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PECO.OQ - Q2 2023 Phillips Edison & Co Inc Earnings Call

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PRESENTATION

Operator

Good day, and welcome to the Phillips Edison & Company's Second Quarter 2023 Earnings Conference Call. Please note that this call is being recorded.

I will now turn the conference over to Kimberly Green, Head of Investor Relations. Kimberly, you may begin.

Kim Green *- Phillips Edison & Company, Inc. - VP of IR*

Thank you, operator. I'm joined on this call by our Chairman and Chief Executive Officer, Jeff Edison; our President, Devin Murphy; and our Chief Financial Officer, John Caulfield. Once we conclude our prepared remarks, we will open the call to Q&A. After today's call, an archived version will be published on our website.

As a reminder, today's discussion may contain forward-looking statements about PECO's view of future business and financial performance, including forward earnings guidance and future market conditions. These are based on management's current beliefs and expectations and are subject to various risks and uncertainties as described in our SEC filings, including in our most recent Form 10-K and 10-Q.

In our discussion today, we will reference certain non-GAAP financial measures. Information regarding our use of these measures and reconciliations of these measures to our GAAP results are available in our earnings press release and supplemental information packet, which have been posted to our website. Please note that we have also posted a presentation with additional information. Our caution on forward-looking statements also applies to these materials. Now I'd like to turn the call over to Jeff Edison, our Chief Executive Officer. Jeff?

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Jeffrey S. Edison - *Phillips Edison & Company, Inc. - Chairman & CEO*

Thank you, Kim, and thank you, everyone, for joining us today. Before we get into our results for this quarter, I would like to acknowledge the recent 2-year anniversary of PECO's IPO. I would also like to highlight the progress the PECO team has made during this period and reiterate our optimism for the future and our long-term growth plans.

PECO's strategy remains simple and consistent. We exclusively own and operate grocery-anchored neighborhood shopping centers. More than 30% of our rents come from our grocers. On average, customers visit our grocers nearly 2 times a week. We are 98% occupied, which gives us strong pricing power. Leasing demand is at historically high levels for our in-line spaces, and we have limited exposure to big-box retailers.

We are lowly levered with a great balance sheet and well positioned for accretive acquisitions in a highly fragmented market. These components have not changed. We remain focused on owning shopping centers anchored by the #1 or #2 grocer within a market. Our neighbor base has an omnichannel strategy and more than 70% of our rents come from neighbors, selling necessity, goods and services. Our centers are situated in targeted trade areas with favorable demographics where our top grocers make money and our neighbors are successful. Each of these components remain critical to our success. We continue to believe that format drives results. Our average center is 115,000 square feet, which is the smallest in the REIT shopping center space. This enhances our pricing power.

Our smaller centers allow for better FFO growth because they yield higher retention rates and strong leasing spreads. Our retention rates averaged 87% between 2017 and 2021. Today, retention is at 94%, reaching a record high of 95% in the first quarter of 2023.

High retention rates result in less downtime and lower tenant improvement costs. Lower capital costs result in better returns. From 2017 to 2020, our average cash leasing spreads were 8.8%, providing a meaningful avenue for NOI growth. Combined, comparable rent spreads for new and renewal leases were 10.1% in 2021.

Today, we are executing record high renewals spread rates of 17.7%, new rent spreads north of 25% and 18.9% rent spreads when all combined. At the time of the IPO, PECO's total portfolio occupancy had exceeded pre-COVID levels and was at 96% leased. Today, leased portfolio occupancy is at a record high, 98%.

Since the IPO, we have pushed annual rent bumps in our new and renewal leases from 2% to nearly 3% on average. Additionally, our smaller format centers and lower exposure to secondary anchors require less CapEx than other retail real estate formats. Lower CapEx leads to higher AFFO. Over 30 years, we have built a fully integrated operating platform and become one of the nation's largest owners and operators of neighborhood, grocery-anchored shopping centers.

We continue to deliver on the operating side, which is reflected in our consistently strong financial results. Since the IPO, we have exceeded market expectations for NOI, FFO and AFFO growth. The quality of our performance is an important differentiator. As a reminder, we define the quality of our performance and our portfolio through the use of the acronym SOAR. This includes spreads, occupancy, the advantages of the markets we're in and retention. PECO has a strong track record of external growth through acquisitions. We have selectively acquired new assets that fit our focused strategy.

At the time of the IPO, we told you our plan was to purchase $1 billion of assets over the next 3 years. Since then, the markets have changed. We cannot control the market, but we can control our response to them, which remains extremely disciplined and opportunistic. The transaction market continues to be fragmented and sporadic as we saw with the dramatically lower volume of activity in the first half of the year.

While we are currently seeing activity increasing, we believe cap rates are still adjusting slowly in the private markets in response to the higher interest rates. There are still gaps between buyer and seller expectations. As we sit here today, we are reiterating our guidance for $200 million to $300 million of net acquisitions this year. That said, if the market remains inconsistent, as we saw in the first half of the year, we may be at the low end of that range. We have a very disciplined acquisition process. We remain focused on accretively growing our shopping center portfolio at the right price, while achieving our acquisition hurdle of a 9% unlevered IRR.

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For the remainder of this year, we remain confident in our business plan as reflected in our guidance increase. Looking beyond 2023, we believe our portfolio can deliver mid- to high single-digit FFO per share growth on a long-term basis given our internal and external growth drivers.

