Bluerock Residential Growth REIT

Third Quarter 2018 Earnings

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CORPORATE PARTICIPANTS

Christopher Vohs - *Chief Financial Officer*

Ramin Kamfar - *Chairman and Chief Executive Officer*

Jordan Ruddy - *President and Chief Operating Officer*

James Babb - *Chief Investment Officer*

Ryan MacDonald - *Chief Acquisitions Officer*

PRESENTATION

Operator
Good morning, ladies and gentlemen, and welcome to Bluerock Residential Growth REIT's Third Quarter 2018 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 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 Third 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 risk 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, please refer to our earnings supplement for a reconciliation to GAAP, and the reasons management uses these non-GAAP measures and the assumptions used with respect to our earnings guidance.

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. We have 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, financial highlights from the quarter and close with some capital markets commentary. Afterwards, Ryan will provide you additional operational, transactional and balance sheet detail.

We followed up on our solid first half of the year by delivering a strong quarter with industry-leading same-store revenue growth of 4.8% over the prior year quarter, which reinforces our investment thesis of investing in highly amenitized, multifamily assets and knowledge economy growth markets with a focus on value-add opportunities.

We have to start with our GAAP net loss to common stockholders, which was $0.44 per share for the quarter as compared to a net loss of $0.45 per share for the prior year quarter. On the funds from operations front, we grew Core FFO by 50% to $0.21 a share in the quarter compared to $0.14 a share in the prior year period. Core FFO is simply NAREIT FFO with the add-back of non-cash, non-operating items including our Series B issuance cost accretion. On a Core FFO basis, we improved our dividend payout ratio to 77% in the quarter.

Moving to AFFO, this quarter, we delivered $0.18 a share, which reflects 38.5% growth versus the prior year quarter figure of $0.13 a share. I should point out that in the 2017 quarter, management fees were paid in equities on a cash basis; we actually grew our AFFO much more significantly from the prior year quarter.

On the revenue front, we produced a healthy 59% growth in the third quarter to $47.9 million from $30.2 million in the prior year period, which reflects our significant investment activity in the latter half of 2017 along with strong same-store performance.

Moving on to property level results. We grew property NOI 52% to $24.2 million in the quarter from $16 million in the prior year period. Same-store revenue and NOI grew 4.8% and 4% respectively for the quarter versus the prior year period. Ryan will provide additional detail in his remarks.

We continue to grow our asset base. Gross assets are up 22.4% for the year and 2.3% for the quarter to over $1.8 billion. On the acquisition front, we closed on one operating property during the quarter and bought out a partner's interest in another asset to continue to grow our wholly-owned asset base. Again, Ryan will provide additional detail.

Shifting to capital markets. During the second quarter, we raised $30 million through sales of our Series B preferred stock. The Series B preferred has a unique advantage for BRG because it allows us to grow accretively, decoupled from the cyclicality of REIT equity pricing. So in a market like today with rising rates, where many REITs including BRG are trading at discounts, we can raise Series B capital and grow with conversion into common at a more favorable part of the REIT equity pricing cycle at a future date at the future price at that time. We continue to expect that the quarterly run rate of the Series B will reaccelerate back to the $45 to $50 million range in 2019.

As we look ahead, we believe we are well positioned with multiple growth levers to deliver shareholder value.

We have strong organic growth from being in the right knowledge economy markets with strong demand dynamics for our highly amenitized assets, which continue to command strong rent growth and the results of which are visible in the industry-leading same-store revenue growth of 4.8% that we delivered this quarter.

We continue to find accretive external growth through issuance of our unique Series B preferred and through sourcing attractive acquisitions with upside potential through our Bluerock network which is visible in the communities which have contributed to our 51.5% growth in NOI over the prior year quarter.

We are getting very strong results on our value-add upgrade program. To date, we have renovated over 1,300 units with an average ROI of 27% with over 4,600 units more to execute which alone could add multiple dollars to our NAV.

And last but not least, management continues to increase its alignment with shareholders. We have increased our ownership by over $3.5 million in 2018 alone and now stand at approximately 25% ownership in the underlying equity of BRG on a fully diluted basis.

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

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

The operating portfolio continues to post top quartile growth with strong gains across the majority of our assets and sustained strength in our Florida markets and reaccelerating top line growth in our Texas asset.

Portfolio-wide across BRG's assets, average occupancy for the third quarter of 2018 was 94.5%, which was a 60 basis point improvement on a sequential quarter-over-quarter basis. And October came in 50 basis points higher at 95%.

