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ALEX - Q3 2016 Alexander & Baldwin Inc Earnings Call

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PRESENTATION

Operator

Good day ladies and gentlemen, and welcome to the Alexander & Baldwin 2016 third-quarter earnings call.

(Operator Instructions)

As a reminder, this conference is being recorded. I would like to introduce your host for today's conference, Suzy Hollinger. You may begin.

Suzy Hollinger - *Alexander & Baldwin, Inc. - Director of IR*

Thank you. Aloha, and welcome to Alexander & Baldwin's third-quarter earnings call. On the call with me today are Chris Benjamin, President and Chief Executive Officer, and Paul Ito, Senior Vice President and Chief Financial Officer. Joining us for the Q&A portion of the call are Lance Parker, President of A&B Properties, and George Morvis, A&B Vice President of Corporate Development.

Before we commence, please note that statements in this call and presentation that are not historical facts, including potential benefits, consequences, and impact of a potential REIT conversion are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 that involve a number of risks and uncertainties that could cause actual results to differ materially from those contemplated by the relevant forward-looking statements. Factors that could cause actual results to differ materially from those contemplated in the statements include, without limitation, those described on pages 17 to 29 of the Company's 2015 annual report on Form 10-K and in other subsequent filings with the SEC. These forward-looking statements are not guarantees a future performance. And we do not undertake any obligation to update our forward-looking statements.

Management will be referring to non-GAAP financial measures when discussing results today. Included in the appendix of today's presentation slides is a statement regarding our use of these non-GAAP financial measures and required reconciliations. Slides from this presentation are available for download at our website, www.AlexanderBaldwin.com. We will start with Chris, who will comment on performance highlights, our announcement that we will be exploring a REIT conversion, and provide an update on operations. Chris will return for closing remarks. Paul Ito will follow, and then Chris will return for closing remarks and open it up for your questions. Chris?

Chris Benjamin - *Alexander & Baldwin, Inc. - President & CEO*

Thank you Suzy, and good afternoon to our listeners. I'm pleased to report another quarter of strong performance in our Commercial Real Estate segment. Segment operating profit and NOI were up 9.6% and 3.4%, respectively. You'll notice that we have changed the name of this segment, and that is not just cosmetic. We used to call it Leasing, but leasing is only one dimension of our Commercial Real Estate business. Just as important are property and asset management, repositioning of properties, and growth of the portfolio through both development and acquisition. By



changing the name, we make it clear that we're pulling all levers to create value from our commercial real estate portfolio. We've also taken steps internally to align our org structure around each of these distinct but complementary objectives. We are leveraging our development expertise to grow the portfolio with projects like the redevelopment of the Kailua Macy's building into the Lau Hala Shops and renovation of the Pearl Highlands Center food court that we discussed last quarter. We've made good progress in the planning of a potential development for hold. And while we're not quite ready to unveil those plans, hope we will be able to do so soon.

On slide 4, it's worth stepping back for a minute and remembering how different A&B is from just a few years ago. In 2012, we dedicated ourselves to investing in the market and communities we know best, and that led to our Hawaii-focused strategy. The success of that strategy to date has been greater than we could have anticipated. As we have invested nearly \$1.5 billion in the State, and begun to realize the benefits of focusing on the attractive but high barrier Hawaii market. We will elaborate on the Hawaii market when we have our Investor Day next week. But suffice it to say that we are pleased with the progress we have made in becoming a more focused Hawaii company.

It's unusual for a C Corporation to own so many commercial real estate assets, but the reasons we have cited for remaining a C Corp rather than becoming a REIT have primarily been related to the diversity of our portfolio, which until recently has been scattered across the U.S. Mainland, and the fact that we have a large number of non-REIT qualifying businesses. Of late, however, we have grown our business and concentrated the portfolio in Hawaii. Over 85% of our commercial NOI is in the State. And virtually all of our other business activity is as well. As a result, we think it is possible to qualify as a REIT with a taxable REIT subsidiary, or TRS, housing our operating businesses. And that this structure may be most advantageous for us. Our Board has approved the full exploration of a possible REIT conversion.

A REIT conversion would present us with several potential benefits, but none more important than advancing our strategic objective of being able to invest in Hawaii. We believe that a REIT structure could put us on a level playing field with a myriad of large investors, REITS, pension funds and others who are active in the market. There's a lot of work ahead to assess the viability and attractiveness of a REIT conversion. To assist with this work, we have hired several advisers. Skadden is advising us on a legal of matters, Goldman Sachs on financial matter, EY on accounting, and Green Street Advisors on disclosure. We also are undertaking some systems and reorganization efforts to more effectively operate, manage and report our business activities, regardless of whether we convert to a REIT.

