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BRT Apartments Corp.

First Quarter 2023 Earnings Conference Call

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CORPORATE PARTICIPANTS

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George Zweier, *Vice President, Chief Financial Officer*

Ryan Baltimore, *Chief Operating Officer*

CONFERENCE CALL PARTICIPANTS

Gaurav Mehta, *EF Hutton*

Michael Gorman, *BTIG*

Craig Kucera, *B. Riley FBR*

PRESENTATION

Operator

Good day, and welcome to the BRT Apartment Corporation's First Quarter Earnings Conference Call.

Today's conference is being recorded.

At this time, I would like to turn the floor over to Mr. Tripp Sullivan of Investor Relations. Thank you. You may begin.

Tripp Sullivan

Thank you for joining us today. On the call are Jeffrey Gould, President and Chief Executive Officer; George Zweier, Chief Financial Officer; and Ryan Baltimore, Chief Operating Officer; as well as David Kalish, Senior Vice President.

I'd like to remind everyone this conference call contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 that are based on Management's current expectations, assumptions, and beliefs. Listeners should not place undue reliance on any forward-looking statements, and are encouraged to review the Company's SEC filings, including its Form 10-Q for a more complete discussion of risks and other factors that could affect these forward-looking statements. Except as required by law, BRT does not undertake any obligation to publicly update or revise any forward-looking statements.

This call also includes a discussion of non-GAAP measures, including FFO, AFFO, NOI, combined portfolio NOI and information regarding our pro rata share of revenues, expenses, NOI, assets and liabilities of BRT's unconsolidated subsidiaries. All the non-GAAP information discussed today has certain limitations and should be used with caution and in conjunction with the GAAP data presented in our supplemental earnings release and our reports filed with the SEC. Please see these reports and filings for the definitions of each non-GAAP measure.

As a reminder, the Company's supplemental information and earnings release have been posted on the Investor Relations section of BRT's website at www.brtapartments.com.

I'd now like to turn the call over to President and CEO, Jeffrey Gould. Please go ahead, Jeff.

Jeffrey Gould

Thank you, and welcome to the call.

I'll start with some brief comments on our overall performance and the transaction environment. Then I'll turn the call over to George and Ryan for some additional color around our results. Our first quarter results were consistent with what we've seen across the sector this quarter. Revenues were in line with what we were anticipating. Leasing was positive, although down from the levels achieved a year-ago. Expenses were in line with what we have estimated, barring some unexpected costs that George will discuss later.

We are in the midst of the spring leasing season now, which is where we typically see a lift in occupancy and rents. With the continued strong population growth and demand in our markets, we have an opportunity to outperform the winter months. It's clear that rental growth in the sector won't be as strong as last year with 5% to 6% rental growth as a reasonable target. We'll need to control operating expenses as much as we can.

It has been relatively quiet on the transaction front, with both sellers and buyers remaining cautious. The environment hasn't changed much since last quarter. However, there seems to be a better understanding of where cap rates are settling. The expected sale of the Chatham Court property in Dallas during the second quarter should be completed at a sub-5% cap rate, generate an IRR of 22% over a seven-year hold and generate net proceeds of $19 million, which we intend to redeploy into our acquisition in Richmond. That acquisition is on track for closing by year-end. Recall that's the $62.5 million total purchase price, including the assumption of approximately $32 million of mortgage debt at a fixed rate of 3.34% and maturing in 2061.

We are hard on the contract and awaiting HUD approval. This is a great long-term play for us, and there are a number of similar opportunities we can pursue if we are able to source capital at the right terms. We did not utilize the ATM again this quarter, given where the stock is traded, but you may have noticed we filed an amended Shelf Registration statement last month. The Shelf was expiring in mid-May. In the interest of good corporate governance, we expect to renew our ATM program in the near future.

We are pleased with how well the portfolio continues to perform and expect that we will see the longer-term benefits of owning and controlling more of our portfolio in the years to come. We have the liquidity to deploy for new opportunities if they meet our return thresholds, and we have substantial flexibility with no debt maturities until 2025.

George, please take it from here.

George Zweier

Thank you, Jeff.

