



## COMPANY UPDATE / ESTIMATE CHANGES

### REITs

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#### Key Metrics

FPO - NYSE (as of 4/27/2017)	\$10.98
Price Target	NA
52-Week Range	\$8.01 - \$11.21
Shares & Units Outstanding (mm)	61
Market Cap. (\$mm)	\$670
3-Mo. Average Daily Volume (000)	218.8
Institutional Ownership	99%
Debt/Total Market Capital (3/17)	50.8%
Dividend	\$0.40
Dividend Yield	3.6%
Interest Coverage Ratio	3.65x

#### Core FFO Per Share FY 12/31

	2016	Prior 2017E	Curr. 2017E	Prior 2018E	Curr. 2018E
1Q	\$0.24		\$0.23 A		\$0.19
2Q	\$0.27	\$0.21	\$0.21		\$0.20
3Q	\$0.28	\$0.19	\$0.19		\$0.20
4Q	\$0.27	\$0.20	\$0.20		\$0.21
Year	\$1.06	\$0.82	\$0.83		\$0.80
P/Core FFO	10.4x		13.2x		13.7x

Core FFO excludes gains from the early retirement of debt and sale of real estate, acquisition costs, and other one-time charges.

#### Revenue (\$mm)

	2016	Prior 2017E	Curr. 2017E	Prior 2018E	Curr. 2018E
1Q	\$43		\$38 A		\$34
2Q	\$38	\$34	\$34		\$34
3Q	\$40	\$34	\$34		\$35
4Q	\$39	\$33	\$33		\$35
Year	\$160	\$138	\$138		\$139

Quarterly amounts may not add up to full year amounts due to rounding.

Previous numbers have not been restated.

**Company Description:** *First Potomac, headquartered in Bethesda, Maryland, is a REIT focused on owning, operating, developing and redeveloping office and business park properties in the greater Washington D.C. region.*

## First Potomac Realty Trust

FPO -- NYSE – Neutral -- 3

### First Quarter Results

- **First Potomac Realty Trust reported first quarter FFO of \$0.23 per share compared to \$0.21 in the year ago period.** Excluding non-recurring items, Core FFO were \$0.23 per share versus \$0.24. Core FFO was a penny above our and the consensus estimate.
- **The company's portfolio was 94.0% leased and 92.4% occupied at the end of the first quarter.** Comparable rental rates increased 2.3% on new leases and 4.6% on renewals on a GAAP basis. Net absorption was negative in the quarter at 115,790 square feet.
- **Management raised 2017 Core FFO per share guidance from a range of \$0.78 to \$0.84 to a range of \$0.80 to \$0.85.** We are raising our 2017 Core FFO per share estimate by a penny to \$0.83.
- **We maintain our Neutral rating.** We believe the shares are fairly valued at this time.

**Note Important Disclosures on Pages 6 and 7.  
Note Analyst Certification on Page 6.**

## **Quarterly Results**

Total revenues were \$37.8 million, consisting of \$30.8 million in rental revenue and \$7.0 million in tenant reimbursements and other revenue (please see income statement on page 3). This compares to total revenues of \$42.7 million in 2016's first quarter, an 11.4% decline year over year.

The company completed new and renewal leases on 162,886 square feet of rentable space. The retention rate declined to 32% from 36% on a sequential basis. FPO's definition of retention is a tenant renewing a lease for the same physical location. Net absorption was negative in the quarter at 115,790 square feet. Consolidated occupancy was down 20 basis points sequentially at 92.4%. Leased space was up 20 basis points sequentially at 94.0%.

Net income was \$43.1 million versus a loss of \$4.1 million in the year ago period. FFO per share were \$0.23 versus \$0.21 on a 0.4% increase in shares and units outstanding. Excluding non-recurring items, Core FFO per share were \$0.23 compared to \$0.24.

## **Overview**

**Current Environment** - Net absorption was negative in the quarter. The U.S. government is FPO's largest tenant. Leases with the U.S. government account for 14.0% of annualized base rent for the company. Other than the U.S. government, FPO has only one additional tenant that accounts for more than 5.0% of annual rent.

**Acquisitions & Dispositions** - During the quarter, FPO sold Plaza 500, a 502,830 square foot industrial property in Alexandria, Virginia for \$75 million and One Fair Oaks, a 214,214 square foot office building in Fairfax, Virginia for \$13.7 million. FPO sold two joint venture properties (River Park I and II and Aviation Business Park) for gross proceeds of \$59.5 million, with FPO's share at \$18.975 million.