We will be discussing our strategy and considerations related to REIT conversion in much more detail next Wednesday at our Investor Day in New York City. We will also be unveiling an enhanced financial supplement next Wednesday that provides additional data about our commercial assets and portfolio performance, as well as data to help you value all the components of our Company. We feel this added level of disclosure is important, again, regardless of whether we are a C Corp or a REIT. Hardcopies will be provided at the Investor Day and the electronic copy will be posted to our website on November 2.

Continuing now with quarter highlights, we had several sales that are active developments during the quarter and also will be delivering units at The Collection in a few weeks. I toured the project recently and I'm very proud of the quality of the project and the value we are delivering. Owners are completing their walkthroughs now and the feedback we have received has been overwhelmingly positive.

In our other active development projects, we had six sales at Ka Milo on the Big Island at an average of \$720 per square foot of living area and a 1,660 foot home closed at Kukui'ula for \$2.9 million, or \$1,750 per square foot. This sale brings total sales year to date at Kukui'ula to eight. In addition, of the 10 units under binding contract, we expect six to close this year. Although sales have been more modest than expected so far this year, construction activity at Kukui'ula continues to be positive. 26 developer homes are under construction and importantly, 14 member homes also are being built. Meanwhile, The Shops at Kukui'ula continues to be a great performer and the gathering spot for the Poipu community. In recognition of this, the Retail Merchants of Hawaii and ICSC, the national shopping center industry group, recently named The Shops as Hawaii's Shopping Center of the Year, recognizing excellence in Hawaii's retail industry.

Moving on to Maui, presales of the Company's 70 unit Keala O Wailea joint venture project located at the Wailea Resort have been positive. To date, 45 units have been presold under binding contract at an average price of \$1.1 million and we have for nonbinding contracts at the same average price. We currently have 20 units under construction and remain on track to begin delivering those units in late 2017. We will likely have another 20 units under construction by the end of the year, given the current level of presales.

Also on Maui is our primary master-planned community development called Kamalani, comprising 630 units. We're sequencing the development of the project by building the 170 affordable units first. This initial increment is not expected to be profitable, but it satisfies the requirements for the subsequent market priced units at Kamalani and also generates affordable housing credits that can be used at other A&B Maui projects, including Wailea. I have to confess that we've been surprised by the slow pace of sales for the affordable product. It's not due to lack of interest. It has been difficult for buyers to meet the strict county affordable housing criteria. After taking over 300 buyers to the verification process, we put 43 of these affordable units up for resale in July, but we've received binding contracts for just 21 units. We continue to work collaboratively through these and other issues with the county and are hopeful we will be able to progress soon.

Development sales in the quarter included a 268-acre ag parcel sale in Haiku, Maui to the County of Maui for \$9.5 million. And on Oahu we sold a lot on Kahala Avenue for \$3 million, bringing total sales proceeds for the project to \$126 million. We have a \$3.9 million binding contract for a non-oceanfront home date that is scheduled to close in November. After that closing, we will have seven properties remaining, including four large beachfront lots.

Shifting to Materials and Construction, this segment was a positive contributor to quarter earnings and cash flow despite some dampening of performance from wet weather. Grace was able to add a paving crew midway through the quarter which helped increased tons paved compared to third quarter of 2015, and recently added another crew temporarily which should help accelerate throughput in our Materials and Construction business in the fourth quarter. We have a healthy \$242.5 million backlog, so we remain very well-positioned.

Lastly, the final sugar harvest is progressing better than expected and as a result, Agribusiness produced operating profit of \$1.9 million in the quarter. The improvement primarily was due to lower sugar production costs, partially offset by lower power margin. As a result of favorable experience so far this year, full-year pretax operating losses and cessation costs are expected to be at the favorable end of the ranges that we provided previously, which were \$5 million to \$15 million operating loss and \$75 million to \$90 million of cessation costs.

I realize this is not a needle mover for our investors, but it's a remarkable indicator of the hard work and dedication of our employees who are giving it their all in this, the final year of sugar production in Hawaii. By the time of our next call we will no longer be in the sugar business and we will have said goodbye to our colleagues and friends at HCNS who are going out with class and a tremendous showing of commitment to their company. With that, let me hand it over to Paul to take you through the numbers.