The first quarter results continued to reflect the positive impact on a year-over-year basis from the partner buyouts and improved operating margins across the portfolio. However, that was offset by the higher non-controllable expenses incurred from the early cancellation costs associated with our previous insurance policies, repairs from the December winter storm and a utility leak at one property. Overall, the net loss attributable to common stockholders was $0.21 per diluted share compared with net income of $0.62 per diluted share a year-ago. The primary reason for the year-over-year decline was the $0.70 gain in the prior-year period from the sale of a property owned by an unconsolidated subsidiary and increased interest expense from higher rates on our sub debt and usage of our credit facility.

FFO was $0.28 per diluted share compared to $0.35 per diluted share a year-ago, primarily due to increased interest expense on the sub debt and credit facility and higher amortization of restricted stock and RSUs. AFFO was $0.36 per diluted share compared to $0.39 per diluted share a year-ago, primarily due to increased interest expense on the sub debt and credit facility. The higher expenses I noted earlier totaled approximately $396,000 or $0.02 per share. The increased borrowing costs year-over-year represented approximately $678,000 or $0.03 per share.

With respect to the winter storm, we anticipate receiving approximately $490,000 in insurance recoveries over the next two quarters. For the combined portfolio, recurring CapEx was $1.2 million for the quarter. When you add the $558,000 in replacements that flow through real estate operating expense on our P&L that totals approximately $1.8 million or $217 per unit. That's below the $300 per unit of replacements we have been assuming in our expense growth, included in the combined portfolio NOI guidance. We completed the rehab of 55 units during the quarter for an investment of $422,000 and an estimated annualized ROI of 43%. Non-recurring CapEx, which represents revenue enhancing and major upgrades to properties, totaled $1.2 million during the quarter.

Turning to the balance sheet, debt to enterprise value, as of March 31, was 62% compared with 59% a year-ago, primarily due to the lower market capitalization. Available liquidity at quarter end was $75 million, which is comprised of cash and availability under our credit facility. At May 1, liquidity was $73 million. As of March 31, our consolidated and unconsolidated mortgage debt had a weighted average interest rate of 4.01% and a weighted average remaining term to maturity of 7.3 years. As we noted previously, we fully paid down the $19 million of borrowings that were outstanding under our credit facility at yearend with a 10-year interest-only loan at a fixed rate of 4.45%. The substantial positive rate arbitrage, considering the current interest rate on the credit facility, is at prime.

Now I'll turn the call over to Ryan.

Ryan Baltimore

Good morning.

I'd like to start with the performance of our multifamily portfolio in the quarter. Average occupancy for the portfolio was 94.2% for the first quarter, which is down from 96.4% in the 2022 quarter, primarily due to the lack of movement during the pandemic among our tenants in the 2022 quarter. This is typically the quarter where we see lighter occupancy, so remaining in the mid-90% range is consistent with our expectations. Average monthly rents for the combined portfolio in the first quarter were up 10.9% compared to the 2022 quarter.

For leases signed in the first quarter of 2023, we saw estimated spreads on new leases at 3.3%, renewal spreads of 6.7% and overall spreads of 5.3%. For April, we have seen estimated spreads on new leases of 3.5%, renewal spreads of 5.6% and overall spreads of 4.6%. Our rent-to-income ratio for all new leases signed in the first quarter is 25%, which demonstrates that our tenants continue to have minimal stress and our properties remain affordable.

Given the performance of the portfolio to-date, the timing of the disposition of Chatham Court, Dallas and the acquisition of Winterfield at Midlothian in Richmond is consistent with our 2023 outlook. We affirm our previously issued guidance as well as the accompanying assumptions. I would refer you to our supplemental for the details on that outlook and our comments on the fourth quarter earnings call for some additional color around those assumptions.

Let's talk about our combined portfolio NOI for the quarter and some of the moving parts in that result. Recall that we introduced this metric to provide more transparency around the underlying performance of the portfolio as well as a substantial change in the composition of our unconsolidated and consolidated properties from 2021 to 2022 as we've completed partner buyouts and sold several joint ventures in this period. Unfortunately, despite our best efforts for two quarters in a row, we've experienced some sizable increases in non-controllable expenses that obscure the performance of the portfolio. I hope to shed some light on this, this morning.

