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PECO.OQ - Q3 2022 Phillips Edison & Co Inc Earnings Call

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PRESENTATION

Operator

Good day, and welcome to the Phillips Edison & Company's Third Quarter 2022 Earnings Conference Call. Please note that this conference is being recorded.

I will now turn the conference over to Kimberly Green, Vice President of Investor Relations. You may begin.

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

Thank you, operator. Thank you, everyone, for joining us today for Phillips Edison's Third Quarter 2022 Earnings Conference Call. Once we conclude our prepared remarks, we will open the call to Q&A. After today's call, an archived version will be published on our Investor Relations website. I'm joined on this call by our Chairman and Chief Executive, Jeff Edison; our President, Devin Murphy; and our Chief Financial Officer, John Caulfield.

As a reminder, today's discussion may contain forward-looking statements about the company's views 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, specifically in our most recent Form 10-K and 10-Q.

In our discussion today, we will also 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 we posted to our Investor Relations website. Please note that we have also posted a presentation on our website with additional information. Our caution on forward-looking statements also applies to these presentation 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. Thank you, everyone, for joining us today.

Our differentiated and focused strategy of owning grocery-anchored neighborhood shopping centers, together with our integrated operating platform have delivered another strong quarter with same-center NOI growth of 4.3%. This performance has allowed us to raise the midpoint of our 2022 guidance for the third quarter in a row. As reflected in our results, 2022 has been a year of reaching record highs in occupancy and releasing spreads. A strong leasing environment and our current positive momentum are evidence of tailwinds for us that, we believe, will continue as we head into 2023 and beyond. This provides us with confidence in our ability to successfully execute our growth strategy and continue to deliver strong results.

As we've discussed, our grocery-anchored neighborhood centers continue to benefit from structural and macroeconomic trends that create strong tailwinds. These include population shifts from urban to suburban communities, the increase in hybrid work, the importance of physical locations in last-mile delivery, low supply and lack of new construction, wage growth, student debt relief and low unemployment, and most importantly, the retailer's recognition of the benefits to them of being located in growing suburban markets. Looking ahead, inflationary impacts on the consumer, combined with higher interest rates, introduce uncertainty.

However, as we reflect on the resiliency of our portfolio throughout the pandemic, combined with the aforementioned tailwinds, we believe PECO's portfolio is well positioned for a recession. This resiliency comes from the following. Our grocery-anchored and necessity-based neighbor mix, our rightsized format and well-positioned locations in growing markets, our record high occupancy with continued strong neighbor demand, our talented and cycle-tested team, our strong credit neighbors and diversified mix, our lack of big box exposure and the lack of distressed retailers in our portfolio.

With regards to our growth profile, we expect future organic growth to come from continued increases in occupancy, contractual rent increases and our pipeline of redevelopment and development activity. PECO also continues to be well positioned to capitalize on external growth through new acquisition opportunities as they arise. Currently, we are seeing cap rates expand with borrowing costs increasing and the volatility in the equity markets, we have moved up our targeted return for new acquisitions to an unlevered IRR of 9% and above. Acquisitions are a key part of our long-term growth strategy, and we will continue to participate in the market, while exercising an appropriate level of caution. As we've said, our focus is on cash flow and earnings per share growth. We will ensure acquisitions will be accretive to earnings, and we will continue to evaluate each acquisition with the same diligence we have always exercised.

I know everyone is looking for signs of weakness in both the market and with the consumer, but we are not currently seeing it in our grocery-anchored portfolio. We continue to enjoy solid growth despite the headwinds. We have a great balance sheet, low leverage and strong occupancy. We are located in markets that are growing and have a strong competitive advantage with our resilient grocery-anchors and necessity-based neighbors.

I would like to briefly comment on the recently announced proposed merger between Kroger and Albertsons. Based upon what we currently know, we believe that overall, this is positive news for PECO. With an expanded footprint post merger, we will see our largest neighbor become stronger and more profitable. Following the merger, these grocery stores will be managed by an operator who has generated higher sales productivity at the store level, invest in their physical stores and has a proven ability to drive strong customer traffic to our centers.

As we specifically think about the impact of this merger on our portfolio, remember, our strategy is focused on owning centers anchored by the #1 or #2 grocer within a market. So we do have a number of stores that are potentially impacted. We have 8 stores located within 1 mile of another store, 15 stores within 1 to 2 and 10 stores within 2 to 3 miles. In total, there are 33 stores located within 3 miles of another store. These 33 stores are productive locations as demonstrated by the following. Their average store sales are $35 million or $620 per foot, which compares to PECO's average of $6.38 per square foot and an average health ratio of 2.1%, which is a key indicator of profitability for the locations. As you can see, these are strong and viable grocery stores. It's still very early. We will continue to carefully evaluate the potential impact to PECO. As we learn more, we will update the market accordingly.

With that, I will turn it over to Devin. Devin?