Paul Ito - *Alexander & Baldwin, Inc. - SVP, CFO & Treasurer*

Thanks Chris. For the first quarter the Company recorded a net loss of \$1.9 million, or \$0.03 per diluted share, compared to net income of \$6.7 million last year. The results for 2016 included a \$9.6 million after-tax loss, or \$0.20 per diluted share for the Agribusiness segment principally due to cessation costs.

Turning to slide 16 our Commercial Real estate Segment's operating profit and cash flow performance showed continued strength in the quarter. Commercial Real Estate operating profit for the third quarter was \$13.7 million a 9.6% increase compared to the third quarter 2015 and NOI was \$21.1 million a [5.6%] (corrected by company after the call). The improvement in operating costs and NOI was principally attributable to improved Hawaii same-store performance which was up 3.7% for the quarter. Total portfolio occupancy was lower at 92% as mainland occupancy of 90% reflected the downsizing of industrial tenant on the mainland. Hawaii occupancy remains stable at 93%. Portfolio occupancy for the third quarter of 2015 was 95% and mainland occupancy was 96%.

Development and Sales operating profit was \$6.6 million in the quarter and included the sale of a 268 acre agricultural parcel and a Kahala Avenue lot sale, but also included joint venture unit closings of the unit at Kukui'ula and six units at Ka Milo. Materials and Construction contributed \$5.6 million of operating profit in the third quarter of 2016 which included a \$1.6 million noncash writedown associated with the October sale of a vacant land parcel owned by an unconsolidated joint venture compared to \$7.5 million in last year's third quarter. Adjusted EBITDA for the third quarter adjusted to exclude this \$1.6 million reduction was \$9.6 million compared to \$10.2 million last year. Performance in the third quarter of 2016 declined compared to last year, due principally to the decrease in materials sales and lower paving margins but was partially offset by quarry efficiency gains.

Wet weather and delays in notices to proceed affected both periods under comparison. As Chris noted, additional crews were added mid quarter, which helped increase tons paved during the quarter compared to last year. The agribusiness segment reported a pretax operating loss for the third quarter of \$15.7 million which included \$17.6 million of sugar cessation related expenses. Agribusiness operating profit excluding sugar cessation related expenses was \$1.9 million compared to a \$9 million loss in the third quarter of 2015. The third quarter improvement compared to last year was due to lower sugar production costs partially offset by lower power margins.

Finally, over the last several months management has undertaken a preliminary analysis of a REIT structure for A&B. Costs associated with this analysis amounted to \$1.9 million in the quarter and \$3.8 million year to date. We've broken out the amount separately in our income statement and intend to track the costs of the REIT conversion evaluation in this line item.

On slide 17, we have our balance sheet at the end of the quarter and at the end of 2015. Our debt to debt plus equity ratio of 33% at September 30, 2016 increased modestly since the end of last year primarily due to the investment in Waihonu, a commercial portfolio and ongoing development projects, partially offset by the paydown of debt using cash from operations.

On slide 18, is our debt maturity schedule and as you can see, maturities are well laddered. In August, we borrowed \$60 million on a secured basis for a 13 year term loan at a fixed interest rate of 3.135% under a swap arrangement. This borrowing which is secured by Manoa Marketplace will effectively fund the repayment of \$32 million of secured debt on The Shops at Kahala and Kahala lots maturing later this year. These actions will increase our weighted average maturities to approximately six years with only a negligible increase in our weighted average cost of debt.

Moving on to slide 19, we invested \$145 million of gross investment capital year to date through September 30, including \$89 million for a commercial property acquisitions primarily related to Manoa Marketplace. Additionally, \$56 million went to investment capital including active real estate projects and joint ventures, the Oahu solar farm investment that we made last quarter and repositioning opportunities in the commercial portfolio. In addition to this growth capital, \$14 million was for maintenance capital. While we are working on a number of ongoing projects and evaluating a number of investment opportunities, given where we are in the year we expect that most of our remaining growth investment capital budget will shift into 2017. So with that, let me turn the call back to Chris for closing remarks.

Chris Benjamin - *Alexander & Baldwin, Inc. - President & CEO*

Thank you, Paul. I am pleased to add that the Hawaii economy continues to perform well. Tourism, real estate and unemployment figures all demonstrating the strength and apparent stamina of the market. This continues to provide a positive environment for our businesses. We've included a number of slides in the appendix to summarize these key economic indicators.