In addition, we still have one of the lowest levered balance sheets in the shopping center space, which gives us the financial capacity to meet our acquisition objectives.

The IPO was a major milestone for our company, but it was just the beginning. We remain focused, motivated and committed to successfully executing our growth strategy, which we believe continues to generate more alpha and less beta.

I will now turn the call over to Devin. Devin?

Devin Ignatius Murphy - *Phillips Edison & Company, Inc. - President*

Thank you, Jeff. Good afternoon, everyone, and thank you for joining us today. The PECO team delivered another solid quarter of growth with same-center NOI increasing by 5.3% and our portfolio reaching new record highs in both occupancy and renewal rent spreads.

The consistency of our operating performance is attributable to our differentiated and focused strategy of exclusively owning grocery-anchored neighborhood shopping centers anchored by the 1 or 2 grocers in a market and our platform's ability to drive results at the property level for our integrated and cycle-tested team.

PECO's leasing team continues to convert strong retailer demand into higher occupancy levels and rents. The retailer demand, we continue to see is driven by the positive impact of the macro trends of hybrid work and suburbanization. Our anchor occupancy increased 10 basis points sequentially to 99.4% and in-line occupancy increased 50 basis points sequentially to a record high of 94.8% representing year-over-year increases of 70 and 160 basis points respectively.

Leasing activity remained strong, and our volume of deals executed in the first half of the year increased year-over-year to 548 leases totaling over 2.6 million square feet. We continue to capitalize on strong renewal demand and making the most of the opportunity to strengthen key lease terms and drive renewal rents higher. Specifically, for the second quarter, we achieved a 17.7% increase in renewal rent spreads, an all-time high.

In terms of new lease activity, we continue to have success driving meaningfully higher rents in our portfolio. New rent spreads for the second quarter increased 25.1%. We expect that leasing spreads will continue to be strong through the balance of this year and into 2024. Our pricing power is the driver of these metrics, and we do not see this changing in the near term.

Our ongoing success in leasing continues to be driven by the strong demand for space across our grocery-anchored portfolio. Demand that continues to come from necessity and service-based neighbors. Currently, we see leasing demand primarily from restaurants, health and beauty neighbors and medical neighbors. Restaurants represent 40% of our leasing pipeline activity today, half of which are quick service restaurants, such as Dunkin' Donuts, Zaxby's and Firehouse Subs. Health and beauty services are 11% of current leasing demand. Medical or Medtail as we call it, is a fast-growing use in PECO's neighbor mix, and we continue to see strong demand for medical uses. Medtail currently represents 6% of our ADR but 20% of our current leasing pipeline. PECO's retention rate remained strong at 94% in the second quarter. High retention rates mean no downtime and less tenant improvement costs, which leads to higher stabilized yields in our assets.

As a reminder, our TI spend on renewals over the last 5 years averaged less than $2 per square foot and average just $1.35 per square foot in the second quarter. On average, our new and renewal in-line leases executed in the second quarter had annual contractual rent bumps of 2.6%, another important contributor to our long-term growth rate.

We continue to invest in our value-creating roundup outparcel development and repositioning projects, which remain a good use of our free cash flow and deliver attractive returns. Year-to-date, we have stabilized 7 projects, delivering over 175,000 square feet of space to our neighbors and incremental NOI of approximately $2.1 million annually.

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These projects provide superior risk-adjusted returns and have a meaningful impact on our long-term NOI growth.

For the full year of 2023, we now expect to invest $35 million to $45 million in ground-up outparcel development and repositioning opportunities with average estimated underwritten cash-on-cash yields between 9% and 12%. We have delayed construction starts for 4 projects that were originally planned to commence in the second half of this year that will now be pushed into 2024, lowering our expected spend in 2023 by approximately $15 million.

We continue to enjoy the many benefits of PECO's grocery-anchored portfolio with our healthy mix of national, regional and local retailers. More than 70% of our rents come from neighbors offering necessity-based goods and services, and our top grocers continue to drive strong recurring foot traffic to our centers.

Our local neighbor health remains strong. Local neighbors, which represent 26% of our ABR, continue to thrive in PECO's portfolio, benefiting from the continued strong foot traffic created by our grocer anchors and the strength of our neighborhood locations. The map behind our local neighbors continues to be positive and is improving. Our local neighbors have been in our centers an average of 9 years. This length of tenancy compares favorably to the capital investment average payback period of just 10 months.

As of the second quarter, we have retained 78% of our local neighbors, an increase from 76% historically. Renewal rent spreads for our local neighbors were 23% for the quarter compared to 18% for the overall PECO portfolio. In addition to the compelling economics behind our local neighbors, they differentiate our centers and offer a unique merchandising mix for our customers. We want to emphasize that successful local entrepreneurs prosper in PECO's grocery-anchored neighborhood centers.

We continue to benefit from a number of positive macroeconomic trends that create strong tailwinds for us and drive strong neighbor demand. These trends include a healthy consumer, hybrid work, migration to the Sunbelt, population shifts that favor suburban communities and the importance of physical locations in last-mile delivery. These demand factors are further amplified due to limited new supply, given the lack of new construction in our space over the last 10 years and going forward, given the economic returns associated with new construction.

I'd now like to turn the call over to John. John?

