn't own the substantial majority, 90% or 100%. So we have a great portfolio going forward and we anticipate what you'll see, and it is hopefully a lot less turnover and disposition activity as we focus on our run rate AFFO and growing that.

So that's a long-winded bigger-picture answer than what you asked, but the short version is: we're not anticipating dispositions from that at this point.

Rob Stevenson
Okay. And then given the different vintage assets that you guys have in the portfolio today, how many units to you guys currently have targeted for either kitchen-and-bath upgrades or something more extensive? And how much of that do you expect to fund in 2018?

Ryan MacDonald
Sure, Rob. This is Ryan. We have almost 4,000 units that we can renovate throughout the course of the lifecycle of the assets, and I think this year we've targeted about 1,400 units across the platform. Our average cost is about $6,000 per unit and the projected ROI is approaching 30%, so about a $150 to $175 increase.

Rob Stevenson
Okay. And then last one for me. You indicated that there was a sort of pause as the Series B expired and you guys are in the process of renewing that. When you take a look at the 50 basis points move in the ten-years at the beginning of the year, how much of a change in appetite are you expecting on there? And is anything that you guys have sold previously been below the $1,000 par?

Ramin Kamfar
So in terms of appetite, we don't see a significant change in appetite for the Series B. As you know, it's a 6% coupon, and that is significantly higher than you could get still in the treasury market, and it comes with a different risk/return profile. People buy the Series B because of stability and a lack of volatility in price, in addition to the fact that it has an attractive yield. So we don't anticipate that there's going to be a significant change in demand and we're not hearing that in the market.

Was the second question that had we sold it at a discount? If I'm understanding the question right, the answer is no and we don't anticipate to.

Rob Stevenson
Okay, perfect guys. Appreciate it. Thanks.

Operator
Once again, if you have a question, please press star then one. Our next question comes from Drew Babin of Robert W Baird. Please go ahead.

Drew Babin
Hi, good morning. A question on your market. I think one market there you had a decent concentration in is Orlando. And looking down the list of your properties, it looks like they have some of the higher occupancy rates across your portfolio, probably having to do with migration in from Puerto Rico, which is happening in that market.

Is there anything that you're doing in Orlando to try to manage down occupancy at the margin and translate that to rate growth as we approach the 2018?

Ryan MacDonald
Certainly, Drew. Yes, we did increase occupancy heading into the end of the year, but we are forecasting it returning to a more normalized, call it 95% rate and driving rental rates throughout the year. So I don't envision it staying up around 97%, 98% across the board, but we are seeing some significant rent growth in Orlando.

Drew Babin
And you see that as being relatively sustainable given the dynamics there and maybe not just kind of a temporary lift?

Ryan MacDonald
We do. I think we're pretty confident with the forecast throughout the year. I think the jobs-to-supply ratio there has been pretty strong, and then long-term I think we're big on Orlando being an experiential entertainment hub that will continue to drive a long-term job growth.

Ramin Kamfar
Drew, I think obviously the in migration from Puerto Rico has eaten up multifamily space in Orlando, and some of the soft markets. It's not really our assets, but obviously as the market tightens up, we get a temporary lift. But that's a small part of what we see in the Orlando picture.

Our core strategy is to build these highly amenitized live/work/play apartment communities and next generation knowledge economy markets. As we transition from an industrial economy to a knowledge economy, these are going to be markets that drive the next generation of job growth. And by that, I mean healthcare, education, technology, finance, trade, high-value manufacturing, entertainment, and energy.

And Orlando, when you look at it, is a market that has irreplaceable entertainment that you can't replicate anywhere else. And as we move towards more of an experience-based economy where people are paying for experiences, this is a market that's going to continue to grow over the next decade, two decades, three decades.

So it's a core next-generation market for us, and I think we'll look back at it in 10 years and see how incredibly it's changed. I just spent two days touring the market and touring our assets there, and we're big believers in Orlando.

So while Puerto Rico is a giving us somewhat of a lift, there are a longer-term job drivers in Orlando that will sustain that over years and decades in our point of view.

Drew Babin
Thank you, that's very helpful. And shifting to other markets, obviously sort of Dallas-Fort Worth there's been some new supply. Obviously, demand is very strong in that market and Ryan touched on Frisco supply kind of dropping off. Are there any other markets across the sun belt where supply presents somewhat of a risk or somewhat of a headwind in 2018 that you might be watching a little bit more closely?

