Bluerock Residential Growth REIT

Second Quarter 2018 Earnings Conference Call

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CORPORATE PARTICIPANTS

Ramin Kamfar – *Chairman and Chief Executive Officer*

Christopher Vohs – *Chief Accounting Officer*

Ryan MacDonald – *Chief Acquisitions Officer*

PRESENTATION

Operator
Good morning, ladies and gentlemen, and welcome to Bluerock Residential Growth REIT's Second Quarter 2018 Earnings Conference Call. All participants will be in listen-only mode. After today's presentation, there will be an opportunity to ask questions. Please note this event is being recorded.

I would now 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 second quarter 2018 earnings conference call. This morning prior to market open, we issued our earnings 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 10-Q this 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 Private 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 a reconciliation to GAAP, the reasons management uses these non-GAAP measures, and the assumptions used with respect to any pro forma measures and their inherent limitations.

And 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 key 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 key strategic accomplishments, our financial highlights from the quarter, and close with some capital markets commentary. Afterwards, Ryan will provide you with additional operational, transactional, and balance sheet detail.

We followed up on our solid start to the year by delivering another solid quarter from an operational perspective. We also continued to advance our strategic objectives in terms of portfolio growth, ongoing balance sheet enhancements, and disciplined capital allocation. Our GAAP net loss attributable to common stockholders for the quarter was $0.44 per share as compared to net income of $0.67 per share for the prior year quarter. I will point out that the 2017 quarter figure benefitted from $1.26 in one-time gains, so on an operating basis the comparable figure was a net loss in the prior year quarter of $0.59 per share.

Turning to operating numbers, on a per-share basis we delivered AFFO of $0.17, which fully covers our $0.16 quarterly dividend for the second consecutive quarter. This reflects, this AFFO per share reflects a 31% growth on a year over year basis. Again, I'll point out that the 2017 quarter benefitted from the payment of our management fee in LTIPs versus paying them in cash. So, excluding the LTIP impact, the year over year per share AFFO growth was much more significant, with an increase of over 450%. I'd like to note that starting this quarter we are expanding our disclosure by reporting a core FFO number. The core FFO number will add back noncash, nonoperating expenses such as accretion on our Series B Preferred Stock, which is a unique expense to us and which depresses our NAREIT FFO and creates misleading valuation metrics when we are compared to our peers. You can find a discussion of our core FFO in our press release and supplement.

The quarter had significant growth on the revenue front, producing a 57% increase in the second quarter to $45 million from $28.7 million in the prior year quarter. This was largely a result of our significant investment activity in the latter half of 2017. Moving on to property level results, property NOI grew to $22.5 million in the quarter, which improved 49% from $15 million in the prior year quarter. Same store revenues and NOI grew a healthy 3.6% and 3.9% respectively for the quarter versus the prior year quarter. Ryan is going to provide additional detail in his remarks. Our asset base continues to grow. Gross assets are now more than $1.8 billion, which is up 28% on a year over year basis and 4% on a quarter to quarter basis. On the acquisition front, we closed on two operating properties during the quarter and another post quarter end for a total of 902 units with BRG investing $42 million in equity. We also continue to add to our wholly owned asset base by buying out our partners' interest in two assets. Again, Ryan is going to provide additional detail.

Shifting to capital markets, during the second quarter we raised $32 million through sales of our Series B 6% Preferred Shares. This preferred offering is an important part of our growth strategy as it continues to offer us access to cost-effective capital while at the same time minimizes potential dilution as the preferred is convertible into common stock based on the future stock price at the time of conversion, not based on our current stock price based on the issue date. We continue to expect that the quarterly run rate will reaccelerate back to its steady state level in the $45 million to the $50 million range over the next several quarters.

Additionally, in the second quarter the Company repurchased approximately $1 million worth of shares at an average price of $8.96, bringing our year-to-date purchases to $5.2 million. The share repurchases are an important component of our capital allocation plan and are accretive both from an NAV and AFFO basis and underscore our conviction in value for equity and commitment to creating value for stockholders. We intend to continue utilizing this program opportunistically with consideration of several factors, including valuation metrics, prudently managing our leverage, and analyzing other available investment alternatives. As we look ahead, we believe we are well positioned with multiple growth levers.