John P. Caulfield - *Phillips Edison & Company, Inc. - CFO, Executive VP & Treasurer*

Thank you, Devin, and good morning, and good afternoon, everyone. I'll start by addressing second quarter results, provide an update on the balance sheet and then speak to our increased 2023 guidance.

Second quarter 2023 Nareit FFO increased 6.7% to $75.9 million or $0.58 per diluted share, driven by an increase in rental income and our strong property operations.

Second quarter core FFO increased 8.2% to $77.7 million or $0.59 per diluted share, driven by increased revenue at our properties from higher occupancy levels and strong leasing spreads, partially offset by higher interest expense.

Our second quarter 2023 same-center NOI increased to $99 million, up 5.3% from a year ago. This improvement was primarily driven by higher occupancy and an increase in average base rent per square foot, driven by our strong leasing spreads partially offset by lower collectibility reserve reversals in the current period when compared to 2022.

From a balance sheet perspective, we ended the quarter with approximately $629 million of borrowing capacity available on our $800 million credit facility. Earlier this week, we extended all of our 2024 term loan maturities into 2026 and '27. The 2026 term loan has 2 12-month extension options that allow us to push the maturity into 2028 at our election. This enhances our already strong liquidity position and maintains our well-laddered debt maturity profile.

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These term loan extensions improve our debt maturity profile, maintaining our financial flexibility and allow for a lower cost of capital as we navigate the current debt capital markets. We appreciate the continued support of our banking partners. As we look at our floating rate exposure, 19% of our debt is currently floating and is influenced by our use of the revolver.

We plan to limit our floating rate debt to less than 10% of our total debt, and we're currently working on alternatives to meet this target. Our leverage ratio continues to be strong as a result of our solid earnings growth as well as our prudent balance sheet management, with our net debt to adjusted EBITDA are at 5.2x as of June 30, 2023. At the end of the second quarter, our debt had a weighted average interest rate of 3.9% and a weighted average maturity of 4.6 years when including the refinancing activity from this week and available extension options, 81% of our debt was fixed rate.

Between the free cash flow generated by our portfolio and the significant capacity available on our revolver, we remain confident in our ability to fund our growth plans.

Turning to our updated guidance. Based on our performance to date, we are raising our Nareit FFO and core FFO per share guidance. Our new core FFO guidance increased to a range of $2.30 to $2.36 per diluted share. We're also increasing our same-center NOI guidance to a range of 3.75% to 4.5%. These increases are a result of strong property performance driven by leasing spreads, record occupancy and high retention.

With that, we look forward to taking your questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Caitlin Burrows of Goldman Sachs.

Caitlin Burrows - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

I know addressing your 2024 debt maturities was a goal of yours for this year. So congrats on getting that done. Now your weighted average maturity of debt is 4.6 years, up from 4.1. So maybe you could talk a little bit about your outlook and opportunity from here regarding kind of the ability to extend that further.

John P. Caulfield - *Phillips Edison & Company, Inc. - CFO, Executive VP & Treasurer*

Sure. So it is -- it was a big project that we worked on and are very grateful for the support of our lenders and the ability to push that out, which just further gives us flexibility with the limited amount that we have on the line in a full acquisition plan for the remainder of the year. We continue to evaluate additional financing alternatives, and that will help us further extend that.

So I think we're looking at -- we like the bond market to see more activity. I mean, obviously, the base rates are higher, but that is -- we want to be a long-term unsecured bond issuer, but we also have flexibility in the secured markets or other financing vehicles available.

Caitlin Burrows - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

Okay. And maybe just on the acquisition side, I think that's a unique earnings driver for PECO versus peers in particular, but the lower transaction volumes year-to-date for the industry and for PECO has limited that positive driver. So I guess could you talk about how the transaction opportunities have developed year-to-date kind of the pace of deals you're seeing, what you've worked on, what you've passed on and kind of your expectation for finding attractive opportunities in the second half.

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Jeffrey S. Edison - *Phillips Edison & Company, Inc. - Chairman & CEO*

Sure, Caitlin. Sorry about that first question. I was on mute, and I gave a great answer though, but John filled it well. But yes, the -- as you know, we're in a difficult acquisition market. We're happy we bought $80 million worth of properties in the first half of the year. And as you know, we've stayed very disciplined in terms of what our underwriting is on those properties and making sure we're getting those centers that have the #1 or #2 grocer and where we can really drive rents and occupancy.

And we're going to continue to have the discipline we've had, the markets, in our view, are starting to loosen a bit. We're seeing a lot more price recognition than we saw during the last 1.5 quarters. And so we are generally, I would say, cautiously optimistic about acquisition pace in the second half of the year. But it's early, and it's early days, and yes, I would say that there is a significant beta in terms of where we would end up. Again, on a short-term basis over the next couple of quarters, we probably -- there's a pretty big beta there of where that could end up. And that's why we feel like we'll certainly -- we're working hard to get to that into the range. And whether we're at the high end or the low end of the range, is really going to depend a lot on how the market continues to evolve.

We have one project today under contract that will close probably in the next couple of weeks, not a big project, a smaller project. But we still have -- so we have a lot of work to do to get there. But I would say, generally, we're -- we feel like the market is moving in a positive direction for us to be able to meet those targeted goals. John, I don't know if you have anything to add to that.

John P. Caulfield - *Phillips Edison & Company, Inc. - CFO, Executive VP & Treasurer*

No, nothing to add.

Operator

Your next question comes from the line of Jeff Spector of Bank of America.