**Balance Sheet and Financials** - Debt to total market cap was 50.8% at March 31, 2017, compared to 52.7% at 2016 year end. At the end of the first quarter, FPO was in compliance with its covenants on the revolving credit facility, unsecured term loan, land loan, and construction loans. We believe the company's near-term debt maturities are manageable.

**Company Guidance and Our Estimates** - Management raised 2017 Core FFO per share guidance from a range of \$0.78 to \$0.84 to a range of \$0.80 to \$0.85. Guidance includes same portfolio net operating income growth of -1.0% to 1.0%, and year end occupancy of 91.0% to 93.0%. Our 2017 Core FFO estimate is \$0.83 per share.

**Quarterly Income Statement**

(in thousands, except per share data)	<b>1Q17</b>	<b>1Q16</b>	<b>% Change</b>
Rental Revenue	\$30,818	\$33,844	-8.9%
Tenant Reimbursements and Other Revenue	7,005	8,853	-20.9%
<b>Total Revenues</b>	<b>37,823</b>	<b>42,697</b>	<b>-11.4%</b>
Real Estate Operating Expenses	9,958	11,537	-13.7%
Real Estate Taxes and Insurance	4,661	5,216	-10.6%
<b>Real Estate NOI (R/E Rev. minus R/E Expenses)</b>	<b>23,204</b>	<b>25,944</b>	<b>-10.6%</b>
General and Administrative Expenses	4,497	4,578	-1.8%
Other Income (Expenses)			
<b>EBITDA</b>	<b>18,707</b>	<b>21,366</b>	<b>-12.4%</b>
Depreciation and Amortization Expense	14,566	15,006	-2.9%
Interest Expense	6,344	6,816	-6.9%
Interest and Other Income	210	1,003	-79.1%
Acquisition Costs			
Loss (Gain) on the Early Retirement of Debt; Other Charges		48	
(Provision) Benefit for Income Taxes			
Income (Loss) from Discontinued Operations, incl. R/E Gains			
Gain on Sale of Investment	42,799	(1,155)	
Equity in Earnings of Affiliates	(4,223)	(555)	
Impairment of Rental Property			
Contingent Consideration Related to Acquisition of Property			
Net Income Attributable to Noncontrolling Interests	(1,884)	147	
Issuance Costs of Redeemed Preferred Shares		1,904	
Dividends on Preferred Shares		2,248	
<b>Net Income (Loss)</b>	<b>\$43,145</b>	<b>(\$4,106)</b>	
<b>Net EPS (diluted)</b>	<b>\$0.74</b>	<b>(\$0.07)</b>	
<b>Avg. Shares Outstanding (diluted)</b>	<b>57,907</b>	<b>57,542</b>	<b>0.6%</b>

<b>Funds From Operations</b>	<b>1Q17</b>	<b>1Q16</b>	<b>% Change</b>
Net Income Available to Common Shareholders	\$43,145	(\$4,106)	
Depreciation and Amortization	14,566	15,006	-2.9%
Discontinued Operations			
Joint Venture Acquisition Fee			
Unconsolidated Joint Ventures	870	881	-1.2%
Consolidated Joint Ventures			
Gain on Sale of Real Estate Properties	(46,574)	1,155	
Impairment of Rental Property			
Net Income Attributable to Noncontrolling Interest	1,884	(133)	
<b>Funds From Operations</b>	<b>\$13,891</b>	<b>\$12,803</b>	<b>8.5%</b>
<b>FFO Per Share*</b>	<b>\$0.23</b>	<b>\$0.21</b>	<b>9.5%</b>
<b>"Core" FFO Per Share **</b>	<b>\$0.23</b>	<b>\$0.24</b>	<b>-4.2%</b>
<b>Avg. Shares and Units Outstanding (diluted)</b>	<b>60,452</b>	<b>60,234</b>	<b>0.4%</b>

\*FFO per share includes non-recurring charges and gains.

\*\*Core FFO per share excludes non-recurring charges and gains.