From an operational perspective, we're focused on achieving NOI growth as demonstrated by our 49% increase in NOI year over year, and by delivering 3.9% on a same-store basis in the second quarter. Our footprint is in markets which continue to display strong demand dynamics for the highly amenitized assets that we own and which continue to demand strong rent growth above the U.S. average. We also have a meaningful opportunity to capture attractive returns from our value-add upgrade program. To date, we've renovated north of 900 units with an average return on investment of 27%, and we have approximately 4,900 additional unrenovated units that we intend to upgrade, which should drive both our NOI and NAV significantly over time. Finally, we remain active but disciplined on the acquisition front, primarily sourcing opportunities which aren't widely marketed. Our ability to access capital through our Series B Preferred Offering allows us to act on such opportunities accretively, grow our portfolio, and add value for shareholders.

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

Ryan MacDonald
Thank you Ramin, and good morning everyone. I'd like to start off by noting that the operating portfolio performance continued to post strong gains across the majority of our assets with particular strength in our Florida markets fueled by robust employment growth. Portfolio wide across BRG's assets, average occupancy for the second quarter of 2018 was 93.9%. Same-store revenue increased 3.6% over the prior year period, driven by a 4.2% increase in average rental rates and a 50 basis-point decrease in occupancy to 94.3%. 16 of the 18 properties in the pool recognized increases in average rental rates in the quarter versus the prior year period. The moderate decline in occupancy was partially driven by an increased focus on pushing through rate increases, which we successfully did in the quarter. It was also negatively impacted by 20 basis points from operational volatility at our Ashton Reserve asset in the northern suburbs of Charlotte. We have taken corrective action and anticipate this asset turning back to its historic level in the mid-90s occupancy over time.

On the expense front, same-store expenses increased by 3.3%. The timing of repairs and maintenance and annual tax increases accounted for the substantial majority of the increase. Same-store NOI for the quarter increased 3.9% on a year over year basis. On a sequential quarter over quarter basis, same store revenue was up 1.9% over the prior year period. Rents and occupancy growth accounted for 1%, with the remaining 90 basis points coming from increased resident fees due to higher seasonal leasing velocity and expirations during the quarter. For the quarter, new and renewal lease rate growth averaged approximately 3.8% with an even dispersion between new leases and renewals. And July continued the acceleration with new and renewal lease rate growth averaging 4%.

On the operational margin front, year over year we expanded our margins by 50 basis points to 57.1% due primarily to our strong top line growth. On a sequential quarter over quarter basis, we experienced a 20 basis-point decline in our margin. This small decline is primarily attributable to increased turnover costs from higher leasing velocity and seasonal repairs and maintenance. In terms of some brief market commentary, our top three markets by operating property concentration, Orlando, Atlanta, and Houston all performed well in the first half of the year. Orlando led the way in rent growth, achieving total lease growth for the first half of the year around 7%. We expect this to moderate towards a more normalized 3% to 4% level heading into the back half of the year as minor pockets of supply come online on the south side of the MSA. Houston and Atlanta averaged 4% and 5% lease growth respectively in the first half of the year, with an accelerating trend from first to second quarter. We expect to maintain the accelerated level going forward through the end of the year. Beyond our top three, the Carolinas trended positively from first to second quarter, with lease growth finishing the second quarter slightly below 3%. In Texas, Austin is also trending modestly positive heading into the summer months. Supply is still slightly elevated but reaccelerating employment growth is creating a stronger demand picture. On the other hand, North Dallas continues to remain challenged by oversupply, which has led to stagnant growth, and when we look at the supply landscape, deliveries aren't expected to subside until the middle part of 2019.