Ryan MacDonald
Sure. Drew, it's Ryan again. I mean, I think Durham has been one that, again, we like long-term, but we continue to see a little bit of supply pressure in downtown Durham, but again long-term we think it's got potential to be, call it the 24-hour destination within the triangle.

So that in particular is one. Charlotte has been a little bit soft, call it through the end of the year, early part of this year, but we expect job growth to accelerate in '18 and then have some of the deliveries drop off. So those are two that come to mind.

Drew Babin
That helps. And I guess I'll leave it with one balance sheet question. A floating rate that is kind of a percentage of your overall debt, that is significant. And with what's happening with interest rates, I guess are you looking at any hedging options or anything that you might view as worthwhile, given the forecasts and increases in interest rates.

Obviously, debt costs are still very low relative to what you invest at, but I'm just curious if there's any conversations happening related to that?

Ryan MacDonald
Sure, Drew. I will tell you that we are migrating the portfolio fixed versus floating percentage up. I think we got a couple refinancings in the works that will drive that up probably about 10% on average. And then, we should be able to continue migrating the fixed versus floating percentage up further throughout 2018 as we focus on fixed rate financing.

So the percentage of floating will come down, I'll say immediately, but also throughout '18 as we populate more fixed rate financings. But yes, we are always looking at hedging options for our floating exposure, as well.

Drew Babin
Great, thank you. Great quarter.

Ramin Kamfar
Thank you.

Operator
Again, if you have a question please press star, then one. At this time, we will pause momentarily to assemble our roster.

And our next question comes from Paul Penney of Northland Capital. Please go ahead.

Paul Penney
Hi, guys. Can you give more color on G&A and how you expect that to trend post now being internally-managed?

Ramin Kamfar
Well hi, Paul. G&A is obviously when we're externally managed, it is growing by one and a half percent of our equity base. That was our management fee. That number, the growth is going to be significantly lower than that, at about, let's say, half to one third of that going forward, because you've got pretty much the senior team in place.

And as we grow out, as we fill in underneath that, it is going to be at a significantly lower ramp, which is one of the benefits of the internalization. You can see the G&A numbers that we've forecast in our outlook. We're guiding to $11.7 to $11.8 million on a cash basis, and that's a significant benefit to where we would have been with externalization, with an external manager, I mean.

Paul Penney
Yes. Great, thank you. I missed the first part of the call, in terms of trends on cap rates, what are you seeing lately and does it change your strategy going forward for the company in terms of your growth plans? And secondarily, are there any markets that are maybe, as you reevaluate, are non-core or nonstrategic that you would potentially look to to sell and redeploy?

Ryan MacDonald
I'll take the first part of that question. On cap rates, Paul, cap rates are pretty much the same as they were last year. There hasn't been any gapping out from interest rate increases, and I think a lot of it has to do with capital flows in the multifamily space.

You know, us as a company, we try not to buy assets on a marketed basis, so we're always looking for an incremental spread when we buy assets relative to market not only immediately but obviously creating additional spread after we drive our core plus renovation strategy.

But as a whole, marketed deals I think generally pricing is pretty consistent with where it was last year. Call it a pre-interest rate run. On the market strategy piece, I think post-recycling of assets in 2017 we're very comfortable with our portfolio footprint today. I mean, we are looking at additional growth markets all the time, whether it's Denver, Phoenix, etc., but it has to be the right opportunity, right cost of capital, the right value proposition for us, so.

But the existing portfolio today, market-wise, we're very comfortable long-term.

Paul Penney
Great. And one last one, are there any new strategic partners that you've added to the fold, like the Trammel Crows of the world? Are there any new partners that you've added that are partners with you guys in '18?

Ryan MacDonald
We haven't added any additional in '18, but we did add one called CWS Capital Partners in '17. Again, great, well-established organization that's been in business for over 30 years, and we partnered on a transaction, a portfolio transaction together in Texas and are currently looking at new opportunities with them, as well. So it's been a good partnership thus far, and we look forward to more deals with them.

Operator
Thank you. And once again, if you have a question, it is star, then one. We will pause momentarily.

As we have no further questions, I would like to turn the conference back over to Ramin Kamfar for any closing remarks.

CONCLUSION

Ramin Kamfar
Thank you, operator, and I wanted to thank everyone for giving us their time today. Look forward to reporting on our progress here and showing our earnings capacity starting at the first quarter of this year. Thank you, everyone, for your support. Have a good day.

Operator
The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.