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

Thank you, Jeff, and good afternoon, everyone. Thank you for joining us. The PECO team, supported by the strength of our neighbors, continues to drive outstanding operating results. We are excited about our record occupancy level of 97.1%. And as you can see, these occupancy levels are driving immediate and measurable growth in our financial results. We continue to see 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.

Throughout 2022, we have seen our grocers continue to strengthen their businesses. Year-to-date, through September 30, U.S. grocery sales grew by 8.4% and margins are holding. Grocer sales are expected to continue to grow in 2023, and our top grocers continue to drive strong recurring foot traffic to our centers. Our in-line neighbors continue to be successful in our centers. On a trailing 12-month basis, our average in-line neighbor health ratio is 10%, which, we believe, is healthy and demonstrate that retailers can operate profitably in our centers.

Third quarter foot traffic at PECO centers remains strong and is generating healthy sales levels for our neighbors. Our record high occupancy levels provide us pricing power to continue to grow rents at attractive rates. With good health ratios, record occupancy and strong foot traffic trends, we do not see any signs that we will not be able to continue to push occupancy and rents higher. As you know, 25% of PECO's ABR is derived from local neighbors. 64% of our local neighbor rents come from retailers, offering necessity goods and services. Our local neighbors are successful businesses run by hard-working entrepreneurs. 30% of our local neighbor rents come from personal services, such as beauty and hair care. Personal services is one of the most stable uses in our centers. These neighbors pay market rents, renew at attractive rent spreads and demand less capital.

Our local neighbors are unique and successful retailers. One example of the unique PECO local neighbor is the backyard kitchen and cocktails at our Murphy Marketplace Center located in Murphy, Texas. This neighbor is the winner of Texasliving Magazine best patio and bar. Also included in our local neighbor category are medical neighbors, including dentists, chiropractors and physical therapists. Medtail, as we call it, is a growing use in PECO's local neighbor mix and currently represents 12% of our local ABR. Our local neighbors are resilient and have been in our centers an average of 8.7 years. This length of tenancy compares favorably to the capital investment payback period of just 10 months. Over the last 3 years, we have retained 76% of our local neighbors. And when we did replace them, the average re-leasing spread was 14% on a trailing 12-month basis.

In summary, our local neighbors are less expensive to put into spaces, have higher retention rates, achieve renewal spreads similar to nationals and offer an attractive economic package. We believe in the strength and resiliency of our local neighbors, and we have added new slides to our investor presentation to highlight these neighbors. In addition to the compelling economics behind our local neighbors, they also differentiate our centers and provide a unique attraction for customers. As we have said before, successful local operators prosper in our grocery-anchored neighborhood centers.

As Jeff mentioned earlier, smart retailers are taking advantage of the growth available in secondary markets. According to recent Placer.ai data insights, migration changes since 2018 have flipped the script and made these markets appealing for many retailers. Suburban markets are gaining at the expense of major urban markets with suburban markets seeing higher growth. According to Placer, our suburban markets offer retailers several advantages in today's environment, including: one, comparable, if not superior, visit per location trends when compared to larger markets; two, less competition; three, greater diversification of customer base; four, easier access to labor as an employer of choice within a market; and five, less expensive build-out costs. These metrics result in higher-margin stores, which are more profitable to the retailer.

National retailers such as Chipotle are raising their long-term store-based targets in our markets because these locations have proven to deliver the same or better store level economics. In addition, retailers such as Chipotle, Petco, Kohl's and Shake Shack saw higher visits per location in suburban markets compared to the top 25 MSAs according to the Placer data. Since 2018, the combined number of national neighbors, including Chipotle, Dunkin' Donuts, Starbucks, Five Guys, Jersey Mike's and Wingstop in PECO's portfolio increased by 40%, evidencing this trend.

During the third quarter, we executed first-time deals with national neighbors, including Shipley Do-Nuts at Coppell Market Center in Coppell, Texas and Pizzeria Locale, a Chipotle-backed concept, at Arapahoe Marketplace in Greenwood Village, Colorado. We continue to see strong retailer demand for our suburban markets. We expect these favorable demographic trends to continue to benefit PECO's well-located neighborhood centers. We have added slides on these Placer insights, I just discussed to our investor presentation. Be sure to check them out.

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I would also like to reiterate a silver lining of the pandemic. Less resilient neighbors were pulled from our portfolio. Our neighbor mix emerged stronger post pandemic. Another strength of our strategy that we like to highlight is that we have limited exposure to high-risk retailer categories and are well diversified. Our largest non-grocery neighbor is T.J. Maxx at 1.4% of ABR. And all other non-grocer neighbors are below 1%. Our combined exposure to distressed retailers such as Bed Bath & Beyond and Party City is minimal. And these 2 retailers represent less than 30 basis points of our ABR, less than 1%.