Jeffrey Alan Spector - *BofA Securities, Research Division - MD and Head of United States REITs*

Just a follow-up on the acquisitions, I'm sorry if I just missed this, but did you provide specifics on, I guess, where cap rates are versus again, what you're looking to acquire at? Like how has the gap been narrowing.

Jeffrey S. Edison - *Phillips Edison & Company, Inc. - Chairman & CEO*

Jeff. Well, thanks for the question. We didn't really talk specifically yet about the narrowing. I think our -- we think that there's been 50 to 100 basis points movement in cap rates. But as you know, we're really focused on getting long-term returns and having our acquisitions be accretive early in their life. And so we're more focused on that and getting to a [non] unlevered is not an easy task in today's environment. But as cap rates have moved out and as the sellers have come to recognition of the new pricing, we are seeing more product coming on to the market.

And we think that, that will allow us to get into the range that we've talked about on the acquisition side. And -- but I would say 50 to -- our 50 to 100 basis points movement in cap rates is probably a pretty good approximation as we know that there's a wide spread in terms of those things. But in terms of just sort of generally an average property, I think that's a way -- a fairly good way of factoring in on where that pricing has changed.

Jeffrey Alan Spector - *BofA Securities, Research Division - MD and Head of United States REITs*

Okay. And then second question is on the gap between leased and economic occupancy. It narrowed this quarter to about 60 basis points. How should we think about that for the second half of the year into '24?

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Jeffrey S. Edison - *Phillips Edison & Company, Inc. - Chairman & CEO*

John, do you want to take that one?

John P. Caulfield - *Phillips Edison & Company, Inc. - CFO, Executive VP & Treasurer*

Sure. Jeff, so our long-term historical average has been 60 basis points over years, and it widens, I think at 1 point in the last year or so, it's gotten to 100 basis points. But it really is pretty consistent at the 60 basis points. And the reason for that is that because the majority of our leasing, the vast majority is -- of our new leasing is in line. We're able to get those spaces up and open and rent paying faster than if we had more box activity. So I would say that as we look forward, I think that 60 basis points is a good delta.

Operator

Your next question comes from the line of Ronald Kamdem of Morgan Stanley.

Ronald Kamdem - *Morgan Stanley, Research Division - Equity Analyst*

Congrats on the quarter. Just 2 quick ones for me. Just back to the debt extension that you executed for '24. Maybe is there a way to quantify once you annualize what the interest cost delta is going to be in '24 versus '23, now that you've extended those pieces. How should we think about that?

Jeffrey S. Edison - *Phillips Edison & Company, Inc. - Chairman & CEO*

John, do you want to take that one?

John P. Caulfield - *Phillips Edison & Company, Inc. - CFO, Executive VP & Treasurer*

Sure. I'll take that one as well. It is -- it depends on what you're assuming for '24 acquisitions. But we do think that, that we do provide the '23 number, but I mean, it will -- between rate increases and the acquisitions that if you assume that those are funded with debt, then I would say that they're likely going up about $15 million.

Ronald Kamdem - *Morgan Stanley, Research Division - Equity Analyst*

Helpful. And then just digging into the acquisition question, I sort of appreciate I guess, the acquisition and the development spend going down those projects pushed. So can you just provide a little bit more color? Was it just the costs were too prohibitive? Was there something else? Why those projects got pushed. Just would love to hear a little bit more about that.

And then on the acquisition front, maybe what do you think is causing deals to be so hard to come by? Is it -- are you getting out bid? Is this just not enough volume? Just trying to figure out how you shake this tree to get more deals through.

Jeffrey S. Edison - *Phillips Edison & Company, Inc. - Chairman & CEO*

Yes. Dev, do you want to take the development and I'll cover the deal side on the acquisition.

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Devin Ignatius Murphy - *Phillips Edison & Company, Inc. - President*

Sure. Ron, No, Ron, look, on the redev delays, it's -- there's basically 4 projects that were pushed from '23 into '24 and the reason varies by project, but it comes down to one of several things: either, a, entitlement delays or b, material delays or c, the need for the neighbor to the way to start, like, for example, one of these projects was the Publix in the portfolio, they did not want the store to be closed during the holiday season. So they pushed it into early '24.

So it's a combination of factors, but it has nothing to do with the kind of returns that we can achieve on these projects. We still continue to believe that we can do $50 million to $60 million of this activity on an annual basis on a go forward and that these projects will deliver cash-on-cash returns of 9% to 12% on average. So it's a very attractive use of capital given the risk-reward of these activities.

Jeffrey S. Edison - *Phillips Edison & Company, Inc. - Chairman & CEO*

Does that -- Ron, does that answer your question on the redev stuff?

Ron, so on the acquisition side, I think the difficulty in the transaction volume side, is not anything really kind of out of the normal when you have a sort of repricing going on in the marketplace. And sellers are hesitant to sell at the new pricing and buyers are hesitant to -- they think the pricing change is going to be wider. And we're really just going through that process, which is a very -- I mean it's happened a bunch of times in the past and it will happen a bunch more. We're really in that process. It's -- and I don't think it's anything more than when interest rates go up and the cost of capital goes up, pricing is going to expand and you're going to be in a market where you -- as an owner, you have to adjust to the new pricing and as a buyer, you're thinking it should change more. And that's sort of the battle that's going on.