The master insurance program we implemented effective in Q4 is, of course, the biggest driver in the year-over-year expense growth. I outlined the benefits of that program last quarter and it's expected to pay off as the year progresses and into 2024. Our full-year outlook assumes a slightly greater than 50% increase for the full year at the midpoint. The larger increase in Q1 was due to the cost of early cancellation for our previous policies, and we do not anticipate this to continue throughout the year.

Combined portfolio NOI was up 1% in the first quarter compared with the first quarter of 2022. The primary components were revenue grew 7.1%, primarily due to increased rental rates across the portfolio. Total expenses increased 15.2%, primarily due to higher insurance, repairs and maintenance and utilities. Another way to look at the expenses is controllable expenses were up 11.8%, while non-controllable expenses were up 21.5%. The $396,000 of expenses related to the items mentioned earlier impacted combined portfolio NOI by 2.6% on a year-over-year basis. Absent these expenses, we would have reported a 3.6% combined portfolio NOI this quarter.

If we were looking at a 25% year-over-year increase in insurance expense similar to many of our peers, we would have reported a combined portfolio NOI increase of 6.3% in Q1.

That completes our prepared remarks. Operator, will you please open the call to questions?

Operator

(Operator Instructions). Our first question of the day will come from Gaurav Mehta with EF Hutton. Please go ahead.

Gaurav Mehta

Thanks. Good morning. In [discussing the combined portfolio] NOI in your earnings release, you talked about expectation of sequential NOI improvement in 2023. Is that sequential improvement driven by the expenses growth rate going lower?

Jeffrey Gould

Yes, we ran in—hi, Gaurav. We ran into a little bit of obviously, some issues with expenses this quarter. I think that it will stabilize, the insurance being one of them. We have a better handle on it, for sure. I think the insurance cost and what we did, taking over, bringing together most of the portfolio, was something that I think, long-term, is a big benefit for us and which obviously knocked us a bit over the last quarter. But yes, we think things will stabilize for sure.

Ryan Baltimore

Yes. Just to add on to that, Gaurav. This is Ryan. The repairs and maintenance and the utilities with the storm damages as well as this utility leak, as we mentioned, this is not where we anticipate continuing throughout the year. I think on the expense side is where we'll really see the benefit.

Gaurav Mehta

Okay. I wanted to ask you on one particular property in San Antonio. I noticed the occupancy for that property is 85.7%, which is lower than your overall portfolio occupancy. Can you provide some color on what's going on at that property? Why is that occupancy low?

Jeffrey Gould

Yes. We've had some short-term problems there. Nothing that we think we can't rectify. Basically, we've had some increased delinquency there. It really stems back from the buyout of the original partner, some of our concerns about putting in tenants that didn't necessarily meet credit and issues like that were part of the problem from the seller. It happens at times where we get into a short-term problem of occupancy after we take over a property. Like I said, we're rectifying delinquencies and those tenants that were in there that were not paying are getting pushed out. We're getting viable tenants in place, but it was a concern for us and glad you pointed it out.

Obviously, the occupancy was a big concern. It's something that, long-term, we think we will handle. No problem. It's already improving quite a bit. I think you'll see steady occupancy growth in that particular property.

Gaurav Mehta

Okay. Lastly, on the transaction market, in the remarks, you talked about selling the property in 2Q at sub-5% cap rate. Is that cap rate indicative of where the CapEx are in all of your markets?

Jeffrey Gould

I'm sorry, I didn't hear your question.

Gaurav Mehta

In your prepared remarks, you talked about selling a property in second quarter at sub-5% cap rate. Is that like sub-5% cap rate what you're seeing in all of the markets for multifamily properties?

Jeffrey Gould

Yes. You're asking generally what's happening with cap rates in the general market. Specific to this property where it was sub-5%, where it is sub-5%, and we're planning on that closing very soon. Generally, with the market, I think we've seen a stabilization in cap rates and a better feel for where things are. I would say, it probably runs about 50 basis points higher than—maybe 50 to 100 basis points higher than the lows in the market, where cap rates were as low as, say, 4%.

I think we're seeing deals typically run and we're focused on cap rates seeing that they're in the probably 4.5% to 5% range. That goes from our own sales as well as from talking to partners and other people in the industry and seeing where they're selling their properties at as well. We've had some calls of late with other investor partners, and they also are seeing similar cap rates in that 4.5% to 5%.