In addition to our strong rental growth trends, we continue to focus on our pipeline of ground-up development and repositioning projects. We currently have 17 projects under active construction. Of these, 14 are being developed on land we already own and 3 are being developed on adjacent land that we acquired. Our total investment in these projects is estimated to be $55 million with an average estimated yield on cost between 10% and 12%. Additionally, 5 projects stabilized during the third quarter, and we delivered over 131,000 square feet of space to our neighbors. This space adds incremental NOI of approximately $1.9 million annually. These projects are attractive because they provide superior risk-adjusted returns and have a meaningful impact on our NOI growth rate.

The list of projects in our third quarter supplement represents projects currently in process and does not include the pipeline of projects that we are evaluating. The 16 projects that we expect to complete in 2022 is the largest number we have ever achieved in a year as a company. This is an area where we see ongoing opportunity, and we are focused on growing our level of opportunity in these activities in the future.

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

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

Thank you, Devin, and good morning and good afternoon, everyone. As Jeff indicated, you won't care to say we are completely immune to all the impacts of an economic downturn. But the good news is that we are operating from a position of strength with several tailwinds heading into 2023. Our growth opportunities remain attractive, featuring a healthy mix of neighbor demand across our growing markets, strong grocery anchors, necessity-based goods and services and our rightsized format with retention rates that continue to be above historical averages. With that, I'll get into the quarter.

Third quarter 2022 NAREIT FFO increased 26.4% to $72 million or $0.55 per diluted share. This result benefited from an increase in rental income and reduced interest expense. Our third quarter core FFO increased 15.4% to $76.6 million, driven by increased revenue at our properties from higher occupancy levels and strong leasing spreads as well as lower interest expense. Our third quarter 2022 same-center NOI increased to $92.5 million, up 4.3% from a year ago. This improvement was primarily driven by higher occupancy and an increase in average base rent per square foot, which was partially offset by lower collectability reserve reversals in the current period when compared to 2021.

Now I want to provide some commentary on our guidance. As Jeff mentioned, based on the performance we have continued to achieve in 2022, we are raising our NAREIT FFO and core FFO per share guidance. Our new core FFO per share guidance range increased to $2.22 to $2.26. We are also increasing our same-center NOI guidance to a range of 4.1% to 4.5%. These increases are a result of strong property results from record occupancy and leasing spreads to date as well as lower-than-expected corporate and general and administrative expenses. As we look at the fourth quarter of 2022, we anticipate some slowdown as a result of approximately $1.5 million of additional interest expense, primarily due to planned acquisitions as well as seasonally higher expenses.

Additionally, we are narrowing our net acquisition guidance range to $200 million to $250 million. This is partly due to timing as certain acquisitions awarded are expected to close in 2023. We also believe there will be even more acquisition opportunities in 2023 as a result of this changing market, and we continue to be committed to buying $1 billion of acquisitions net in the first 3 years post IPO. Despite lower acquisitions than we anticipated this year, our operating performance has allowed us to meet and exceed our expectations for core FFO per share.

Turning to the balance sheet. Our leverage ratio continues to be strong as a result of our continued earnings growth as well as our prudent balance sheet management with our net debt to adjusted EBITDAre of 5.4x as of September 30, 2022, compared to 5.6x at December 31, 2021. At September 30, 2022, our debt had a weighted average interest rate of 3.3% and a weighted average maturity of 4.6 years. Approximately 87% of our debt was fixed rate. At the end of the period, we had approximately $733 million of borrowing capacity available on our $800 million credit facility. We have

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no significant debt maturities until 2024. Between the free cash flow generated by our portfolio and the significant capacity available on our revolver, we have excellent liquidity, which is a nice place to be given the current capital markets environment.

With the macro market concerns around recession, inflation and rising interest rates, we believe the importance of a fortress balance sheet has increased. Our leverage gives us meaningful capacity and flexibility to pursue accretive acquisitions as they arise in the market and extend our acquisition runway beyond 2024. We still have a target leverage level of low- to mid-6x net debt to EBITDAre.

As Jeff and Devin mentioned, we have a strong pipeline of growth with the flexibility to be patient and pursue accretive opportunities that we expect will provide meaningful NOI contribution in 2023 and 2024. And maybe most importantly, as we consider the economic uncertainties, we have one of the strongest balance sheets in the sector, allowing us the ability to remain on offense and pivot quickly to create value through acquisitions in response to changing market conditions.

With that, we look forward to taking your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from Haendel St. Juste with Mizuho.

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

This is Ravi Vaidya on the line for Haendel. Just wanted to ask you about the broader transaction market. Where do you -- where are cap rates for grocery-anchored centers in your target markets? And where do you think transaction volumes and acquisition cap rates? What's your forecast for 2023 versus '22 given everything that's happening with the financing and rising rates?

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

Yes. Ravi, this is Jeff. Thanks for the question. We're seeing the market as -- and again, I'm really just focused on rightsized grocery-anchored shopping centers. We're not talking about power centers or large grocery-anchored centers. So that's the market that we are obviously one of the leaders in terms of acquisitions. So we're very active in that market. And what I would say is that, that has been one of the most attractive sector of the retail market. And so pricing was very aggressive, and it was clearly a seller's market over the last 12 to 18 months. And what we've seen is we've seen that changing. It's really moving into much more of a buyer's market. And we anticipate that will continue with -- obviously, with debt increasing and in the public markets, the equity cost increasing. So our feeling is that, that will change. We'll see some change in there.