Meanwhile we're making good progress across the board in pursuit of our strategic objectives, but the signs are most evident in the Commercial Real Estate segment as we expand our portfolio and embark on the exploration of a potential REIT conversion. We look forward to sharing more details about our strategy and this evaluation next week and our investor day in New York. That concludes our presentation this afternoon and we will be happy to take your questions now.

QUESTIONS AND ANSWERS

Operator

Thank you ladies and gentlemen.

(Operator Instructions)

Sheila McGrath, Evercore.



Sheila McGrath - *Evercore ISI - Analyst*

Chris, I know you're going to talk about it next week for the most part, but I was just wondering if you could give us little bit of insight in terms of the REIT conversion analysis. How long do you think that process takes? Will it take you well into next year? What you think the timing of that decision one way or another might be coming?

Chris Benjamin - *Alexander & Baldwin, Inc. - President & CEO*

Yes, Sheila. Thanks. The short answer to your question is, I would expect probably that will take into next year, probably into toward the middle of the year. It is hard to say for sure. But I would guess probably sometime second quarter, late second quarter maybe. But there's no definitive timeline at this point.

Sheila McGrath - *Evercore ISI - Analyst*

Okay. And then you did have a large land sale on Maui. I was wondering if that is a good proxy for ag land values, number one, and number two, in contemplation of a REIT conversion, should we expect more of these non-core land sales that you could 1031 into income producing commercial real estate assets?

Chris Benjamin - *Alexander & Baldwin, Inc. - President & CEO*

Yes, let me take the second question first. As far as the impact of potential REIT conversion on land sales, I don't think there would be any direct impact in terms of the pace of sales or anything like that. The primary benefits of the REIT would be related to our ability to grow our commercial portfolio. With respect to land sales we have commented on the fact that the sugar business was very, very high fixed cost and relied on every last acre of land. And now that we're transitioning out of the sugar business, it does give us some more degrees of freedom to pursue some land sales on the margin where maybe in the past it was land dedicated to sugar and would have been more difficult for us to monetize it. We do probably have some more degrees of freedom here, but our primary focus here is on repurchasing our sugar lands to diversified agriculture, whether it is our own operations, leases, or in some cases sales.

This particular parcel, it is very difficult, as you know, to come up with a number that is a good proxy for ag land sales. This land is very attractive land in a number of respects and it is probably toward the higher end of what we would expect to get for ag land. But certainly not beyond the range for what we've gotten on several transactions in the past. But it's always important to qualify that and make sure that we don't assume that all of our ag land is worth this kind of value, it's a pretty wide range. We have given in the past, and I'm sure will do it again, probably next week, examples of the range of ag land sales that we have had. And I would say that those examples in that range is still valid.

Sheila McGrath - *Evercore ISI - Analyst*

Okay. My last question is on The Collection. If you could give us an update on the townhouses and also on the high-rise units. Are most of them closing prior to year end, and how much cash back does that mean in the fourth quarter for ALEX?

Chris Benjamin - *Alexander & Baldwin, Inc. - President & CEO*

Let me have Lance take the question.

Lance Parker - *Alexander & Baldwin, Inc. - President, A&B Properties*

Sure, hello Sheila, how are you?



Sheila McGrath - *Evercore ISI - Analyst*

Hi Lance.

Lance Parker - *Alexander & Baldwin, Inc. - President, A&B Properties*

With regard to the townhomes we still have three binding contracts for the townhomes. We do have 11 of the 14 still available. We're contemplating that all townhome sales would likely occur in the beginning of next year. With regards to the tower and the midrise, we're anticipating all the sales to close in 2016, and I'm going to defer to Paul to answer the financial question.

Paul Ito - *Alexander & Baldwin, Inc. - SVP, CFO & Treasurer*

Yes, Sheila, in terms of the cash back, this is in a joint venture structure. So we anticipate that most of the cash will come in 2017. It's possible that some of it comes back in 2016. But typically what happens is the proceeds are received, of course we have to settle the loan that we have on the property, and then there's some accounting thinking about warranty reserves et cetera before we distribute to the partners. I would say you probably should assume that most of the proceeds will probably be in 2017.

Sheila McGrath - *Evercore ISI - Analyst*

Okay. Great. Thank you.

Chris Benjamin - *Alexander & Baldwin, Inc. - President & CEO*

Thank you.

Operator

(Operator Instructions)

Steve O'Hara, Sidoti & Company.

Steve O'Hara - *Sidoti & Company - Analyst*

Hi, good afternoon.

Chris Benjamin - *Alexander & Baldwin, Inc. - President & CEO*

Hello Steve.