Operator

The next question will come from Michael Gorman with BTIG. Please go ahead.

Michael Gorman

Yes. Thanks. Good morning, guys. Ryan, you talked a little bit about some of the move-outs or some of the lack of move-outs during COVID and that maybe having some impact on the comps. Can you just talk about the retention rate that you saw in the quarter? Where you think that's going to settle out? Maybe just walk through kind of where the residents—what kind of other options the residents are moving out to in this environment? Is it home purchases? Are they leaving the market? Kind of what's driving that?

Ryan Baltimore

Sure. Good morning, Michael. Yes, we're not seeing a tremendous amount of move-outs due to home buying. I think interest rates have played a significant factor in that. The retention rate still kind of hovers in that 50%, 55% range generally across the portfolio. That being said, I think, obviously, during the pandemic, there was a lot less movement. We were definitely higher than that, probably closer to 60% plus on the retention side. We're also seeing, as rent growth has slowed down, people are definitely renewing more, and we're seeing more push on that front as well.

But one thing to note is with our value-add program, which as you saw, we did about 55 units, we do look at that quite often, to see if we can be more aggressive there. We look at returns and see where there's opportunities. That can have short-term effects on retention and occupancy as well. But generally speaking, we're not seeing a tremendous amount of home buying. It's a lot of job relocation or alternative options to where people are moving to.

Jeffrey Gould

Yes. On that, we hope to do more on the renovation of units. We're focusing on renewal rents in markets and seeing where it pays to vacate and do a full renovation because the returns, as you see, have been great. We like to see and we'd like to do more units, moving forward. It's something that we're definitely focused on.

Michael Gorman

Yes, for sure. Maybe a follow-up on that. I think you mentioned that kind of 880 units over the next 24 months potentially. How does that work in terms of your line of sight? Is this just from your perspective, units that you'd like to get back because you think the returns are there? Do you have line of sight into kind of what those tenants are going to do over the next 24 months? Kind of walk me through how that pipeline is constructed.

Jeffrey Gould

No. Basically, when a proof-of-concept is there on a particular property, where you see that the demand is there, let's assume rents increase by $200 because you've done a full renovation. If you've done a third or half of the property, and you've seen the occupancy be minimal in those—vacancy be minimal in those renovated units, it's a good sign that the market allows and can sustain rents in the higher breakpoints. If the renewal rents stay at 3% or 4%, it's something that we would probably consider, and we'd work towards doing a renovation. We're seeing more proof of concept, frankly. I don't know, Ryan, do you have anything you want to add to that?

Ryan Baltimore

No. I think just on the number of units, that's I think—our goal is to be able to do all of the units. I think as we've mentioned, there are properties where retention is higher and people continue to renew, even if we're more aggressive on those renewal rates. We do them when we can. I think the 880 units available. It's not necessarily—there's no guarantee we're going to get all those units back. It really depends on the property. But as Jeff mentioned, a lot of those units are already existing properties that have proved out the value-add concept. We do believe there's opportunity there. We don't know when we'll get those units back right now.

Jeffrey Gould

The other thing is a lot of the portfolio that you saw we bought back from partners, there was always a conversation with the partners as to what we want to do. It was a joint conversation. I think now that we own more of it 100% ourselves, we're probably a little bit more aggressive than—to do the renovations and to get the bumps than maybe some of our partners would have been. We have more of an appetite, and owning 100%, we have full control.

Michael Gorman

Got it. That's helpful. Then maybe, Jeff, just quickly on the transaction market. Obviously, you understand kind of across the board, there's this bid-ask spread between buyers and sellers and expectations. I wonder if that goes further down, if you're seeing any disconnect between expectations for the fundamental performance in the transaction market, where maybe buyers have different expectations for expense and NOI growth when they're looking to acquire versus what the sellers are forecasting. Is it just on the price? Or is it even on the underlying income that there's kind of a disconnect?

Jeffrey Gould

Well, I think there is a new norm on rental growth, and I think everyone is starting to see that you can anticipate the growth that we and others have had over the last 1.5 years or 2 years. Sellers don't have any expectation, for example, no understanding what's going on with insurance as an example. Insurance costs are skyrocketing, and sellers—I think, want to bury their head and not see the real impact of insurance.