I would guess that we're -- you really can't go across the country and say, because the markets are very different regionally and there's certainly expansion of cap rates. And as you know, I mean, we're not really cap rate buyers, we're IRR buyers. And if you look at where our unlevered IRRs are today, I mean, what we're looking for is north of a 9, and you look 9 to 12 months ago, we were looking north of 8. So you can see that there is an expansion in our underwriting on an IRR basis. And obviously, that would affect cap rates as well.

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

Got it. Just one more here. How has food inflation impacted your grocer tenants? Are you seeing additional sales or foot traffic at your properties given the higher pricing and a broader pullback in casual dining given elevated recession risk?

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

Devin, do you want to take that one?

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

Sure. Thanks, Jeff. Thanks for the question. As foot traffic at our centers is remaining constant, so the number of visitors to our centers is equivalent to what it's been last year and this year. What we're finding is that the average spend per visit is higher. And as we mentioned in our prepared remarks, U.S. grocers saw sales increase by over 8% this year, and they're expected to increase again next year. And the good news is that their margins are holding. So we are optimistic that the grocers are going to continue to have a favorable operating environment. They're going to continue to perform well, and they're going to continue to drive strong recurring foot traffic to our centers.

Operator

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

Eric Borden - *BMO Capital Markets Equity Research - Senior Associate*

It's Eric on for Juan. I appreciate all the color on the in-line portfolio. I was just curious if you could kind of talk about the health ratio for in-line. You quoted a 10%. I'm just wondering how that's trended coming out of the pandemic? And how should we think about that 10% going forward into 2024 or '23 and '24?

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

Devin, do you want to take that one?

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

Sure. Eric, thanks for the question. Again, that metric has held fairly consistently. Our instincts are that there's an ability for that metric to increase from the 10% that it currently stands at to -- again, it's going to depend on use. As you know, certain retailers can absorb a much higher health ratio than other retailers. But on average, we believe that there's an incremental growth in that health ratio to circa 12%. So we believe that as long as sales are holding constant and growing, there's an ability to continue to push rents.

And as you've seen, you've seen our re-leasing spreads in this quarter be up 15.5%. And one of the things that I like people to look at is if you look at what our re-leasing spread trend has been, it's grown from Q4 '21 where it was circa 8% to now it's almost double that at 15.5%. And in addition to that increase in the re-leasing spread, we've been able to generate a higher CAGR, where in Q4, we had a 2% CAGR, and we're now at almost a 3% CAGR. So we believe that our in-line tenants are operating at a level where they continue to be successful and that they're operating at a health ratio where there's additional room, which will allow us to continue to grow rents.

Eric Borden - *BMO Capital Markets Equity Research - Senior Associate*

Appreciate that. And then on the in-line portfolio, maybe outside of medical or beauty and hair care, are you seeing any of the less affluent customer kind of step away or any weakness there? I just want to better understand what we're reading in the news and what you're actually seeing on the ground.

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

It's hard to get a clear picture of that. I would tell you that we look across segments, both primarily on a household income basis. And we are not seeing that change. We are hearing from some of our grocers that we're seeing people -- they're seeing some people trade down to private label. They're seeing some people trade down to lower level grocers. But it's at the margin and not substantial at this point. But that's certainly one of the things that we look at pretty closely to make sure that we aren't seeing the certain segments and being able to adjust accordingly, but it's -- the truth is we're not seeing it. And we'll obviously talk about it when we start to see some change in that segment.

I don't know, Devin, if you have anything to add to that, but that's been our experience so far.

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

Yes. I mean, Jeff, the only thing I would add to that is understand that in our portfolio, the average household income in the 3-mile ring is circa $77,000. So this is a middle class customer that is shopping at our centers. So it's not a lower end customer. And I just want to emphasize that point number one. And then number two, the one thing that's underreported from our perspective in the media is the fact that household balance sheets today are in materially better shape than they were pre-pandemic.

And the average American consumer has a very strong balance sheet. They have capital that will allow them to continue to spend in a higher inflation environment, now that can't go on forever because they will begin to dig into that savings. But the bottom line is employment is at a level where people are continuing to find jobs. As you know, one of the big things the Fed is concerned about is how strong the employment dynamic continues to be. So the consumer is employed. They have a strong balance sheet, and therefore, they're continuing to spend. And we are not seeing any signs in our portfolio of retailers that are beginning to see a negative trend from the consumer.

Operator

Your next question comes from the line of Mike Mueller with JPMorgan.

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

I guess looking at the Crossroads acquisition, can you give us a sense as to -- and I appreciate that you focus on IRRs, but a sense as to what the going in cap rate was the initial yield? And then it looks like you bought it with about 88% or 89% lease grade on it. Is that still about where the lease rate is today? Or has there been any progress on that?