And as we talked about, that's probably led to somewhere between 50 and 100 basis points difference in spread. And as you know, we've moved our targeted unlevered IRR from 8% to 9%. And that -- as we go through that process, it will take time. But as I said, it has changed probably a little quicker than we thought it would. We thought we would be -- it would be a slower progress than what we're seeing right now, and hopefully, that will allow us to meet and exceed our what our expectations are for the year on the acquisition side.

Operator

Your next question comes from the line of Juan Sanabria of BMO Capital Markets.

Juan Carlos Sanabria - *BMO Capital Markets Equity Research - MD & Senior U.S. Real Estate Analyst*

Just a question on the balance sheet. You guys have done a good job taking leverage down over time. So how should we think about you funding future acquisitions as the attention to lever up or to fund it kind of with an equity debt mix to keep leverage closer to where it is today. And as part of that, John mentioned reducing the floating rate exposure. So just curious on what the options there are.

Jeffrey S. Edison - *Phillips Edison & Company, Inc. - Chairman & CEO*

Okay. John, why don't I -- I will talk a little bit about the first part of the question, if you can talk a little bit about the -- what we're thinking about in terms of fixing some of the debt.

Juan, as you know, we're very focused on matching our cost of capital with our acquisitions. So you can expect that we have an unlevered balance sheet in order to be able to acquire actively when the opportunities are right. And that's the discipline that we have shown this year and will continue to show going forward that we will use the balance sheet to do that, but only when we can get into a market where we're getting accretive with solid growth properties that we can use our machine to create a lot of value in.

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And so that's sort of a long-winded way of saying that we will be looking at the debt markets and at the right time where the equity markets are favorable. That -- as you know, we tapped our ATM last year at a time where we thought we were getting a really good spread between our cost of capital and what we were buying, and we thought that was an appropriate thing to do at the time. And so we're always looking at that and keeping -- trying to keep that balance between the two. John, do you want to talk a little bit about our strategy on fixing rates.

Devin Ignatius Murphy - *Phillips Edison & Company, Inc. - President*

Before we move on to John on picking rates, I just want to remind Juan that Juan, we generate over $100 million a year in free cash flow after the dividend and we can acquire $250 million a year in assets with that free cash flow. So the funding need for us kicks in when we exceed $250 million a year in acquisitions. So -- and then as you know, our balance sheet is now 5.2x debt to EBITDA so we do have leverage capacity. And so increment to that $250 million, we would typically take advantage of our leverage capacity to acquire that increment.

John P. Caulfield - *Phillips Edison & Company, Inc. - CFO, Executive VP & Treasurer*

Yes. And I'll say the $250 million that Devin is referencing is really to say that we can buy $250 million without increasing leverage and then increasing, we have a long-term leverage target of approximately 6x. But in this environment, we are utilizing our low leverage and this is a place to be. But given the opportunities, I think, to Devin's point, we would definitely increase that.

With regards to the floating versus fixed, yes, we are floating more right now. And as we look at it, we have about $168 million at the end of the quarter, great liquidity. What the term loan financing really does for us is it gives us flexibility in this time frame where we can discuss whether or not the treasuries are higher or lower, where they're going from here, but also the spread in those markets do seem elevated because of that uncertainty. And what the term loans do is it gives us flexibility of time to get to a more opportunistic debt capital market.

And so we think about that as we're thinking about fixed instruments and the term loan allowed us to do that. We have an $800 million revolver available to us. We do have a long-term goal of being less than 10% fixed -- I'm sorry, less than 10% floating -- sorry, less than 10% floating and so as I'm thinking about it, if as we buy our acquisition target for the year, and we move forward with a fixed instrument to fund that, that will help us move towards that 10% target. And hopefully, then with a longer-term goal of getting even closer to where our peers are, (inaudible) on a fixed basis. So again, a long-winded way, but thinking about it as in terms of the financing opportunity and where we are right now.

Juan Carlos Sanabria - *BMO Capital Markets Equity Research - MD & Senior U.S. Real Estate Analyst*

And then just one last follow-up. Bad debt, you reduced the guidance there, seems like you're maybe running towards the low end of that revised range. Just curious on the assumptions behind the high and low end of the bad debt range? And kind of what's built in there is there further -- is there an assumed degradation of the economy at the lower end of the weaker end of the range? Or just curious on that range.

Jeffrey S. Edison - *Phillips Edison & Company, Inc. - Chairman & CEO*

John, do you want to take that?

John P. Caulfield - *Phillips Edison & Company, Inc. - CFO, Executive VP & Treasurer*

Sure. So historically, this portfolio has been between 16 and 80 basis points over -- of revenue over a long period of time. And we are trending well given the strength of the consumer and our neighbors. As we look to the second half of this year, we do think that there is continued strength. I would say that it's in the middle of that. I don't -- we're not forecasting quite as positive as it was in the first half. But in terms of disruption that we would do, I would say that's probably less taken into account in the bad debt number because it's a pretty tight number there.

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I would say it's more considered in the FFO range that we provide. But based on everything that we're seeing, whether it be retention, leasing, collections, we're not seeing any signs of deterioration. And so we're very positive on the second half of the year.

Operator

Next question comes from the line of Mike Mueller of JPMorgan.

Michael William Mueller - *JPMorgan Chase & Co, Research Division - Senior Analyst*

My question was answered, tried to get out of the queue. Thank you, though.

Operator

Your next question comes from the line of Haendel St. Juste of Mizuho.