Same-store revenue increased at an industry leading pace of 4.8% over the prior year period, driven by a 4.3% increase in average rental rates, and a 10 basis point increase in occupancy. Twenty of the twenty-two properties in the pool recognized increases in average rental rates in the quarter versus the prior year period. We continue to focus on balancing rental rate growth along with healthy occupancy, which is important heading into the seasonally slower part of the year.

Last quarter, we highlighted operational volatility at our Ashton Reserve asset in the northern suburbs of Charlotte and I'm pleased to report that our corrective action has taken immediate effect with sequential occupancy and revenue gains of 2.1% and 5% respectively.

On the expense front, same-store expenses increased by 5.8% with annual tax increases accounting for over half of the increase. Same-store NOI for the quarter increased 4% on a year-over-year basis.

On a sequential quarter-over-quarter basis, same-store revenue was up 2.1% over the prior year period, a 1.7% increase in average rental rate, and a 60 basis point increase in occupancy accounted for 2.3% growth, while the reduction in resident fees from lower seasonal move-ins accounted for the majority of the 20 basis point decline in other income during the quarter.

For the quarter, blended lease-over-lease growth averaged approximately 3.5% compared to the prior year with renewals and new leases achieving 4.2% and 3% respectively. October accelerated by 80 basis points with blended lease-over-lease growth achieving 4.3%, with renewals and new leases at 4.8% and 3.7% respectively.

On the operational margin front, we expanded our year-over-year and sequential margins by 40 and 30 basis points respectively to 57.4%, due primarily to our strong top line growth.

I would like to point out that our value-add renovation program continues to deliver results. To date, through the third quarter of 2018 across the existing portfolio, we have completed 1,327 interior unit renovations at an average cost of approximately $4,800 per unit and have yielded monthly rental increases of $107, resulting in weighted average ROI of approximately 27%. Excluding new acquisitions, we estimate there are north of 4,600 units remaining to be renovated in the portfolio with comparable economics, which could drive our NAV significantly. We look forward to reporting on our progress each quarter going forward.

In terms of some brief market commentary, our top three markets by operating property concentration, Orlando, Atlanta, and Houston, all continued to perform well to start the second half of the year. During the quarter, Atlanta and Austin lead the way achieving total lease growth of approximately 6%. Orlando came in around 5%, with the Carolinas trending in the 1% to 3% range with particular strength in the Raleigh MSA. And Austin rebounded particularly well this quarter as the majority of the new developments on the south side of town achieved stabilization.

Shifting to the investment front, utilizing our unique Bluerock network, we continue to find attractive opportunities and knowledge economy growth markets with potential for value-add upside through our repositioning programs.

During the quarter, we closed the purchase of a 400-unit Houston operating property called Veranda at Centerfield for approximately $40 million. The asset is located within the same submarket as our successful Villages of Cypress investment and has a similar business plan, which includes focusing 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 the 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 Veranda, during the quarter, we closed on the buyout of a minority ownership interest in Arium Palms in Orlando totaling $3 million in BRG equity. The buyout, which took our ownership to 100%, was funded through refinancing the existing loan with a floating rate loan in the amount of approximately $30 million and an interest rate at a floating basis of LIBOR plus 140 basis points. Currently, we are in the process of testing and a more comprehensive renovation program, which we believe will yield additional NAV growth above the baseline economics we are currently achieving at the property.

Moving briefly to our development commitments. As of the end of the third quarter, the total BRG investment in development preferred equity and mezzanine loans stood at $241 million across 11 projects. Of the 11 projects, 7 are currently in lease-up, and we look forward to reporting on their progress in future quarters.

Now, turning to the balance sheet, during the quarter, we refinanced four floating rate loans totaling $130 million and on average, the new loans were executed with spreads 90 basis points inside our previous loans.

Additionally, we've undertaken an effort to hedge our floating rate loan exposure through LIBOR cap purchases. As of today, we've purchased three year LIBOR caps at 2.5% with notional balances totaling $221 million, and we expect to purchase additional caps with similar economics and a notional balance totaling approximately $200 million over the next few weeks. In total, following the remaining cap purchases, we estimate 99% of the total debt balance will be fixed or hedged at 2.5% LIBOR for the next two to three years.

Finally, on the balance sheet, as of the end of October, BRG has approximately $52 million available for investment through a combination of cash and availability on our revolving credit facilities. Plus, we continue to grow our capacity through our Series B preferred offering.