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

Yes. Thanks, Mike, for the question. So we have made some progress on that. We have one second floor space that is probably the key linchpin to getting that to substantially moving the occupancy. The others are smaller spaces that will -- where we have activity, and we have signed a couple of leases. We have not moved it, I wouldn't say substantially yet, but have, I think -- at this point, we're ahead of where we had projected we'd be on the leasing pace. And we continue to see Las Vegas as having a very strong -- being a very strong market with really good demand.

But again, we're cautious about that. But yes, that -- and in terms of where we bought it, this was a deal that came back to us. We increased our pricing from where it had been. And then when we underwrote it, we underwrote it pretty tough and ended up getting it at a level that was substantially higher. I mean I think it was under contract in high 5s, and we ended up buying it at close to 7, and that got us an unlevered IRR north of 9 in our view. So this met our criteria for how we're looking at these centers today.

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Operator

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

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

A couple of quick ones. Just going back to the acquisitions, the acquisition market, just wondering if you could talk a little bit about sort of what the competition looks like today versus sort of 6 to 12 months ago, for example, like this recent deal that was closed, who was looking at it or were you guys the only ones? Just trying to get a sense who's still out there, who's the biggest competitor?

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

Yes. So the -- I mean there were a number of leverage buyers who were very active in the market. Some of them are 1031 buyers, but there were also just leverage buyers that were very active in the market. I would say that, that portion of the competition is gone. I would say that the public companies have effectively stepped back from the acquisition market. So that's a less competitive part of the market. There continue to be some families that have -- that are -- that continue to buy. But the level of competition is down dramatically. Now it's early days, and it's hard to know because we haven't -- there has not been a lot of new product coming on the market. So a lot of this is anecdotal on a very small base. So I wouldn't -- I mean it's early to be making conclusions from it. But generally, I think we are -- the level of competition is down, and it's moved to be much more of a buyer's market than it was 12 months ago.

I don't know, Devin, if you have anything to add to that?

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

No. I mean I would just say, Ron, that a year ago, there was a depth to the marketplace. And on the kind of centers that we are looking to acquire, the depth was 5 to 6 buyers, very close to one another in terms of pricing. And that number has come down by probably half. So now there's 2 to 3 when there was 5 to 6. So there's still demand and it's still an active market, but it's less -- there's less depth to it than there was a year ago.

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

Got it. And then just my last one was just on the Propco deal. I think you guys commented -- you view it as a positive for the portfolio. I think there were sort of talks of a potential sell portfolio and so forth. So is the view that you guys wouldn't be impacted by that at all? Or how do you think about that?

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

Well, with the announcement date they're not going to let the dividend go through. We know that this is really early days to be able to say because what Propco looks like, what the transaction looks like, it's just -- there are an awful lot of different variable ways that it could move, including not closing and including closing with maybe 300 or 400 stores in Propco. So we're kind of -- I think we're trying to stay very informed to be on sort of the front of the information. But as a whole, like Kroger and Albertsons, don't know where this is going.

The FCC doesn't know where this is going. The Kors don't know where this is going. So I think it's a little early to be making any kind of prognosis of what -- where it ends up. But we're obviously going to stay really close to it. And if you end up with -- I mean, our goal is to have a great operator running each one of our grocery stores. And we think that, that will be the outcome of this, and we want to make sure that we do everything we can to make sure that, that happens.

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Operator

Your next question comes from the line of Paulina Rojas with Green Street.

Paulina A. Rojas-Schmidt - *Green Street Advisors, LLC, Research Division - Analyst of Retail*

In your prepared remarks, you mentioned that out of period collections were drag this quarter, which is not evident to me from the numbers I can see. So can you please share with us how much that drag was? And more broadly year-to-date, how much 2020 rents have you collected? And is it a reasonable assumption to think of 0 additional collections in 2023?

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

Paulina, thanks for the call. John, do you want to take that?

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

Yes. Thanks, Paulina, for the question. So as we look at it, we did have additional out of period, but we really feel like we are back to normal. And when we look at it, if I look at the net reserves in the period, both on the 3 months and the 9 months, we've historically said that our bad debt is 60 to 80 basis points. I would say, in '22, that is getting closer to 50 basis points. So the challenge is that '21 -- the collections were even stronger from 2020. I think when you look to the full year and the impact, we do have negative reserves for collectability, which is kind of what you would typically expect.

When we think about that for '22 year-to-date, if you use that 60 to 80 basis points, you kind of get there net of reserve reversal. So when you do that, it's roughly about a $2 million difference from what's there on a year-to-date basis. When I look forward to 2023 and even the fourth quarter here, we're down to less than $1 million. That's on payment plans. And our collection to those have been very positive. So I think I would expect 2023 to get back to sort of historical levels in the 60 to 80 basis points of revenue.

Paulina A. Rojas-Schmidt - *Green Street Advisors, LLC, Research Division - Analyst of Retail*

Okay. I'm not sure I follow on the details because there you're talking about bad debt in aggregate, right? You're not isolating just prior period collections, right?