Ravi Vijay Vaidya - *Mizuho Securities USA LLC, Research Division - VP*

This is Ravi Vaidya on the line for Haendel. I hope you guys are doing well. I just wanted to ask here with the portfolio nearly full and minimal bankruptcies and now limited acquisition volumes going forward. Where do you think the incremental source of growth will be coming from? Do you think you'll be able to continue to push renewal rents and similar spreads going forward? What do you estimate the current mark-to-market opportunities within your portfolio?

Jeffrey S. Edison - *Phillips Edison & Company, Inc. - Chairman & CEO*

Rav, thanks for the question. As you know, there are 2 pillars for our growth. There's the internal growth that we get, and that's coming from the ability to really grow our rental stream through both contractual rent bumps, but also through getting strong re-leasing spreads on those. And trying to minimize our capital while we're doing that with a really strong retention rate.

So I think that internal you mentioned will be less driven by occupancy increases and more driven by the pricing power we have to really grow rents. And you can see that in our numbers that, that we believe that will be ongoing. We still think we've got anywhere from 50 to 150 basis points of increased small store occupancy to go, and we're working hard at getting that to go. But on a longer-term basis, we think that, that -- those engines will be there. And then we also have the readout stuff we're doing, which is obviously very accretive and work has been very positive in adding to the growth.

And then we've got a strong balance sheet, which allows us to have the external growth. And when you combine those things, we still -- we believe we can grow our core FFO on an annual basis in that mid- to high single-digit range. And the operating environment and some of the points Devin made in his prepared remarks, we have some tailwinds that are allowing us to really see very solid growth there.

So I would -- we're very optimistic about our ability to continue to do that. And we really -- one thing we want to make sure we emphasize everyone is that we're not seeing any cracks. I mean it's not like we're thinking that there's a huge storm happening, and we're just getting into it. That doesn't appear to be happening in the market as we see it today. I don't know, Devin, if you want to add anything there that I missed, but...

Devin Ignatius Murphy - *Phillips Edison & Company, Inc. - President*

Yes. I mean, Jeff, what I would say, Ravi, we think that this portfolio on a go-forward can generate same-store NOI growth of 3% to 4% and we realized that the growth that we've been getting in that same-store NOI number from occupancy is going to go down, and we're getting closer to

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an occupancy level where it will no longer contribute to same-store NOI growth. That will be replaced by the growth we will get from new and renewal spreads which in the second quarter was 150 basis points of our NOI growth. And over time, we think that will be 100 to 125 basis points. Then contractual rent increases will contribute 75 to 100 basis points.

And then lastly, redev will contribute 75 to 125. So even without the growth in same-store NOI created by occupancy uplift, we still get to that 3% to 4% same-store number with those other 3 elements of growth.

Ravi Vijay Vaidya - *Mizuho Securities USA LLC, Research Division - VP*

Very helpful. Just one more here. Do you have any update with the Albertsons Kroger merger and any update regarding the potential store closure impact.

Jeffrey S. Edison - *Phillips Edison & Company, Inc. - Chairman & CEO*

We don't really have -- we don't have anything that would -- I would say as an update. We continue to feel that it would be a really positive thing for us and we don't really see any downside in either of the options that are -- could happen. We continue to watch the Albertsons stock as a metric of where -- what the market thinks is the chances of it happening, still trading at a 20% discount to the strike price in the merger. So there's still obviously a lot of uncertainty around it.

And you get bits and pieces, but nothing that we've seen throws us to say one way or the other, that it's highly likely or less highly likely. It feels -- and I think we're hearing that from management that it's taking its normal course, which doesn't mean it's absolutely going to happen or not going to happen, but it is going through a very normal process for looking at these kind of sizable mergers in an environment where it's -- there is a real big pushback from the government.

Now the government lost a big case this week with Microsoft so that you can see that it's not an all-win thing for the government. So there is a -- I believe that both Kroger and Albertsons believe that it is going to go through. I mean -- and they certainly are continuing to say that.

Devin Ignatius Murphy - *Phillips Edison & Company, Inc. - President*

Jeff, but on Ravi's question regarding closures, Ravi. What we've been advised is that in order for the merger to be approved, there will not be store closing that occur as part of the merger generally, and then specifically to the PECO portfolio, we're confident that there would be no store closures in our portfolio because as we look at the productivity of these banners in our portfolio, from a sales per foot and the health ratio, they are viable grocery locations. And so we're confident that there will not be any closures in the PECO portfolio as a result of that merger.

Operator

Your next question comes from the line of Todd Thomas of KeyBanc Capital Markets.

Todd Michael Thomas - *KeyBanc Capital Markets Inc., Research Division - MD & Senior Equity Research Analyst*

A couple of questions. First, I just wanted to clarify quickly. Jeff, your comments about asset pricing. You mentioned 50 to 100 basis points. I think I also heard 150 basis points in response to a question. Were you speaking to cap rate expansion or the spread that you require for new investments versus your cost of capital? Or something else entirely. Can you just clarify what you're speaking to and...

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Jeffrey S. Edison - *Phillips Edison & Company, Inc. - Chairman & CEO*

I guess I was clear as mud, right? Sorry about that. The -- what I was talking about 50 to 100 basis points was the increase in the cap rate. The 100 basis points was the increase in the unlevered IRR that PECO has done to our underwriting as we look at new opportunities. So those were, I think, the 2 numbers. I don't know what the -- I said about the 150 because I don't know where that would have come from. But I -- but we did add 100 basis points to unlevered IRR and believe that there's 50 to 100 basis point increase in the cap rates.