Source: Company reports

**Condensed Balance Sheet**

(in thousands)	31-Dec-15	31-Dec-16	31-Mar-17
<b>Rental Property (Net of Depreciation)</b>	<b>\$1,130,266</b>	<b>\$1,059,272</b>	<b>\$1,024,605</b>
Assets Held for Sale	90,674	13,176	
Cash	13,527	14,144	13,269
Escrow and Reserves	2,514	1,419	2,348
Accounts & Other Receivables	9,868	6,892	5,611
Accrued Straight-Line Rents	36,888	42,745	45,211
Notes Receivable, net	34,000		
Investment in Affiliate	48,223	49,392	42,314
Deferred Costs (net)	44,502	42,712	41,603
Prepaid Expenses & Other Assets	6,950	5,389	5,414
Intangible Assets (net)	32,959	25,106	23,622
<b>Total Assets</b>	<b>\$1,450,371</b>	<b>\$1,260,247</b>	<b>\$1,203,997</b>
Mortgage Loans	\$312,003	\$296,212	\$295,523
Liabilities Held-for-Sale			
Exchangeable Senior Notes			
Senior Notes			
Secured Term Loan			
Unsecured Term Loan	300,000	299,404	299,433
Credit Facility	120,000	141,555	48,758
<b>Total Debt</b>	<b>\$732,003</b>	<b>\$737,171</b>	<b>\$643,714</b>
Financing Obligation			
Accounts Payable & Accrued Expenses	47,972	43,904	40,897
Accrued Interest	1,603	1,537	1,470
Rents Received in Advance	6,003	6,234	6,493
Tenant Security Deposits	4,982	4,982	4,831
Other Liabilities	3,667	1,792	1,716
<b>Total Liabilities</b>	<b>\$796,230</b>	<b>\$795,620</b>	<b>\$699,121</b>
Noncontrolling Interest in OP	28,813	28,244	27,516
<b>Total Equity</b>	<b>\$625,328</b>	<b>\$436,383</b>	<b>\$477,360</b>
<b>Total Liabilities and Equity</b>	<b>\$1,450,371</b>	<b>\$1,260,247</b>	<b>\$1,203,997</b>

Balance Sheet Ratio Analysis	31-Dec-15	31-Dec-16	31-Mar-17
<b>Net R/E Investments/ Total Debt</b>	154.4%	143.7%	159.2%
<b>Debt to Equity</b>	117.1%	168.9%	134.8%
<b>Variable Rate Debt as % of Total Debt</b>	66.0%	66.0%	64.3%
<b>Debt to Total Market Capitalization</b>	46.3%	46.3%	50.8%
<b>Debt as % of Total Assets</b>	50.5%	58.5%	53.5%
<b>Equity as % of Total Assets</b>	43.1%	34.6%	39.6%

Previous numbers have not been restated.

Source: Company reports

## Valuation

At current levels FPO's stock is trading at 13.7x our 2018 Core FFO per share estimate. FPO is trading at a discount to the peer group and at a premium to its median 5-year historic forward Price/FFO multiple. At the current level, we believe the shares are fairly valued given FPO's near-term leasing challenges, offset by the company's progress on its strategic plan. We rate FPO Neutral.

Peer REITs	Symbol	Price	Current	Yield	Payout Ratio	FFO Per Share			2-Year Exp.	18/17 Exp.	Price/FFO	
		4/27/2017	Dividend			2016	2017E	2018E	Avg. Growth	Growth Rate	2017E	2018E
Boston Properties Inc.	BXP	\$125.99	\$3.00	2.4%	48.4%	\$6.02	\$6.20	\$6.69	5.6%	7.9%	20.3x	18.8x
Mack-Cali Realty Corp.	CLI	\$27.35	\$0.60	2.2%	25.8%	\$2.16	\$2.33	\$2.40	5.6%	3.0%	11.7x	11.4x
Corporate Office Properties Trust	OFC	\$32.77	\$1.10	3.4%	53.7%	\$1.72	\$2.05	\$2.21	14.2%	7.8%	16.0x	14.8x
Brandywine Realty Trust	BDN	\$17.02	\$0.64	3.8%	46.4%	\$1.28	\$1.38	\$1.51	9.0%	9.4%	12.3x	11.3x
Parkway Properties Inc.	PKY	\$20.27	\$0.40	2.0%	26.0%	\$1.29	\$1.54	\$1.35	2.3%	-12.3%	13.2x	15.0x
<b>Peer Average</b>		<b>\$44.68</b>	<b>\$1.15</b>	<b>2.7%</b>	<b>40.0%</b>	<b>\$2.49</b>	<b>\$2.70</b>	<b>\$2.83</b>	<b>7.3%</b>	<b>3.2%</b>	<b>14.7x</b>	<b>14.3x</b>
<b>S&amp;P 500</b>	<b>SPX</b>	<b>2388.77</b>	<b>\$48.08</b>	<b>2.0%</b>	<b>36.8%</b>	<b>\$117.75</b>	<b>\$130.61</b>	<b>\$140.06</b>	<b>9.5%</b>	<b>7.2%</b>	<b>18.3x</b>	<b>17.1x</b>
<b>First Potomac Realty Trust</b>	<b>FPO</b>	<b>\$10.98</b>	<b>\$0.40</b>	<b>3.6%</b>	<b>48.2%</b>	<b>\$1.06</b>	<b>\$0.83</b>	<b>\$0.80</b>	<b>-12.3%</b>	<b>-3.6%</b>	<b>13.2x</b>	<b>13.7x</b>

FPO's FFO numbers are Core FFO.  
SPX figures are EPS not FFO per share.