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

Yes. The challenge is, even if I look at just the third quarter, I have movement from stuff that was recorded in the second quarter. So that's why I tend to look at it over a longer time frame. So I think on the 9 months, that's where I'm looking at it because when you get down to an individual quarter, I have things that I reserved in Q1 reversed in Q3, things reserved in Q2, re-leased in Q3. So when I say we're back to normal, it's kind of of those ebbs and flows. And so when I break apart the pieces and say, well, what did I have in '22 related to '21, I would say it's probably about $2 million. And then as I look to '23, I think if you consider we're back to normal, I mean, I think in '23, we will have some reversals from '22, but at that point, it's a normal course. The only thing that's residual from previous years is about $700,000.

Paulina A. Rojas-Schmidt - *Green Street Advisors, LLC, Research Division - Analyst of Retail*

Okay. And then a more detailed question. So you highlighted you are IRR buyers. I'm wondering what assumptions you have -- you use when you calculate that IRR. So I assume, of course, the intermediate growth is driven by the specifics of the property. You have -- you're growing in cap rate. So what you usually assume for your exit cap rate is the question. And if you approach this more from the perspective of a longer-term holder, maybe what do you assume for long-term growth? Do you have any traditional assumptions that you use there?

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

Yes. They are very project specific, Paulina. So making any kind of generalizations is just not how we really look at it. How we look at it is we go into the market where this center is, and we underwrite each space to a rent that we -- and fortunately, we're in a lot of these markets, so we know rents, and we know what we can get there. We underwrite each space to a rent to a TI to a timing in terms of when it's going to either be leased if it's vacant or rolled over when their lease term happens. And then from that, we generate a very specific plan of what we -- and it's a 7-year plan of what we think we can do to the project on a -- it's both from an operating side, but also from a financial side.

And then in terms of cap rate, obviously, the longer we move out, the less driver, the cap rate is. But our rule of thumb is it will not go down. We will, in certain cases, expand it based upon what product we think we have at the end of the turnaround period and where we think that will be. But generally, it is at starting cap rate or above, and we're not bringing cap rates down in order to get to those levels. It's really all driven operationally. And fortunately, we do on a very regular basis, go back and look at each of our acquisition underwriting compared them to actuals. And we -- across the portfolio over the last 3 years, if you look at those properties, they have performed above what we underwrote them to. So we feel really good about that. Maybe we've been too conservative in our underwriting, but we'd rather be there.

Operator

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

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

Just to follow up on the discussion around investments a little bit. Jeff, I appreciate the detail around that Las Vegas deal. It sounded like a big price adjustment and some of the color you just provided around your targeted IRRs. But just generally, how far are the deals that you're looking at today from sort of penciling out to that 9% unlevered IRR?

And then, John, can you elaborate a little bit on your comments around that $1 billion of investments that you've talked about over the first 3 years following the IPO and what to sort of expect in the near term? Just trying to get a handle on the next several quarters really thinking about '23, just given the changing market conditions and sort of the pullback in the near term that we've seen in terms of investments?

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

You're thinking about the same things we're thinking about and the same sort of level of uncertainty in the market. We're pretty confident there's going to be a strong opportunity. We're less confident in when that's going to happen. And so we're taking probably a pretty conservative look in terms of what we think we will buy next year. But I -- again, I -- one of the reasons we've worked really hard to get the balance sheet we have and get public and have access to capital was that we want to be able to take advantage of opportunities as they arise. And we do think that there will be opportunities in '23, and we want to -- we think we're really well positioned to take advantage of those. So we will -- we're going to stay sort of laser-focused on seeing everything that's in the market, which we do and then finding those unique opportunities where they truly are opportunities and where we can get to pricing that's commensurate with the change in the cost of capital that's happened.

And I think we're -- I mean, certainly, the things that we have closed in the second half of the year, we feel really good about being in that position. And I think we'll keep the same discipline going forward. And then the market will tell us there's how much of that there is that we can buy and we'll be very active there. And -- but again, it's -- as you said, it's difficult to know where the market is going other than directionally, the cost of capital has gone up, and traditionally, that's going to put some pressure on. And we're seeing it in the market. We're seeing less buyers. We're seeing projects come back to us that we haven't seen for 18 months. So we are optimistic about that opportunity.

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

Okay. And then in terms of the same-store results, John, the rental income was higher by 6.7%. A very strong result, a nice pickup from 5.2% last quarter. I see in the disclosures, that's a cash number. It doesn't include reserves or expense recoveries or lease term fee income or anything like that. I think it's just minimum rents, right? What's driving that big increase? Is there anything behind that growth other than leasing and occupancy gains?

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

Sure. Thanks, Todd. So the -- so in the rental income, you do have things like temporary rent and percentage. But the answer is that it is the re-leasing spreads that we've had in leasing activity. I mean we mentioned we're at peak in all-time occupancy, but it doesn't have collectability reserves and the like. We do have a page in the supplement that gives some additional incremental detail on total revenue that I think can help with that kind of the break out there. But we think it is a solid place for us to continue and to grow off of.

