City Office REIT, Inc.
Form 10-Q
November 01, 2018
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2018

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from __________ to __________

Commission file no: 001-36409

CITY OFFICE REIT, INC.

Maryland	**98-1141883**
(State or other jurisdiction of incorporation)	**(IRS Employer Identification No.)**

1075 West Georgia Street
Suite 2010
Vancouver, BC
V6E 3C9
(Address of principal executive offices) (Zip Code)

Registrant s telephone number, including area code: (604) 806-3366

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of large accelerated filer, accelerated filer , smaller reporting company and emerging growth company in Rule 12b-2 of the Exchange Act.

Large accelerated filer	Accelerated filer
Non-accelerated filer	Smaller reporting company
	Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

The number of shares of Common Stock, $0.01 par value, of the registrant outstanding at October 29, 2018 was 39,544,073.

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City Office REIT, Inc.

Quarterly Report on Form 10-Q

For the Quarter Ended September 30, 2018

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

City Office REIT, Inc.

Condensed Consolidated Balance Sheets

(Unaudited)

(In thousands, except par value and share data)

	September 30, 2018	December 31, 2017
Assets		
Real estate properties		
Land	$ 204,934	$ 188,110
Building and improvement	656,538	534,473
Tenant improvement	74,306	53,427
Furniture, fixtures and equipment	321	291
	936,099	776,301
Accumulated depreciation	(67,870)	(48,234)
	868,229	728,067
Cash and cash equivalents	13,696	12,301
Restricted cash	20,136	22,713
Rents receivable, net	25,081	20,087
Deferred leasing costs, net	10,250	7,793
Acquired lease intangible assets, net	73,777	65,088
Prepaid expenses and other assets	2,706	2,013
Assets held for sale		38,427
Total Assets	$ 1,013,875	$ 896,489
Liabilities and Equity		
Liabilities:		
Debt	$ 546,016	$ 489,509
Accounts payable and accrued liabilities	23,163	17,605
Deferred rent	4,698	4,223
Tenant rent deposits	4,406	3,523
Acquired lease intangible liabilities, net	8,693	8,649
Dividend distributions payable	11,148	10,318
Liabilities related to assets held for sale		2,830

Total Liabilities	598,124	536,657
Commitments and Contingencies (Note 9)		
Equity:		
6.625% Series A Preferred stock, $0.01 par value per share, 5,600,000 shares authorized, 4,480,000 issued and outstanding	112,000	112,000
Common stock, $0.01 par value, 100,000,000 shares authorized, 39,544,073 and 36,012,086 shares issued and outstanding	395	360
Additional paid-in capital	376,689	334,241
Accumulated deficit	(74,079)	(86,977)
Total Stockholders Equity	415,005	359,624
Non-controlling interests in properties	746	208
Total Equity	415,751	359,832
Total Liabilities and Equity	$ 1,013,875	$ 896,489

Subsequent Events (Note 11)

The accompanying notes are an integral part of these condensed consolidated financial statements.

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City Office REIT, Inc.

Condensed Consolidated Statements of Operations

(Unaudited)

(In thousands, except per share data)

	Three Months Ended September 30, 2018	Three Months Ended September 30, 2017	Nine Months Ended September 30, 2018	Nine Months Ended September 30, 2017
Revenues:				
Rental income	$ 28,195	$ 21,452	$ 81,089	$ 65,400
Expense reimbursement	4,502	2,541	11,592	7,682
Other	850	757	2,636	2,224
Total Revenues	33,547	24,750	95,317	75,306
Operating Expenses:				
Property operating expenses	13,253	10,693	36,627	30,977
General and administrative	1,850	1,446	5,793	5,236
Depreciation and amortization	13,379	9,449	37,044	29,095
Total Operating Expenses	28,482	21,588	79,464	65,308
Operating income	5,065	3,162	15,853	9,998
Interest Expense:				
Contractual interest expense	(5,915)	(4,513)	(16,184)	(12,941)
Amortization of deferred financing costs	(311)	(372)	(1,297)	(1,027)
	(6,226)	(4,885)	(17,481)	(13,968)
Change in fair value of contingent consideration				2,000
Net gain on sale of real estate property			46,980	12,116
Net (loss)/income	(1,161)	(1,723)	45,352	10,146
Less:				
Net income attributable to non-controlling interests in properties	(135)	(52)	(384)	(3,324)
Net (loss)/income attributable to the Company	(1,296)	(1,775)	44,968	6,822
Preferred stock distributions	(1,855)	(1,855)	(5,565)	(5,556)
Net (loss)/income attributable to common stockholders	$ (3,151)	$ (3,630)	$ 39,403	$ 1,266
Net (loss)/income per common share:				
Basic	$ (0.08)	$ (0.12)	$ 1.08	$ 0.04