Todd Michael Thomas - *KeyBanc Capital Markets Inc., Research Division - MD & Senior Equity Research Analyst*

Okay. Got it. And are you still seeing cap rates expand a bit today? Or have they stabilized a bit more recently?

Jeffrey S. Edison - *Phillips Edison & Company, Inc. - Chairman & CEO*

I would say that we believe that there probably is some more expansion in the cap rates, but it's minor compared to what's happened so far in our opinion. Now if rates stay higher for longer, that could change. But our belief is that we've seen the major change from here, it will be more adjustments than it will be any kind of major change in cap rates.

Todd Michael Thomas - *KeyBanc Capital Markets Inc., Research Division - MD & Senior Equity Research Analyst*

Okay. And then you talked about the high retention across the portfolio, almost 94% again this quarter. Do you expect that to hold in '24? And particularly with regard to the 71 anchor lease expirations, any thoughts there? Any early indications on what you might expect around the anchor expiration specifically?

Jeffrey S. Edison - *Phillips Edison & Company, Inc. - Chairman & CEO*

I don't know if Devin or John, do you want to take that one on those specifics.

Devin Ignatius Murphy - *Phillips Edison & Company, Inc. - President*

I mean I would just say, Todd, in terms of retention, we have seen fairly consistent retention rates over the last year, varying from a low of 89 to a high of 95. So the 94 is at the higher end of the range. But we believe that our retention rates are going to be fairly stable because we continue to see very strong retailer demand for our product type. And so we're not expecting to see a material move in that retention rate relative to what we've seen historically.

That was an overall retention rate, Todd. And then on the anchors, it's varied between a low of 98.7% and a high of 100%. So again, it's between 99% and 100%. So we're pretty confident that, that rate will be consistent in -- on a go forward.

Again, given the productivity that we're seeing out of our anchors and the kind of health ratios that we're seeing from them, the combination of those factors lead us to be confident that they will all exercise renewals or options that they may have.

Todd Michael Thomas - *KeyBanc Capital Markets Inc., Research Division - MD & Senior Equity Research Analyst*

Okay. And then lastly, there was an article out this morning discussing Amazon and their -- growth from them in grocery. I know they've tested various formats, but growth in their grocery footprint has been somewhat limited, maybe a little unclear over the last few years. Just curious, any thoughts on the potential for them to expand their footprint, what that might look like and how that could impact the grocery landscape and maybe your portfolio specifically as you think about that potential expansion?

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Jeffrey S. Edison - *Phillips Edison & Company, Inc. - Chairman & CEO*

Yes. So Todd, it's a great question. It's one that we actually looked at -- have looked at consistently since they opened their first new grocery concept. They have a lot of work to do. I mean they've got to prove that -- I mean you never underestimate Amazon. I take that as a given. But on the grocery side, they have not been able to really find a differentiated strategy that allows them to be a lot more productive than a traditional grocery store.

And it's nice to have a new store and all that, but when you go into their stores, they just are very similar with very little sort of anything you'd see that you say, wow, this is really going to get every customer to want to be there. So there -- they've got a lot of work to prove that they actually can develop a format that the consumer is willing to say, look, I'm not going to go to my Kroger anymore. I'm going to go to Amazon. And so far, they haven't been able to do that.

And until they do that, they're really not a serious threat in any kind of scale. And they certainly aren't going to scale it at the current format because the current format is not making money. And it's not only not making money, I mean, we're hearing sales numbers that are very mediocre. So they -- I mean they've got to find something where they can really differentiate themselves. And to date, they haven't been able to do that.

So until they do that, we're going to -- you always watch Amazon because they can do a lot of stuff. I mean there have been rumors that they were going to buy a bunch of the overlapping Kroger, Albertsons deals. I mean they've been rumors forever about them. They don't seem to be opening the stores that they've got obligations to open up even. So they're in a -- they've got a lot of work to do to prove they can successfully get into that market.

Operator

Your next question comes from the line of Dori Kesten of Wells Fargo.

Dori Lynn Kesten - *Wells Fargo Securities, LLC, Research Division - Senior Analyst*

When you look at your watch list, I know it's relatively small at this point, but would you imagine your '24 bad debt looks close to your long-term average, you say the 60 to 80 basis points.

Jeffrey S. Edison - *Phillips Edison & Company, Inc. - Chairman & CEO*

Yes. Dori, we do believe that it will -- I mean, that's what we are projecting. We don't see anything there that -- obviously, we don't -- as you know, we don't have a lot of big box exposure. So our exposures to any particular brand other than our grocers is very limited. And so we -- and we don't see anything there that would push us outside of sort of a normal category.

Obviously, you have a major recession and then you see what happens. But as you know, I mean we did -- we've done really well in the last 2 recessions on a relative basis, losing, I think, the least in terms of occupancy of anybody in our space. And again, that's the focus on necessity-based goods and our grocer focus.

Operator

Your next question comes from the line of Floris Gerbrand Van Dijkum of Compass Point.

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Floris Gerbrand Hendrik Van Dijkum - *Compass Point Research & Trading, LLC, Research Division - MD & Senior Research Analyst*

You guys continue to amaze me because I think your anchor occupancy, I believe, is the highest in the sector. I don't know how many empty boxes you have in your portfolio, but it's got to be a handful, less than a handful. And your shop occupancy, I think, is also the highest in the sector.