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

And Todd, this is Jeff. The part of this that we probably saw a little bit like a broken record on is there are macro tailwinds, as I talked about in the presentation that are real. I mean this is not something we're making up to explain something. I mean they're going on. They're happening in the market, and we're getting the benefit of them. And we are really laser -- we have a new sort of laser focus on what we call ROS, R-O-S, and that's rental renewal rates, rent spreads and occupancy. And when you take those 3 things and you look at sort of why we are market leading in those 3 areas, it's because the retailers are making the decisions to be in our centers and they're being in at a cost where they obviously think they can make money. And that gives us really good renewal rates for the ones who are there who know what they're doing. They know what their sales are. They know what they can grow.

Our occupancy levels are really high. So they're staying there and our space is good consistently across the portfolio and then our rental spreads. And if you put those 3 things together in what we call ROS, you have a really good definition of the quality of the assets. And if you look at those things, they're pretty good. They have a pretty good correlation with the ability to really grow the cash flow of the business, and that's what we're focused on.

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

Todd, it's Devin. You had also asked about the $1 billion. And as you know, at the time of the IPO, we committed that we expected to invest, acquire $1 billion of assets in the 3-year period ended in the second quarter of 2024. So we're basically halfway through that period of time, and we've acquired $400 million of assets to date. So we are on track reasonably in terms of hitting that metric. We will continue to be disciplined. And as you know, the market is evolving, as Jeff has just indicated. But the point that John was making in terms of our capacity is we have the ability today to acquire an incremental $1 billion given our balance sheet flexibility because as you know, we're only 5.4x levered, number one.

Number two, we generate $100 million a year of free cash flow post dividends. And so we have the capital capacity to acquire an incremental $1 billion of assets and stay within our leverage metrics before needing to go back to the equity market. So number one, we're on track to hit the $1 billion guidance that we gave at the time of the IPO, and we believe we will do that. The timing is uncertain given the uncertainties in the market. But number two, we've got more than enough balance sheet capacity to hit that metric. So that's the reason why we believe that, that metric is one that we will be able to achieve.

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

Okay. Yes. No, that's helpful. I appreciate that follow-up. And then, John, back to rental income, though, for a second. And can you remind us whether -- is some of the ground-up and redevelopment that's taking place within the same-store centers, is that a potential contribution? Is that impacting -- positively impacting the same-store as that NOI comes online?

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

It is. That's right.

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

Okay. And what's the contribution from development and redevelopment look like for the full year within the revised same-store guidance?

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

So I believe when I look at the revised, I believe it's about 100 basis points of our growth. And we are very optimistic about our continued -- about the pipeline that we disclosed, and we have -- I should say, the projects we have in progress, we have not disclosed our pipeline, but we have development because of the -- just the positive tailwinds we have there. Obviously, our occupancy is at record high, and we do this in a very controlled way that allows us to expand our footprint and redeploy capital with great returns. So we think that this can continue our growth into the future.

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

Okay. Great. That's helpful. And just one last one for me. The transaction expenses in the quarter, about $3.7 million. What is that attributable to? I guess, why are they being expense at that level, I guess, Crossroads or the Las Vegas deal, I know some of the accounting changes, it's back and forth over the years, I guess. But I thought the all costs were capitalized. So are these deal-related costs from deals that are not being completed that you're pursuing? And I'm just curious what that is. It seems like a pretty big number.

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, I'll take that. So on that -- so a component of it is we -- you write capital on acquisitions that we closed. We are able to capitalize those. We did have transactions that were in pursuit that given the changes we terminated. So we did have assets that we determined that based on the moves we did not continue with those. So there is a component of that. But then we also do have some expenses that we've had each year that will -- we anticipate it will be declining related to our IPO. That is just amortization from that.

Operator

(Operator Instructions) Your next question comes from the line of Tayo Okusanya with Credit Suisse.

Omotayo Tejamude Okusanya - *Crédit Suisse AG, Research Division - Analyst*

Yes. On one of the -- on the earnings calls of one of your peers, they were really kind of stressing their higher demographics. That's something that's going to be a key differentiator in kind of a slowing economic backdrop. I'm curious how you guys kind of think about that? And specifically how a sewer economy, how you think your portfolio may perform? Again, granted, I understand your focus on necessity shopping, again, you're more of a middle-class shopper with your demographics. But relative to the affluent end of the market, if I may use this word, just how do you think you end up kind of performing against that backdrop?

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

It's a great question, and we have kind of -- we've been talking about this for a long time. And what our belief is, is that we -- our centers service the average to above -- slightly above average American, and we get them their necessity goods close to their home. That's what our properties do. And that customer is a -- it's where Publix and Kroger and Albertsons, that's where they make their money. That's -- and we're very aligned with them on that. And when you look at that segment of the business, it's often confused with a lower end customer.