It took a while for them to understand a readjustment in real estate taxes, for example, when a buyer had to come in, and the tax rates were going up, and they didn't want to focus on the increase that a buyer would then have. Well, the same thing happened with insurance. I think it's a model that they have to learn and understand and realize that the increases have been substantial. It's partly on the expense side. It's partly on the rental side as well.

I would say the rental side, I think people read about and hear about and sellers see that it's not the same growth as it was. I don't think there's a real focus on the expense side as much as they need to see. In time, I think they'll understand it better. Then there'll be more of an understanding between buyer and seller of what real true NOI is.

Michael Gorman

Great. Then just last one for me, just quickly. I know the loan on Silvana, you closed on that in February. When was that rate locked? Is that kind of representative of where you think we could do additional secured debt in today's market?

Jeffrey Gould

Yes. That rate was locked earlier this year. It was done at—we kind of got a good timing. We were monitoring rates pretty much daily when we were ready to lock, and we were able to take advantage of a good dip in the market. I think today, you're seeing still probably closer to that 5% plus on the debt side. I don't think—I think the 4.45% that we got is a very strong piece of paper now, and we do believe it's very good long term. As George mentioned, the arbitrage versus the credit facility rate at prime is pretty significant there. Yes, I think today, we're still getting quoted and seeing things probably in the five-plus percent range on the Fannie, Freddie debt.

Ryan Baltimore

The good news is we have no—our line is—there's nothing outstanding. We're very focused on keeping the line balance at or near zero for the most part as best we can. With the rate that we're paying on the line, obviously, we don't think it's a very good borrowing right now. We're very cognizant of that and careful of the usage of the line.

Michael Gorman

Great. Thanks for the time, guys.

Jeffrey Gould

Sure.

Operator

The last question will come from Craig Kucera with B. Riley FBR. Please go ahead.

Craig Kucera

Hey, good morning, guys. Jeff, I appreciated the color on the San Antonio property, but your suburban Dallas JV asset has also seen some occupancy softness over the past several quarters. Is that property also having some bad debt issues? Or is something else going on?

Jeffrey Gould

No. What we saw there is, frankly, just a little bit of supply issues. I mean I'm pleased to say that the portfolio, overall, has seen—we have not seen a great deal of new supply in our markets, which is obviously terrific. Exception is, to some extent, is Dallas, Huntsville, Alabama, maybe Nashville, Tennessee. But these markets continue to expand. With new development, there's increased job growth and all. I think some of the Dallas-specific portfolio had to do with new supply in these markets, which is being absorbed. I think it's number one or top couple of states and cities where population growth is still rampant, and I think with that, the new supplier is getting eaten up, but that had some impact on Dallas.

Craig Kucera

Okay. Great. Just circling back to some bigger picture comments. You mentioned that cap rates were settling down, and you kind of give your thoughts on where they had gone. But I'm curious, are you seeing a pickup in transaction volume? Or are things still relatively slow?

Jeffrey Gould

Things are still relatively slow. I would say, it picked up slightly from, maybe, February of this year, but slightly only. As far as overall, I mean the deal flow is not what's in the normal path of what we've seen over the years. Again, I think it goes back to the earlier question from Michael of sellers' understanding of what markets are and what pricing they can get. People waiting to see what's going to happen with the economy and seeing what's going on with all the reports, etc. We'd like to think that volume will pick up.

I think once you first get an understanding of cap rates and there's some stabilization that helps. But until interest rates are going to stay at a certain level where everyone is comfortable and there's not that uncertainty, I think it will remain somewhat quiet going forward.

Craig Kucera

All right. Thanks.

Jeffrey Gould

Sure.

Operator

This concludes our question-and-answer session. I would like to turn the conference back over to Mr. Jeff Gould for any closing remarks. Please go ahead.

Jeffrey Gould

Just want to say thank you all for joining us. We appreciate your continued support and interest in BRT. Have a nice day. If you have any follow-up questions, feel free to call Ryan or myself at any time, and we'll be happy to speak with you. Thank you.

Operator

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