To conclude, I want to reiterate that our portfolio continues to perform exceptionally well, producing top quartile operational results on a consistent basis. As a result, we are comfortable further increasing the low end of our full year AFFO per share guidance outlook from $0.66 to $0.68 per share, which narrows our full year AFFO guidance above the midpoint of our prior range to $0.68 to $0.70 per share. Please refer to our earnings supplement for the assumptions used with respect to our revised AFFO guidance.

And with that, let me hand the call back to Ramin before we open it up to Q&A. Ramin?

Ramin Kamfar
Thank you, Ryan.

As some of you may have noticed, the fund recently filed a 13-D reporting that they had sent us a non-binding indication of interest. We did receive that indication of interest and notwithstanding that it was highly conditional and not supported by financing, we took it to our board and we carefully reviewed it with the board. Our board determined that now wasn't the time to explore that interest or other similar opportunities, and we informed the fund of that determination. They then withdrew their indication of interest. As this call is focused on our earnings, we're not going to take questions on that indication of interest at this point.

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

QUESTIONS AND ANSWERS

Operator
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're using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star then two. At this time we will pause momentarily to assemble our roster.

And the first question comes from Jim Lykins with DA Davidson. Please go ahead with your question.

Jim Lykins
Good morning, guys. Just a couple of things for me. First of all, with the Veranda acquisition, can you tell us what the occupancy is there, the rents, what opportunities you might have on those fronts? And also any more color on the value-add opportunities there as well?

Ryan MacDonald
Sure, Jim, this is Ryan. Rents were just shy of $1,000. We have a pretty good handle of the opportunity given our other asset in the submarket. So we think that there's significant upside on the value-add renovation. We closed on it. I think the occupancy was in very, very low-90s. We're actually high-90s, 97, 98 consistently at our Villages at Cypress asset. So we think there's not only occupancy gains, but once we get through the beginning of the year and take care of some of the deferred maintenance, there is significant value-add renovation opportunity.

I will tell you that the 4,600 units that we talked about does not have Veranda in that number yet.

Jim Lykins
Okay. And also in your prepared remarks, you mentioned the more comprehensive renovation program. Any more color on how that might be evolving?

Ryan MacDonald
Sure. That was specifically with the Arium Palms that we bought out our partner. Right now, we've got a renovation program that's flooring, some blinds. That's primarily about a $3,000 a unit renovation with about $80 of uptick. We think we can take that up significantly with a more comprehensive renovation program in around $8,000 to $9,000 a unit with rental increases approaching $200.

Ramin Kamfar

Okay. Jim, just in general, we continually evaluate our properties for upgrade opportunities and some of them, by the time we finish the first round upgrades when you look at the market, and you benchmark us, you find opportunities for a second round and there have been even cases where we're doing our third round upgrades. If you're in the right markets with the right assets, as new product comes online and pushes rents, you're going to have these opportunities and we're always aggressively out there looking for them.

Jim Lykins
All right. That's helpful. And one last one for me. I'm wondering if you can give us any sense for Series B when you accelerate back to that $45 million to $50 million run rate you highlighted.

Ramin Kamfar
Well, I think we projected a range for 2018 and this year we're coming on the low end of that range. I think it had to do with concentration wherein one of the large broker dealers that put us on hold. So that concentration issue we've gotten below there, and kind of concentration target, that issue has gone away, so we're back on line with that broker dealer.

So I think in 2019 you're going to see the impact of that. We are having—the current offering does run out, so we have a follow-on offering coming on line, so there will be a transition period first half. But I think you're going to see the ramp up effect sometime mid- to mid-2019. I think we're going to do more in 2019 than we did in 2018 and it could be significant. We're going through the budgeting right now with our capital markets team.

Jim Lykins
Okay. Thanks, guys.

Ramin Kamfar
Thank you.

Operator
And the next question comes from Craig Kucera with B. Riley FBR. Please go ahead with your questions.

Craig Kucera
Good morning, guys. Can you tell us how lease-up is moving along as you're renovating units? And do you have a sense of the renewal percentage as you upgrade these units and are able to raise rents north of $100?

Ryan MacDonald
Sure, Craig. I think during the quarter we renovated 385 units. We've leased, this was actually as of the quarter end, 320, so that number is significantly higher than that today as we move throughout October. So we're having no problem leasing the upgraded units.