Shifting to the investment front, we continue to remain active but disciplined in terms of acquisitions and investments. In the quarter we closed on two off-market acquisitions, totaling 502 units and $82 million. Both acquisitions were sourced from local developers and contracted during the lease-up periods, which provided assurance to the developers who needed to repatriate capital into new projects with tight closing timeframes, and it also allowed BRG to enter into attractive purchases. The first investment, in Daytona, Florida, is projected to yield a year-one and stabilized cap rate of approximately 5.4% and 6%, which we believe is 20 basis points and 80 basis points above prevailing market cap rates. To fund the purchase, we utilized $18 million in equity and $29 million from our senior line of credit. The second acquisition located within the Houston, Texas metroplex totals 238 units and was purchased for approximately $36 million. We believe our year-one cap rate and projected stabilized yield of 6% and 6.5% is 25 and 75 basis points above the prevailing market cap rates. BRG funded the purchase with approximately $8 million in equity for 80% ownership and then venture capitalized the deal with a $27 million fixed-rate loan from Fannie Mae at 4.64%. Following the end of the quarter, we closed the purchase of an additional 400-unit Houston operating property for $40 million. The business plan focuses on executing a value-add renovation strategy with targeted capital improvements to the interior units and amenity areas to upgrade the asset to our standard highly amenitized live-work-play lifestyle product. The asset is projected to yield a year-one cap rate of approximately 5.6% and grow to a stabilized cap rate of approximately 6.7% versus market cap rates ranging from 4.75% to 5.25%. BRG funded the purchase with approximately $16 million in equity for 93% ownership and then venture capitalized the deal with a $26 million floating-rate bank loan at LIBOR plus 125 basis points with a LIBOR cap of 2.5% for the next three years.

In addition to the acquisitions, during the quarter we closed on the buyouts of minority ownership interests in Arium Gulfshore and Arium Palmer Ranch, totaling $9 million in BRG equity. The buyouts, which took our ownership to 100% in each property, were funded through refinancing both existing loans. Arium Gulfshore was added to the senior line of credit for $41 million and Arium Palmer Ranch was funded with a fixed-rate agency loan in the amount of $41 million as well. Following the buyouts and refinance of the existing loans, $12 million in equity was returned to the Company.

Moving briefly to our development commitments, as of the end of the second quarter the total BRG investment in development preferred equity and mezzanine loans stood at $240 million across 11 projects. Of the 11 projects, seven are currently in lease-up, and we look forward to reporting on their progress in future quarters. Turning briefly to the balance sheet, as of the end of July BRG has approximately $39 million available for investment through a combination of cash and availability on our junior line of credit, plus we continue to grow our capacity through our Series B Preferred offering.

Before concluding, I'd like to elaborate on Ramin's comments on our value-add renovation program. Value-add upgrades have always been a part of our investment strategy, and we feel it's important to provide additional disclosure, which we have done on page 23 of our quarterly supplement, illustrating the embedded AFFO and NAV growth opportunity that exists in our underlying portfolio. To date through the second quarter of '18 across the existing portfolio, we have completed 942 interior unit renovations at an average cost of approximately $4,700 per unit and have yielded monthly rental increases of $107 per month, resulting in ROIs of 27%. We estimate that there are approximately 4,900 units remaining to be renovated in the portfolio with comparable economics, which could drive our NAV significantly over the next few years as we target annual renovations of 900 to 1,200 units annually. We look forward to reporting on our progress each quarter going forward.

To conclude, I will note that our first half performance exceeded expectations primarily as a result of our outperformance within our Orlando portfolio. While we expect some top line moderation in this market as it absorbs supply and are projecting a modest rise in portfolio operating costs, we are comfortable raising the low end of our full-year AFFO per share guidance outlook from $0.65 to $0.66 per share and as a result, the revised full-year AFFO guidance has narrowed to $0.66 to $0.70 per share. Please refer to our earnings supplement for the assumptions used with respect to our revised AFFO guidance.

With the end of our prepared remarks, I'm happy to open it up to Q&A.