And the lower end customer is -- they're not at our centers. I mean that's the $30,000 to $50,000 median household income, not the $77,000 median household income. And this is most of America, and that is the way we look at it. And most of America shops at a Kroger or Publix or an Albertsons and does their necessity-based shopping somewhere within 3 miles of their house. And that customer today has a much stronger balance sheet than they have had going into any recession that I can remember. So they've got a strong balance sheet.

We have a really low unemployment rate. So you've got -- you kind of are looking at like the thing that is most difficult on the middle class has been there when they can't get a job. And that is not the issue today. It may be -- and I think the Fed's trying to make it more of an issue. But today, the only issue places that we're seeing that are in really on the technology side where you're seeing significant layoffs and reductions from a very rapid pace. So when we look at our centers, we kind of -- I mean what we really believe is that with the tailwinds that we talked about in the presentation in our markets and the stability that our centers and the necessity-based bring in a more difficult time, that our centers really do provide more alpha with a lot less beta. And that's -- we think why at this point in time, it's a great place to be with your capital because you really are hedging your downside and giving yourselves the upside.

Operator

Your next question comes from the line of Craig Schmidt with Bank of America.

Craig Richard Schmidt - *BofA Securities, Research Division - Director*

I know we've been talking about the Kroger and Albertsons merger. But what happens if the merger between these 2 doesn't go through? What does that mean? I mean we hear that the merger is trying to help them compete against Walmart and Amazon, and that some of the investors in Albertsons are looking at a way to exit stock. What are your thoughts about if the merger doesn't go through?

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

Craig, thanks for the question. I mean my take on it is service is going to drive the bus. They're going to be the one who decide what the outcome is post lawsuit if they lose the lawsuit, and the merger does not go through. If that does happen, their playbook has been pretty clear. They want to sell and get out of the investments. So we have heard rumors that there are other buyers. There were other buyers in the discussion. That -- maybe they go back to them. Maybe they break the company up and sell it off regionally. That's another possibility.

There is a possibility that they say, look, we're just going to hold this long term, and we're going to keep bleeding shares into the market and get out that way through a public execution. It's really uncertain for us, Craig. I mean -- and we -- I would say that there's -- that's probably a scenario where they actually sell to another -- somebody other than Kroger is probably certainly for us, one of the best outcomes because now you're introducing another competitor into the market, who's a really strong operator, who would put -- reinvest in the stores and so that -- I mean, I think that's a really good scenario for us.

And then the breakup -- if they break it up and sell it in pieces that will be regionally which -- who buys what. And I do think they have the opportunity to do that. And -- but -- we -- I think this -- with -- like even the announcement today, I mean, this is going to be a saga that's going to go on for 18 to 24 months easily. And we'll know more as things get closer. But as I like to say, the biggest decision about this whole thing is when they decide

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which judge is going to oversee the case in -- probably in Washington, D.C. on the -- where the FTC is challenging the merger. That -- who that judge is, is going to be probably the most important part of all of this, not all the other pieces that we're focused on and talking about.

Craig Richard Schmidt - *BofA Securities, Research Division - Director*

Great. And then just thinking about the more recessionary resilient portfolio that you have, does this mean that your sales will be flat, while other formats may be negative? Or do you think PECO can actually see stronger sales and foot traffic in 2023?

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

We believe that we can continue to see stable traffic, probably increasing cost per basket. So sales going up, probably not -- we don't see a ton of increased traffic because I think things will probably not probably move as much in that direction. So that would be an increasing -- that would be increasing sales. We could -- we would say that that's a likely outcome for 2023. Now if the Fed has to slam the brakes on harder and harder and harder, and we don't seem to be able to handle inflation, it doesn't seem to be. Now that is a different story. You will -- I mean, the customer will change their habits.

Our view is the customers most likely to change habits when employment changes, when they don't have the certainty in their job, that's when it tends to move even more in our mind than balance sheet. It's like when they -- if they've got a job, they will continue to spend maybe at a slightly reduced rate, but they'll continue spend. So I would say that our centers, grocery sales will be up in a recession and they historically have been. Our small stores will be stable in terms of sales. That's our guess.

Operator

This concludes our question-and-answer session. I would like to turn it back to Jeff Edison for some closing comments.

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

Great. Thank you, operator.

Our third quarter results continue to highlight the strength of PECO's focused and differentiated strategy of owning and operating small format neighborhood centers anchored by the #1 or #2 grocer in the market. This drives high recurring foot traffic and neighbor demand and results in superior financial and operating performance, which we've shown this quarter. Our experienced and cycle-tested team, our integrated operating platform and grocer-anchored strategy placed PECO in a strong position despite -- and that is even despite the uncertain macroeconomic environment. Our fortress balance sheet and liquidity will allow us to take advantage of the opportunities as they arise.

On behalf of the management team, I'd like to thank our stockholders, associates and importantly, our neighbors for their continued support. I hope you all have a great day and a great weekend. Thanks for being on the call.

Operator

Thank you for participating. You may now disconnect.

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