On the second question about renewals, as a portfolio, we are in the low- to mid-50s renewal, so it's slightly below where some of the larger REITs are, but part of that is obviously we're pushing rent significantly more on the top line, so there is a little bit of friction there as well.

Craig Kucera
Got it. And moving to your acquisition pace this quarter, it was a little lighter than we would have thought just given the preferred equity issuance. And is that more a function of timing or is it just continued cap rate compression making it a little tougher to find deals to pencil out?

Ryan MacDonald
I think it's actually, Craig, a function of timing. So I think we look for it, I think, for the year we're estimating about $359 million in total acquisition volume. We'll be right around that, maybe slightly below that by the end of the year. So, I think it's just a timing issue.

Ramin Kamfar
You'll see us catch up in Q4.

Craig Kucera
Got it. And just to make sure, you guys did not repurchase any stock here in the third quarter, did you?

Ramin Kamfar
That is correct.

Craig Kucera
Okay. And as far as the pipeline, I know you say you're going to catch up, but is it skewed to any particular markets or in the same markets that you are currently?

Ryan MacDonald
It's in the same markets, Craig. I mean, I think as we look into 2019, some of the markets that we're not in like Tampa, Jacksonville, Phoenix. Phoenix, obviously, is difficult given the cap rates. But if we could find the right opportunity, it's a market that has significantly long-term growth that we like, but I think across our markets we're seeing significant opportunity.

Craig Kucera
Okay. Thank you.

Operator
And our next question comes from Drew Babin with Baird. Please go ahead with your questions.

Alex Kubicek
Good morning. This is Alex Kubicek on for Drew. We were curious how your total portfolio performance has done relative to internal expectations in 3Q and thus far through October. Any markets jumping out as being significantly above or below your initial forecast?

Ryan MacDonald
Sure. Alex, good morning. This is Ryan. I think as a whole we're probably about 1% higher just on NOI for the year-to-date numbers, if you look relative to internal guidance. I think generally speaking, we thought Orlando would perform exceptionally well. That's why we overweighted our portfolio there, and it has continued to perform exceptionally well.

Texas, in general, to start the year, Dallas in particular was a little bit softer. We're starting to see a little pickup at our North Dallas asset that we hadn't seen in the beginning of the year and part of that's just a function of supply in the immediate submarket. As we get through that supply and that winds down we're starting to see some positive attributes.

Same thing with the south side of Austin, I think, most of the other REITs reported challenges in Austin. We're actually seeing some good trajectory there, and that's a function of where our portfolio is located and seeing some supply, I'd say more through 2017. And as we've gotten through 2018, we've gotten through that supply; we've seen a good run rate there. So I think that's probably surprised us a little bit—Austin—to the upside.

Alex Kubicek
Thanks, really helpful there. Looking at the balance sheet, I'm wondering if you guys have any appetite at all to sell into this kind of aggressive market landscape to either pay down debt or just seek capital recycling. I know you guys are looking to grow, but just curious how you guys have been looking at that over the last six months.

Ramin Kamfar
We'll evaluate. We continuously evaluate the landscape. I think the core strategy here is to—we're obviously in a part of the repricing cycle, as the Fed is raising rates, where REITs are generally trading below NAV. Last we checked, which was last week when we had a board meeting, I think 80% of the REIT universe is trading below NAV and something around 50%, in the high 50% range, 56%, 57% have a 10% or higher discount.

So from our point of view, we have the unique advantage of having the Series B, which allows us to continue to grow without being dilutive in this part of the cycle because it decouples the conversion of that Series B into common with where we are in the cycle. So the strategy, the core strategy is to issue the Series B. We will accretively—we continue to find tremendous opportunities through our Bluerock network of being able to find assets that we can buy off market at a discount with substantial value-add opportunity. You're seeing the results we're getting there.

And then to position ourselves for when the cycle changes, because the cycle is not one way, we're in the down lag. But as the economy, our view, is as the fiscal stimulus runs through the economy and wears off, the Fed's rate rises will have more of an impact. So we'll see a slowdown in the Fed sometime in the next year, 18 months, we'll have to slow down and maybe eventually reverse itself.

And then you're going to end up on the other side of the repricing cycle on that. We're positioning ourselves for that part of that cycle. If we can grow through this down lag with accretively and build up, grow AFFO, grow core FFO, grow NAV, then you position yourself as the pricing in that, the pricing cycle changes, to be able to deliver through conversion of the preferred, through issuance of common and obviously closing that during this whole period. Not just growing NAV, but closing that gap.