Source: NAREIT, Baseline, and Hilliard Lyons' estimates

## Suitability

We assign shares of First Potomac Realty Investors a suitability rating of 3 on our scale of 1 - 4 (1=most conservative, 4=most aggressive). Our rating is based on the company's lack of property type diversification and large exposure to government related tenants.

## Risks & Considerations

**Interest Rate Risk** - Like all REITs, FPO is interest rate sensitive. FPO has 64.3% of its debt at variable rates. However, we note that 57.4% of the company's floating rate debt is hedged. In addition, the company's interest coverage ratio of 3.65x appears adequate. We believe FPO should be able to weather an increase in interest expense in a rising rate environment.

**Regional Market Risk** - FPO's real estate portfolio is predominately in the Maryland, Washington, D.C., Northern Virginia, and Southern Virginia markets. These markets are dependent on U.S. government spending programs, primarily defense spending. The U.S. government is FPO's largest tenant at 14.0% of total annualized rental revenue.

**Strategic Plan Risk** - We believe the completion of the company's strategic plan should help shareholder value. However, if the plan takes longer than investors expect or if there is a hiccup, the stock price could negatively react. We note the company has made good progress on this plan so far.

**Acquisitions Versus Dispositions** - We believe one internal risk for First Potomac is growing too rapidly through potentially dilutive acquisitions. We also believe dispositions can be dilutive to FFO.

**SEC Inquiry Risk** - FPO has fully remediated its material weakness discussed in its 2011 10-K. However, the SEC has made an informal inquiry related to this. There were legal costs in 1Q13 associated with this inquiry. At this point, we do not know if any additional costs or actions could be taken as a result of this inquiry. Any additional cost or negative actions could impact earnings.

Annual yield is calculated by dividing the distribution amount by the current market price of the security. For US income tax purposes, the Company may classify all or a portion of its distributions as dividends or other non-dividend distributions. Note that for some investors, for US income tax purposes

all or a portion of the Company's 2016 dividend or distribution was treated as return of capital and not as "dividend income" as reflected on the IRS Form 1099-Div for the 2016 tax year. The Company generally makes a final determination regarding the proper tax treatment of distributions after calendar year end. We urge each shareholder to consult with his or her own tax advisor to determine the tax consequences of the distributions received, including any state, local or foreign tax considerations.

*Additional information is available upon request.*

### **Analyst Certification**

I, Carol L. Kemple, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company(ies) and its (their) securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

### **Important Disclosures**

Hilliard Lyons' analysts receive bonus compensation based on Hilliard Lyons' profitability. They do not receive direct payments from investment banking activity.

### **Investment Ratings**

**Buy** - We believe the stock has significant total return potential in the coming 12 months.

**Long-term Buy** - We believe the stock is an above average holding in its sector, and expect solid total returns to be realized over a longer time frame than our Buy rated issues, typically 2-3 years.

**Neutral** - We believe the stock is an average holding in its sector, is currently fully valued, and may be used as a source of funds if better opportunities arise.

**Underperform** - We believe the stock is vulnerable to a price set back in the next 12 months.

### **Suitability Ratings**

**1** - A large cap, core holding with a solid history

**2** - A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks

**3** - An above average risk/reward ratio could be due to small size, lack of product diversity, sporadic earnings or high leverage

**4** - Speculative, due to small size, inconsistent profitability, erratic revenue, volatility, low trading volume or a narrow customer or product base.



	Hilliard Lyons Recommended Issues		Investment Banking Provided in Past 12 Mo.	
	# of Stocks Covered	% of Stocks Covered	Banking	No Banking
<b>Rating</b>				
<b>Buy</b>	36	30%	14%	86%
<b>Hold/Neutral</b>	71	58%	6%	94%
<b>Sell</b>	15	12%	7%	93%

As of 5 April 2017

**Other Disclosures**

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