Obviously that impacts your ability to grow occupancy, particularly on the anchor side. But maybe if you can give us a how much more can you push shop occupancy in your opinion, realistically?

And then the follow-up on that is -- the underlying fundamentals certainly appear very positive for retail right now. There's almost no new supply. But as you know, Jeff, the landscape evolves continually. What -- how much more do you think rents need to rise in your markets in order for new construction to be justified.

Jeffrey S. Edison - *Phillips Edison & Company, Inc. - Chairman & CEO*

Dev, do you want to take the -- Floris, thanks for your question. Dev, do you want to take the occupancy growth, and then I'll talk about the -- what we think sort of the retail opportunity is on the growth side for new development.

Devin Ignatius Murphy - *Phillips Edison & Company, Inc. - President*

Sure, Floris, we continue to surprise you because you continue to underestimate us. And our focus is to continue to surprise you. So in terms of super shop occupancy, we think we have another, as Jeff said, 50 to 150 basis points of occupancy uptick there. We realize that, that then impacts our same-store NOI growth, which we continue to believe will be 3% to 4% going forward because the loss of same-store NOI growth created by occupancy will be replaced by our ability to continue to push rents.

And so we think the components of our same-store NOI growth going forward, our new and renewal spreads at 100 to 125 basis points. In the second quarter, that metric was 150 basis points. Contractual rent increases of 75 to 100 basis points of growth and then the contribution of our redev activity at 75 to 125 basis points, which gets you to that 3% to 4% same-store metric.

And again, we continue to believe that these growth profiles are reasonable on a go-forward because as we look at the marketplace, if you look at the centers we acquired in Q1, we paid on average $220 a square foot for those assets. We think replacement costs for those assets is circa $425 a square foot. So rents would need to almost double in order for new development to generate an acceptable return on investment.

So our view of this market is there's been limited supply over the last 10 years and there will not be incremental supply on a go-forward until we see rents move meaningfully from where they are today.

Jeffrey S. Edison - *Phillips Edison & Company, Inc. - Chairman & CEO*

Yes. And Floris, just to add to that, there are specific markets where some of the regional grocers are expanding. You look at Hy-Vee, you look at Publix, you look at HEB. They are doing some new stores in very specific markets. But it's those areas that you've got to be cautious about in terms of where that competition is coming in because as you know more like we compete in a 3-mile radius around our centers, and each one is its own market with its own competition. And we have to win it, you got to win it in those levels.

So development is not happening in the vast majority of the markets we're in. And but we're always watching because you don't -- it is very specific to the specific stores that -- where we have locations. And one of the things that we look at is the rents that you need to get for new development. If you look at some of the more urban and major markets, the rents are closer to where you could actually do development than some of the markets where we're in. And that will -- the first new development, as you see, it happened is more likely to happen in those markets than it is to happen in the markets that we're in. I mean, it's -- you're not going to see that happening. We believe in Atlanta and Tampa and Orlando, where our centers are, you're more likely to see it in more denser urban areas where they can get the kind of rents that justify new construction.

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Floris Gerbrand Hendrik Van Dijkum - *Compass Point Research & Trading, LLC, Research Division - MD & Senior Research Analyst*

Maybe just my follow-up, I noticed your NOI margins dropped marginally during the quarter. Obviously, they were relatively consistent through the first 6 months, but anything that you can -- is it some expense growth or anything else? Is this part of the previously uncollected rents that you got last year that caused that drop?

Jeffrey S. Edison - *Phillips Edison & Company, Inc. - Chairman & CEO*

John, do you want to take that one?

John P. Caulfield - *Phillips Edison & Company, Inc. - CFO, Executive VP & Treasurer*

Sure. Floris, we're talking about 30 basis points here. So 72.4% in the quarter, 72% on the 6 months, I mean I think at that point, it's really the 72% margin is where we see it. I mean, expenses are going to move. But I mean, I think that's a good run rate, and it's still very strong.

Floris Gerbrand Hendrik Van Dijkum - *Compass Point Research & Trading, LLC, Research Division - MD & Senior Research Analyst*

That's it. And by the way, that also is a testament to your -- your ability to run your business?

Jeffrey S. Edison - *Phillips Edison & Company, Inc. - Chairman & CEO*

Thanks, Floris. We appreciate it.

Operator

(Operator Instructions) This concludes our question-and-answer session. I would like to turn the call back to Jeff Edison. Jeff?

Jeffrey S. Edison - *Phillips Edison & Company, Inc. - Chairman & CEO*

Well, first of all, thanks, everybody, for being on the call today. We did have a really solid quarter when you're getting same-store NOI growth of 5.3%, when you're at record occupancy for your anchors and your in-line stores, and you're seeing very little if any -- really no cracks in terms of our leasing ability. When you're able to purchase $80 million in the first half of a really tough year and a tough adjusting market. And we were able to improve our balance sheet, increasing our debt to EBITDA, extending our loan maturities until '25 and really on a material basis to 2027 giving us the flexibility that we want.

We're going to continue to drive, we think, strong results through '23 and '24, and we're going to focus on really good internal and external growth. So again, thank you for being on the call today, and have a great day.

Operator

Thank you. This concludes today's call. You may now disconnect.

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