Diluted	$ (0.08)	$ (0.12)	$ 1.07	$ 0.04
Weighted average common shares outstanding:				
Basic	37,494	30,262	36,572	29,966
Diluted	37,494	30,262	36,920	30,268
Dividend distributions declared per common share	$ 0.235	$ 0.235	$ 0.705	$ 0.705

The accompanying notes are an integral part of these condensed consolidated financial statements.

City Office REIT, Inc.

Condensed Consolidated Statements of Changes in Equity

(Unaudited)

(In thousands)

	Number of shares of preferred stock	**Preferred stock**	**Number of shares of common stock**	**Common stock**	**Additional paid-in capital**	**Accumulated deficit**	**Total stockholders' equity**	**Operating Partnership unitholders' non-controlling interests**	**Non-controlling interests in properties**	**Total equity**
Balance December 31, 2016	4,480	$ 112,000	24,382	$ 244	$ 195,566	$ (53,608)	$ 254,202	$ 108	$ 1,749	$ 256,059
Conversion of OP units to shares			40		108		108	(108)		
Restricted stock award grants and vesting			90	1	1,741	(71)	1,671			1,671
Net proceeds from sale of common stock			11,500	115	136,826		136,941			136,941
Common stock dividend distributions declared						(31,148)	(31,148)			(31,148)
Preferred stock dividend distributions declared						(7,906)	(7,906)			(7,906)
Distributions									(4,943)	(4,943)
Net income						5,756	5,756		3,402	9,158
Balance December 31, 2017	4,480	112,000	36,012	360	334,241	(86,977)	359,624		208	359,832
Restricted stock award grants and vesting			121	1	1,204	(230)	975			975
Net proceeds from sale of			3,411	34	42,868		42,902			42,902

common stock										
Common stock dividend distributions declared						(26,275)	(26,275)			(26,275)
Preferred stock dividend distributions declared						(5,565)	(5,565)			(5,565)
Minority interest buyout					(1,624)		(1,624)		485	(1,139)
Contributions									43	43
Distributions									(374)	(374)
Net income						44,968	44,968		384	45,352
Balance September 30, 2018	4,480	$ 112,000	39,544	$ 395	$ 376,689	$ (74,079)	$ 415,005	$	$ 746	$ 415,751

The accompanying notes are an integral part of these condensed consolidated financial statements.

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City Office REIT, Inc.

Condensed Consolidated Statements of Cash Flows

(Unaudited)

(In thousands)