QUESTIONS AND ANSWERS

Operator
Thank you. To join the question queue, you may press star (*) then one (1) on your telephone keypad. You will hear a tone acknowledging your request. If you are using a speakerphone, please pick up your handset before pressing any keys. To withdraw your question, please press star (*) then two (2). We will pause for a moment as callers join the queue. Our first question is from Jim Lykins of D.A. Davidson.

Jim Lykins
Good morning, everyone. Just a couple for me. First of all, you mentioned the 4,900 renovations. I'm just wondering, first of all, if you think that the run rate may be accelerating in 2019 from where we are right now, and also, what are you seeing right now with labor and construction? I'm wondering if labor and construction costs may be, or how they may be impacting the returns you've been getting in the program.

Ramin Kamfar
Hi, Jim. I think it's you know, we've budgeted 900 to 1,200; I think that's partially a factor of turnover. You obviously don't want to empty out units to renovate them because of its impact on occupancy and NOI, you want to do it naturally as units turn over, and partially it's a function of demand. You want to make sure that you measure it and you deliver units based on where you think the demand's going to be rather than flooding the market. So, the 4,900 obviously is going to create tremendous value for us in terms of growing NOI, growing NAV, and we'd like to do it as quickly as possible but on a measured basis so that we can manage supply and demand. So, can we do better than 900 to 1,200? Potentially, but we're going to evaluate it on a year-by-year basis and we're not comfortable today based on what we're saying projecting more than that.

In terms of labor and materials costs, they are going up. I think you're going to see the impact more in terms of new development properties, okay? So, as we look out and see, okay, what's going to happen with the development pipeline and when is it going to slow down and what is going to drive it to slow down, it's going to be, I think, less construction financing than having deals pencil out because land has gone up significantly and labor has gone up significantly and continues to go up and construction costs, raw materials have gone up. When you're talking about $5,000 a unit, it's not much of an impact, but when you're talking about a big new development project, you're, that's where you're going to see the impact and that's what's going to keep a lid in terms of supply. Sometime, I think you'll see the impact of it sometime in mid-2019ish.

Ryan MacDonald
And Jim, we actually don't have the lumber and concrete inputs that development projects do where we've seen significant escalation on the development side, so we don't have that in the interior renovation program.

Jim Lykins
Okay. That's all very helpful. And, also I'm just wondering if you can provide us with what your acquisition assumptions are in your guidance forecast?

Ryan MacDonald
Sure. Our 2018 guidance forecast assumed $350 million in gross asset value, about $125 million

in equity invested by BRG throughout the year. I think year-to-date we are $183 million of acquisitions year-to-date, with $93 million in BRG equity. So we're tracking ahead of budget.

Jim Lykins
Okay. Thanks guys.

Ramin Kamfar
Thanks, Jim.

Operator
Our next question comes from Drew Babin of Robert W. Baird.

Drew Babin
Hey, good morning.

Ramin Kamfar
Good morning, Drew.

Drew Babin
I wanted to ask on the Daytona and Lake Jackson acquisitions, not exactly in the major MSAs within Texas or Florida but somebody could elaborate on just the unique kind of demand-supply conditions in each of those markets and what makes you optimistic on the demand trends and employment trends going forward?

Ryan MacDonald
Sure. Good morning, Drew. Daytona it actually fits very, very well with our healthcare education playbook on the knowledge economy growth side. So we've been, we targeted that deal based on its proximity to some of the significant medical employers. Embry-Riddle, also a major education employer is located about 15 minutes away and so we we've seen significant demand from those two. And on Lake Jackson, one is a mission critical location for the petrochemical industry. Two, it has had basically no supply over the last I think 10 to 15 years, so when you couple those two kind of key metrics together we think there's a unique opportunity to come in here and buy a class A deal that has significant upside and was built and managed by local operators. So, additionally it's also Dow Chemical's headquarters and has been for 50 plus years. So, we think there is a unique opportunity here to really go in and put some, I'll call it robust property management, implement some robust property management into the deal.