So, that's the big picture strategy. Opportunistically, if there's an opportunity to sell an asset or two here and recycle that into something that helps us grow that helps us accelerate that strategy, we actively look at that. And I can tell you that there's a couple of transactions that we're working around that would qualify as capital recycling that would help us achieve our big picture plan.

So does that answer your question, Alex?

Alex Kubicek
Yes, that was a lot of great color. Just one more for me, 2020 is still obviously a ways off. Curious if you have any initial expectations on what the general sources of capital you might use to call the Series A preferred or just give us some general color on how you think about that capital decision process down the road.

Ramin Kamfar
I think the A is obviously very accretive to redeem. It was our first preferred and most expensive at 8.25%. So, we would look to redeem it. I think we have, I think, by 2020. I think we're going to be in this other part of the REIT equity pricing cycle that I talked about.

So our view is that we will have access to much less expensive common equity to be able to do that. But if we're not, we can use the Series B, which is obviously at 6% versus 8.25%, and alternatively as we take these assets, you'll note we're buying them around a 5-ish number in terms of cap rate and we are doing value add to get them up to a 6.5%. So it's 150 basis points of value creation. You can always sell down assets and use it to take in the preferred.

So those are the three arrows we have in our quiver in the order in which we're thinking about at this point. But obviously as you mentioned, it's a couple of years away, but we are thinking about it.

Alex Kubicek
Great. Thanks for taking my questions.

Operator
And once again, if you'd like to ask a question, please press star then one.

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

Paul Penney
Hi, guys. Good morning. Going back to the value-added properties the 4,600 you have left, is it fair to assume the cadence will be around a 1,000 of these per year or given your top tier, high-20% returns, are there any levers to accelerate the pace?

Ramin Kamfar
I think we've been running at about 1,200 and we can obviously slow that down or accelerate it. It is a great return on investment. We are going through our budgeting process for 2019 so I don't have a specific number for you. It's a combination of factors that we take into consideration, one of which is absorption and also the ability to execute these without disrupting our existing operations. Because one thing we don't want to do is to a) do too many and then have unrented units; or b) do it in a way that's disruptive to our occupancy and you're going to pay a price today for the future. We're trying to do it in a way where we got the best of all worlds.

So having said that, as the market continues to grow in terms of rent growth and occupancy, we're always looking for opportunities to accelerate it, and you might see us do that. I will tell you that that number, the 4,600, will also grow over time. The deal that we just closed that Ryan talked about, we'll add to it, a deal that we're doing in the fourth quarter, we'll add to it and so on and so forth. So we'll have plenty of pipeline in terms of its value creation from the value add.

Paul Penney
Okay, great. And then last one, just any update on the potential to be added to the RMZ REIT index? Is May '19 the likely next potential timeline for inclusion?

Ramin Kamfar
I think that's obviously not a formula. There's a selection committee that picks REITs and they look at a number of metrics, including trading volume and market cap. Now the last time we looked at it, which was maybe 12 or 18 months ago, we were just shy of the smallest shops that got added. Obviously, we have our eye on that prize because the last three guys our size in the multifamily sector that got added had a 20% drawn up in their pricing because of what's happening with the passive index funds these days.

So we're focused on it, and I think our market cap needs to be a little higher and we want to get there, but we are very, very cognizant of where our common is trading today and not wanting to be dilutive in terms of growing our market cap. That's why we look at it as a big picture, okay, when's the right time to do it. It's, you got to get through this part of the equity cycle. It's not just us. Like I said, it's a lot of guys out there that are trading particularly at the small cap level the percentages are even higher. The guys that are trading at a discount—I think 90% of the small cap, everyone below a billion is trading at a discount.

So we don't want to just issue stock to get on there and be dilutive to get on the RMZ. We want to do it intelligently and be cognizant of the value that our shareholders have and unlock it properly for them, and obviously as management with a 25% stake has significant alignment with the shareholders.

So I wish there was a quick magic bullet that I could use to give you a better answer, Paul, but sometimes the right thing to do is just be patient and wait for the right time to execute the transaction.

Does that make sense, Paul?

Paul Penney
It makes a lot. Thanks a lot, Ramin. Take care.

CONCLUSION

Operator
And this concludes our question and answer session. I would like to turn the conference back over to Ramin Kamfar for any closing remarks.

Ramin Kamfar
Thank you, operator, and thank you, everyone, for giving us the time today. We look forward to continuing to report on our progress to you on a regular basis. Goodbye.

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