	Nine Months Ended September 30, 2018	2017
Cash Flows from Operating Activities:		
Net income	$ 45,352	$ 10,146
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	37,044	29,095
Amortization of deferred financing costs	1,297	1,027
Amortization of above/below market leases	(143)	(126)
Increase in straight-line rent	(3,491)	(2,417)
Non-cash stock compensation	1,061	1,430
Earn-out termination payment		(2,400)
Net gain on sale of real estate property	(46,980)	(12,116)
Changes in non-cash working capital:		
Rents receivable, net	(1,177)	(285)
Prepaid expenses and other assets	(162)	(1,648)
Accounts payable and accrued liabilities	(1,434)	2,270
Deferred rent	(1,428)	(77)
Tenant rent deposits	140	580
Net Cash Provided By Operating Activities	30,079	25,479
Cash Flows to Investing Activities:		
Additions to real estate properties	(15,785)	(6,119)
Acquisition of real estate	(162,462)	(216,310)
Net proceeds from sale of real estate	84,839	16,993
Deferred leasing costs	(3,222)	(2,578)
Net Cash Used In Investing Activities	(96,630)	(208,014)
Cash Flows from Financing Activities:		
Proceeds from sale of common stock	42,902	67,991
Debt issuance and extinguishment costs	(2,662)	(1,198)
Proceeds from mortgage loans payable	73,324	119,340
Repayment of mortgage loans payable	(35,128)	(26,759)
Proceeds from credit facility	196,500	187,000
Repayment of credit facility	(177,000)	(117,500)
Shares withheld for payment of taxes on restricted stock unit vesting	(87)	

Minority interest buyout		(1,139)		
Contributions from non-controlling interests in properties		43		
Distributions to non-controlling interests in properties		(374)		(4,764)
Dividend distributions paid to stockholders and Operating Partnership unitholders		(31,010)		(27,290)
Net Cash Provided By Financing Activities		65,369		196,820
Net (Decrease)/Increase in Cash, Cash Equivalents and Restricted Cash		(1,182)		14,285
Cash, Cash Equivalents and Restricted Cash, Beginning of Period		35,014		29,651
Cash, Cash Equivalents and Restricted Cash, End of Period	$	33,832	$	43,936
Reconciliation of Cash, Cash Equivalents and Restricted Cash:				
Cash and Cash Equivalents, End of Period		13,696		18,896
Restricted Cash, End of Period		20,136		25,040
Cash, Cash Equivalents and Restricted Cash, End of Period	$	33,832	$	43,936
Supplemental Disclosures of Cash Flow Information:				
Cash paid for interest	$	15,967	$	12,800
Purchases of additions in real estate properties included in accounts payable	$	4,379	$	364
Purchases of deferred leasing costs included in accounts payable	$	430	$	27

The accompanying notes are an integral part of these condensed consolidated financial statements.

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City Office REIT, Inc.

Notes to the Condensed Consolidated Financial Statements

1. Organization and Description of Business

City Office REIT, Inc. (the Company) was organized in the state of Maryland on November 26, 2013. On April 21, 2014, the Company completed its initial public offering (IPO) of shares of the Company s common stock. The Company contributed the net proceeds of the IPO to City Office REIT Operating Partnership, L.P., a Maryland limited partnership (the Operating Partnership), in exchange for common units of limited partnership interest in the Operating Partnership (common units).

The Company s interest in the Operating Partnership entitles the Company to share in distributions from, and allocations of profits and losses of, the Operating Partnership in proportion to the Company s percentage ownership of common units. As the sole general partner of the Operating Partnership, the Company has the exclusive power under the Operating Partnership s partnership agreement to manage and conduct the Operating Partnership s business, subject to limited approval and voting rights of the limited partners.

The Company has elected to be taxed and will continue to operate in a manner that will allow it to continue to qualify as a real estate investment trust (REIT) under the Internal Revenue Code of 1986, as amended (the Code). Subject to qualification as a REIT, the Company will be permitted to deduct dividend distributions paid to its stockholders, eliminating the U.S. federal taxation of income represented by such distributions at the Company level. REITs are subject to a number of organizational and operational requirements. If the Company fails to qualify as a REIT in any taxable year, the Company will be subject to U.S. federal and state income tax on its taxable income at regular corporate tax rates and, for tax years beginning before 2018, any applicable alternative minimum tax.

2. Summary of Significant Accounting Policies

Basis of Preparation and Summary of Significant Accounting Policies

The accompanying unaudited condensed consolidated financial statements have been prepared by the Company in accordance with Securities and Exchange Commission rules and regulations and generally accepted accounting principles in the United States of America (US GAAP) and in the opinion of management contain all adjustments (including normal recurring adjustments) necessary to present fairly the financial position, results of operations and cash flows for the periods presented. The preparation of financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2017.