Ramin Kamfar
Just to add to that that, Dow has a research, R&D, a big R&D presence in that market and you've got some very highly educated, highly compensated engineers, which is basically our target market that work in that market, but they haven't had the -- there has been no new class A product where they can live there, so they're commuting from Houston. And so when you look at this property that was built over there, when we looked at it, that's what we saw that people who were commuting from Houston are now living here and there was tremendous upside and basically taking it over from local operator and switching it over to more institutional ownership and operation and drive values there.

Drew Babin
Great. And then the Houston acquisition which you mentioned in the third quarter here, I think you said that was $48 million acquisition. I was hoping you could clarify that and also, is that sort of a smaller kind of unique market outside of the MSA or is that one kind of a little more just

located a little closer to the city?

Ryan MacDonald
Yeah, sure. A $40 million acquisition, Drew, and it's actually in the same submarket as our Villages at Cypress Creek deal which we bought last September and have had tremendous success driving rental rates actually before we even implemented the upgrade program. So that's a submarket that significantly closer in to the CBD of downtown Houston and the Northwest quadrant up there, so this is an identical playbook to an asset that we own about a mile away, so we're excited.

Drew Babin
Okay. And then just one more. The Ashton Reserve operating noise you mentioned, was that an operator issue? Kind of what caused that, and can you just detail your plans going forward and how to rectify the situation?

Ryan MacDonald
Yes, that was an operator issue. So, we've since replaced that operator, I think last month was the first month that we had with our new operator, who actually manages assets for us in Charlotte and does a great job, so we think that it's -- it will recover shortly.

Drew Babin
All right. That's all for me. Thank you.

Ramin Kamfar
Thanks, Drew.

Operator
Our next question comes from Craig Kucera of B. Riley FBR.

Craig Kucera
Hey, good morning guys. You mentioned at the new acquisitions you closed this quarter that you are seeing maybe a 50 basis-point plus increase in sort of your stabilized cap rate versus a year one coming from property management, can you give us some color what you mean by that? Is just pushing rents more aggressively or is it on the expense side or just some color would be great.

Ryan MacDonald
Sure, happy to do it Craig. So, on Plantation Park, which is our Lake Jackson deal, it's a combination of concession burn off during lease-up. We've been able to burn off concessions actually almost immediately, from two months we're now down to a month and we expect that to burn off to zero over time. Also, some modest occupancy gains. I think there's a net 50 basis points, there is a 200 basis-point occupancy gain from 91% to 93%, and then some very, very modest 2% rent growth. So to get to 6.5% from six is, there's not a lot of levers that we need to pull and we're actually doing that right now, so we may get there faster than we had projected. On Veranda, which is more of a traditional value add which should be I think we announced 5.6% kind of initial cap rate going to six, seven, that's a combination of some occupancy gain - it's been incredibly poorly managed; rent growth, and then also some renovation increases, I think about half the property at $75 increases gets you to the 110 basis points kind of stabilized versus today.

Craig Kucera
Okay. Going to your preferred program, Ramin, you made comments that you expect things to ramp back up to $45 million to $50 million and, over the next several quarters. Can you comment on what was completed here in July or are you still running about $10 million, or have you seen any sort of pickup per month?

Ramin Kamfar
July has been around the same run rate. I think we're still short one major broker-dealer that was selling our product. And we're still going through the process. Nothing structural here, it's just a question of time to get them on board. We expect to get them on board sometime in Q3, I can't tell you when, but that was at points of time up to 40% of our sales. So, I think you'll see an uptick there. We have some new firms in our selling group that haven't been there but that we have relationships with but that haven't been part of selling group before that are large tier 1 firms and those firms are coming online and that should also drive volumes. So, we're seeing good trends but you won't see it in July.

Craig Kucera
Got it. Okay. Just going to the balance sheet, I think more than 30% of your debt is floating rate. Can you talk about how you think about that going forward and any sort of hedging or swap considerations that you might consider if we continue to be in a rising rate environment?