Steve O'Hara - *Sidoti & Company - Analyst*

Just kind of curious about the operating businesses and how that might work going forward. From my understanding of it, you would not be able to move funds from the operating businesses into the REIT. I think Grace was starting to fund that cash flow to fund the Development and Sales. Would there be -- the ultimate question is does it make sense to have an operating businesses combined with a REIT, or does it make more sense to separate them altogether?

Chris Benjamin - *Alexander & Baldwin, Inc. - President & CEO*

Steve, this is Chris. There are actually number of questions embedded in there, let me make sure I address them all. First of all, I want to make it very clear that a very important objective for us is to ensuring that we can retain and continue to support all of our existing operating business in whatever structure we adopt. As we've been asked the question in the past about why aren't you a REIT, one of the primary reasons has been that we do have operating businesses and we have to make sure that they can qualify within the REIT. We do believe that there is a structure of a REIT with a taxable REIT subsidiary that could accommodate the businesses. But a big part of our evaluation going forward will be confirming that.

The reference that you made to the Grace business helping support the development business would not in any way be impeded by such a structure because both of those businesses would likely be in the taxable REIT subsidiary. If we do development for hold, which we do hope to do more of, that would take place within the REIT. But our traditional development for sale, which we would intend to continue to do, would happen within a TRS. So that same sort of cross-subsidization could take place.

With respect to the notion of spinning off, frankly beside the fact that the IRS rules do not allow that, that would not be our objective because it's not our objective through this to in any way break up the Company. It's very much our objective to keep the Company together. We think they are very good synergies between the business and we think at this early stage we believe that the REIT with the TRS structure would allow us to do that. But that's what we'll be working to confirm through our evaluation.

Steve O'Hara - *Sidoti & Company - Analyst*

Okay. Then I think Sheila had asked the question but I'm not sure if it got answered. On the ag lands, would that the sale that you made and maybe going forward, would those sales be allowed to be moved into the REIT or into the leasing portfolio on a 1031 basis? Maybe the REIT question could be asked later, but the other side of it.

Chris Benjamin - *Alexander & Baldwin, Inc. - President & CEO*

Right. We're probably getting a little bit ahead of ourselves, because we still have a lot of evaluation to do. But essentially any assets that are sold that are within the REIT, to Sheila's point, could be 1031'd and the replacement asset held in the REIT. I think if you're selling assets are in the TRS, which typically would be development assets and non-REIT assets, you would not be able to do that. The likelihood at this point is that a good portion of the land may well reside in the REIT but that has yet to be determined.

Steve O'Hara - *Sidoti & Company - Analyst*

Okay. Just for clarification. I think you had said [Kukui'ula] had eight, I don't know if it was lots or homes sold thus far this year, and you expected six more in the fourth quarter? Was that correct?

Lance Parker - *Alexander & Baldwin, Inc. - President, A&B Properties*

Yes, this is Lance, Steve. That's correct.

Steve O'Hara - *Sidoti & Company - Analyst*

I know you started off the year off slow from a sales standpoint and I think you'd commented on that fact earlier in the year. It seems like things are picking up. Is that the right way to read what is happening here, or is it just maybe things are getting back to normal?

Lance Parker - *Alexander & Baldwin, Inc. - President, A&B Properties*

I think it's a little difficult to tell right now, to be honest, Steve. We've had, as we indicated, a slow first quarter. We picked up activity in the middle part of the year that's going to translate to these sales we see towards the end of the year. We will be bringing on additional inventory in 2017 which we hope will address some of the issues that we've had in terms of buyer preference and hopefully stoke some sales.

Steve O'Hara - *Sidoti & Company - Analyst*

Okay. Thank you. Just on the Keala O Wailea, is that in a JV or is that wholly owned, just curious?

Chris Benjamin - *Alexander & Baldwin, Inc. - President & CEO*

That's in a joint venture.

Steve O'Hara - *Sidoti & Company - Analyst*

Okay. Thank you very much.

Operator

(Operator Instructions)

At this time I'm showing no further questions in the queue. I would like to turn the call back over to Suzy Hollinger for closing remarks.

Suzy Hollinger - *Alexander & Baldwin, Inc. - Director of IR*

Thank you everyone for being on the call, but before we hang up, I want to just correct some information that was provided. We provided 3.7% growth for Hawaii same-store. That growth for Hawaii same-store is actually 5.6%. I just wanted to make sure I made that correction with you. If you have further questions, please call me at area code 808-525-8422. Thanks again.

Operator

Thank you. Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the program. You may now disconnect. Everyone have a great day.

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