New Accounting Pronouncements

Adopted in the Current Year

Effective January 1, 2018, the Company adopted FASB ASU 2014-09, Revenue From Contracts with Customers, on a modified retrospective basis. The standard is principle-based and provides a five-step model to determine when and how revenue is recognized. The core principle is that a company should recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which it expects to be entitled in exchange for those goods or services. The Company has reviewed its revenue streams and determined that the majority are under the guidance of ASU 2016-02, Leases. Net gain on sale of real estate is under the guidance of ASU 2017-05, Other Income. The adoption of this guidance did not have a material impact to the Company s condensed consolidated financial statements or notes to our condensed consolidated financial statements.

Effective January 1, 2018, the Company adopted FASB ASU 2016-01, Recognition and Measurement of Financial Assets and Financial Liabilities. The amendments in ASU 2016-01 address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. The adoption of this guidance did not have a material impact to the Company s condensed consolidated financial statements.

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Effective January 1, 2018, the Company adopted FASB ASU 2016-15, Statement of Cash Flow: Classification of Certain Cash Receipts and Cash Payments, on a retrospective basis. The adoption of this guidance did not have a material impact to the Company s condensed consolidated financial statements.

Effective January 1, 2018, the Company adopted FASB ASU 2016-18, Statement of Cash Flows: Restricted Cash, on a retrospective basis. The update required the statement of cash flows to explain the changes during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents.

To be Adopted in Future Years

In February 2016, the FASB issued ASU 2016-02, Leases. The update amends the existing accounting standards for lease accounting, including requiring lessees to recognize most leases on their balance sheets and making targeted changes to lessor accounting. The standard requires a modified retrospective transition approach for all leases existing at, or entered into after, the date of initial application, with an option to use certain transition relief. ASU 2016-02 will be effective for annual reporting periods beginning after December 15, 2018. Early adoption is permitted. On July 30, 2018, the FASB released ASU 2018-11 which allows lessors to elect, as a practical expedient, to not separate lease and non-lease components and allow these components to be accounted for as a single lease component if both (i) the timing and pattern of transfer to the lessee of the lease component and the related non-lease component are the same and (ii) the lease component, if accounted for separately, would be classified as an operating lease. In addition, a company is permitted to use its effective date as the date of initial application. Therefore, a company electing this option will not restate comparative period financial information, will not make the new required lease disclosures in comparative periods beginning before the effective date and will recognize its cumulative effect transition adjustment as of the effective date. The Company is in the process of evaluating whether it will elect to apply the practical expedient. If the Company elects to apply the practical expedient we expect expense reimbursements that qualify as non-lease components will be presented under a single lease component. If the Company does not elect to apply the practical expedient we expect that certain non-lease components of expense reimbursement may be subject to ASC 606.

3. Real Estate Investments

Acquisitions

During the nine months ended September 30, 2018 and 2017 the Company acquired the following properties:

Property	Date Acquired	Percentage Owned
The Quad	July 2018	100%
Circle Point	July 2018	100%
Pima Center	April 2018	100%
Mission City and Sorrento Mesa	September 2017	100%
2525 McKinnon	January 2017	100%

All of the properties acquired were accounted for as asset acquisitions.

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The following table summarizes the Company s allocations of the purchase price of assets acquired and liabilities assumed during the nine months ended September 30, 2018 (in thousands):

	The Quad	Circle Point	Pima Center	Total Sept. 30, 2018
Land	$ 8,079	$ 8,744	$	$ 16,823
Buildings and improvements	38,060	33,708	42,235	114,003
Tenant improvements	1,798	5,393	2,898	10,089
Acquired intangible assets	4,209	10,299	10,691	25,199
Prepaid expenses and other assets	15	25	95	135
Accounts payable and other liabilities	(527)	(1,157)	(337)	(2,021)
Lease intangible liabilities	(1,247)	(390)	(129)	(1,766)
Total consideration	**$ 50,387**	**$ 56,622**	**$ 55,453**	**$ 162,462**