Ryan MacDonald
Sure. I think we've targeted, right now we're about 70-30 fixed-to-floating on the secured piece, and that fixed piece is up from 60% last quarter. So our goal is to get it in the 75% to 80% fixed-to-floating range over time. We are considering some hedges. We have on some new acquisitions and some new refinancings that we are in the process of doing right now, we've been buying kind of lower in the money caps and we look forward to kind of reporting I'll call it our future LIBOR increase exposure as we execute some of these refinances that I think will limit our exposure even on the floating-rate piece over time.

Craig Kucera
Okay. One more for me. I just wanted to talk about the assets that are expected to stabilize in the mezzanine and preferred investment pool. I think a significant number are expected to stabilize here over the next year or so, and do you have a sense of any that maybe you're not going to execute on or just any color there on kind of what you think you're going to do with a number of those assets being completed and stabilized?

Ramin Kamfar
I think that's a case by case decision that we're going to make as they stabilize. Alexan City Center, for example, we have a relatively small investment in it so that maybe -- and if we exercise our conversion option we're going to get significantly below 50% ownership, so that may be a case where we don't hold the asset and we sell it. There are other cases where we have a discounted purchase option, and you may see us exercise those. We want to own these assets, that's why we're doing the program. We're not in the lending business otherwise. But you're going to have to make that, but when it gets to stabilization we look at it as the same as we would in terms of an acquisition decision. So we underwrite it, look for it, look and see where is the further value creation in terms of owning the asset long-term or whether we would get better returns for the investors by selling it and redeploying that capital. It's more work than just converting it and holding it, but that's where it comes from our focus on driving value at each property.

Craig Kucera
All right. Thanks, guys.

Ramin Kamfar
Thanks, Craig.

Operator
Our next question comes from Paul Penney of Northland Securities.

Greg
Good morning. This is Greg on for Paul. Thanks for taking my questions. First, in terms of go-forward cadence on redevelopment efforts, will the pace in the second half be similar to the first half and will the 27% return you've achieved of late be the same type of expected return profile?

Ryan MacDonald
Hi, good morning, Greg. With respect to cadence, I think you'll see the volume pick up in the third quarter and then kind of moderate from there. So, I think we've done 462 to date. I think our budget for the third quarter is above that. That gets you to the 900 to 1,200 kind of run rate with a 1,000 unit midpoint. With respect to costs and ROI, I think those are pretty solid. I think we'll continue to be in that high $4,000s low $5,000 unit range with monthly increases kind of north of $100 and ROIs north of 25%. So, I think that's a good run rate metric for you going forward.

Greg
Okay, perfect.

Ramin Kamfar
Let's just say ROIs around 25% instead of north of 25%.

Greg
Okay. Got it, got it. And then do you expect your Orlando, Atlanta, and Houston markets to continue to be the main drivers of growth looking forward? And conversely, which markets are you may be seeing supply and demand related issues?

Ryan MacDonald
Sure. I think we're long-term believers in Florida; it's not just our Orlando assets that are performing well. I thank all of Florida has performed well. Atlanta seems to be doing very well, especially in the northern suburbs where the majority of our portfolio is located. I think there has been some supply issues kind of in town, midtown, and Buckhead, but we've been fairly insulated from that. So, I think we generally believe over the next call it 12-to-24 months the trends will be the same for our Atlanta portfolio. Houston, we are starting to see acceleration. So, I think we were in the 3% kind of blended-lease growth range for the first part of the year. That's been accelerating to north of 4% today. So, I think we're pretty excited about the trends in Houston and certainly over the next 12-to-24 months as being a catalyst to kind of some underlying portfolio growth for us, especially as our concentration there increases to about 10% of the portfolio.

Greg
Okay. Thank you.

Operator
Once again, if you have a question please press star (*) then one (1). We currently have no

questioners in the queue. This concludes the question-and-answer session. I would like to turn the conference back over to Mr. Kamfar for any closing remarks.

CONCLUSION

Ramin Kamfar
Thank you, operator, and thank you everyone for giving us the time today. We look forward to continuing to report to you on our continued progress in quarters to come. Good bye.

Operator
This concludes today's conference call. You may disconnect your lines. Thank you for participating and have a pleasant day.