The following table summarizes the Company s allocations of the purchase price of assets acquired and liabilities assumed during the nine months ended September 30, 2017 (in thousands):

	Mission City and Sorrento Mesa	2525 McKinnon	Total Sept. 30, 2017
Land	$ 66,097	$ 10,629	$ 76,726
Buildings and improvements	78,072	33,357	111,429
Tenant improvements	8,393	1,158	9,551
Acquired intangible assets	22,846	3,267	26,113
Prepaid expenses and other assets	140		140
Accounts payable and other liabilities	(1,507)	(190)	(1,697)
Lease intangible liabilities	(3,766)	(2,186)	(5,952)
Total consideration	**$ 170,275**	**$ 46,035**	**$ 216,310**

Sale of Real Estate Property

On March 8, 2018, the Company sold the Washington Group Plaza property in Boise, Idaho for $86.5 million, resulting in an aggregate net gain of $47.0 million, net of $1.7 million in costs, which has been classified as net gain on sale of real estate property in the condensed consolidated statements of operations. In connection with the sale of the property, certain debt repayments were made.

On May 2, 2017, the Company sold the 1400 and 1600 buildings at the AmberGlen property in Portland, Oregon, and its related assets and liabilities, for a sales price of $18.9 million, resulting in an aggregate net gain of $12.1 million, net of $2.0 million in costs, which has been classified as net gain on sale of real estate property in the condensed consolidated statements of operations. In connection with the sale of the property, certain debt repayments were made.

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4. Lease Intangibles

Lease intangibles and the value of assumed lease obligations as of September 30, 2018 and December 31, 2017 were comprised as follows (in thousands):

	Lease Intangible Assets					Lease Intangible Liabilities		
September 30, 2018	Above Market Leases	Below Market Ground Lease(1)	In Place Leases	Leasing Commissions	Total	Below Market Leases	Below Market Ground Lease(1)	Total
Cost	$ 10,477	$ 1,855	$ 82,138	$ 30,421	$ 124,891	$ (12,616)	$ (138)	$ (12,754)
Accumulated amortization	(4,599)	(13)	(34,698)	(11,804)	(51,114)	4,026	35	4,061
	$ 5,878	$ 1,842	$ 47,440	$ 18,617	$ 73,777	$ (8,590)	$ (103)	$ (8,693)

	Lease Intangible Assets					Lease Intangible Liabilities		
December 31, 2017	Above Market Leases	Below Market Ground Lease	In Place Leases	Leasing Commissions	Total	Below Market Leases	Below Market Ground Lease(1)	Total
Cost	$ 9,082	$	$ 71,426	$ 27,706	$ 108,214	$ (11,608)	$ (138)	$ (11,746)
Accumulated amortization	(3,215)		(30,613)	(9,298)	(43,126)	3,065	32	3,097
	$ 5,867	$	$ 40,813	$ 18,408	$ 65,088	$ (8,543)	$ (106)	$ (8,649)

(1) For the below market ground lease asset the Company is the lessee, whereas, for the below market ground lease liability the Company is the lessor.

The estimated aggregate amortization expense for lease intangibles for the next five years and in the aggregate are as follows (in thousands):

2018	$ 4,722
2019	18,534
2020	16,298
2021	13,186
2022	5,667
Thereafter	6,677
	$ 65,084

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5. Debt

The following table summarizes the indebtedness as of September 30, 2018 and December 31, 2017 (in thousands):

Property	September 30, 2018	December 31, 2017	Interest Rate as of September 30, 2018	Maturity
Unsecured Credit Facility (1)	$ 53,000	$	LIBOR +1.50%(2)	March 2022
Midland Life Insurance (3)	87,382	88,582	4.34	May 2021
Mission City	47,000	47,000	3.78	November 2027
190 Office Center (4)	41,250	41,250	4.79	October 2025
Circle Point (4)	39,650		4.49	September 2028
SanTan (4)	34,823	35,100	4.56	March 2027
Intellicenter (4)	33,562	33,563	4.65	October 2025
The Quad	30,600			