

QTS Realty Trust, Inc.
Form 10-Q
August 06, 2018
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FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2018

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission File Number 001-36109

QTS Realty Trust, Inc.

QualityTech, LP

(Exact name of registrant as specified in its charter)

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Maryland (QTS Realty Trust, Inc.)	46-2809094
Delaware (QualityTech, LP)	27-0707288
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
12851 Foster Street, Overland Park, Kansas (Address of principal executive offices)	66213 (Zip Code)

(Registrant's telephone number, including area code) (913) 312-5503

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

QTS Realty Trust, Inc. Yes No QualityTech, LP Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

QTS Realty Trust, Inc. Yes No QualityTech, LP Yes No

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

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Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

Emerging growth company

QualityTech, LP

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

Emerging growth company

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

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

QTS Realty Trust, Inc. Yes No QualityTech, LP Yes No

There were 51,018,919 shares of Class A common stock, \$0.01 par value per share, and 128,408 shares of Class B common stock, \$0.01 par value per share, of QTS Realty Trust, Inc. outstanding on August 1, 2018.

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EXPLANATORY NOTE

This report combines the quarterly reports on Form 10-Q of QTS Realty Trust, Inc. (“QTS”) and QualityTech, LP, a Delaware limited partnership, which is our operating partnership (the “Operating Partnership”). This report also includes the financial statements of QTS and those of the Operating Partnership, although it presents only one set of combined notes for QTS’ financial statements and those of the Operating Partnership.

Substantially all of QTS’s assets are held by, and its operations are conducted through, the Operating Partnership. QTS is the sole general partner of the Operating Partnership, and, as of June 30, 2018, its only material asset consisted of its ownership of approximately 88.5% of the Operating Partnership. Management operates QTS and the Operating Partnership as one business. The management of QTS consists of the same employees as the management of the Operating Partnership. QTS does not conduct business itself, other than acting as the sole general partner of the Operating Partnership and issuing public equity from time to time. QTS has not issued or guaranteed any indebtedness. Except for net proceeds from public equity issuances by QTS, which are contributed to the Operating Partnership in exchange for units of limited partnership interest of the Operating Partnership, the Operating Partnership generates all remaining capital required by our business through its operations, the direct or indirect incurrence of indebtedness, and the issuance of partnership units. Therefore, as general partner with voting control of the Operating Partnership, QTS consolidates the Operating Partnership for financial reporting purposes.

We believe, therefore, that a combined presentation with respect to QTS and the Operating Partnership, including providing one set of notes for the financial statements of QTS and the Operating Partnership, provides the following benefits:

- enhances investors’ understanding of QTS and the Operating Partnership by enabling investors to view the business as a whole in the same manner as management views and operates the business;
- eliminates duplicative disclosure and provides a more streamlined and readable presentation since a substantial portion of the disclosure in this report applies to both QTS and the Operating Partnership; and
- creates time and cost efficiencies through the preparation of one presentation instead of two separate presentations.

In addition, in light of these combined disclosures, we believe it is important for investors to understand the few differences between QTS and the Operating Partnership in the context of how QTS and the Operating Partnership operate as a consolidated company. With respect to balance sheets, the presentation of stockholders’ equity and partners’ capital are the main areas of difference between the consolidated balance sheets of QTS and those of the Operating Partnership. On the Operating Partnership’s consolidated balance sheets, partners’ capital includes preferred partnership units and common partnership units as well as accumulated other comprehensive income (loss) that are owned by or attributable to QTS and other partners. On QTS’ consolidated balance sheets, stockholders’ equity includes preferred stock, common stock, additional paid-in capital, accumulated other comprehensive income (loss) and accumulated dividends in excess of earnings. The remaining equity reflected on QTS’ consolidated balance sheet is the

portion of net assets that are retained by partners other than QTS, referred to as noncontrolling interests. With respect to statements of operations, the primary difference in QTS' Statements of Operations and Statements of Comprehensive Income (Loss) is that for net income (loss), QTS retains its proportionate share of the net income (loss) based on its ownership of the Operating Partnership, with the remaining balance being retained by the Operating Partnership.

In order to highlight the few differences between QTS and the Operating Partnership, there are sections and disclosure in this report that discuss QTS and the Operating Partnership separately, including separate financial statements, separate audit reports, separate controls and procedures sections, separate Exhibit 31 and 32 certifications, and separate presentation of certain accompanying notes to the financial statements, including Note 8 – Partners' Capital, Equity and Incentive Compensation Plans. In the sections that combine disclosure for QTS and the Operating Partnership, this report refers to actions or holdings as being actions or holdings of “we,” “our,” “us,” “our company” and “the Company.” Although the Operating Partnership is generally the entity that enters into contracts, holds assets and issues debt, we believe that these general references to “we,” “our,” “us,” “our company” and “the Company” in this context are appropriate because the business is one enterprise operated through the Operating Partnership.

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QTS Realty Trust, Inc.

QualityTech, LP

Form 10-Q

For the Quarterly Period Ended June 30, 2018

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PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements

QTS REALTY TRUST, INC.

INTERIM CONSOLIDATED FINANCIAL STATEMENTS

BALANCE SHEETS

(in thousands except per share data)

	June 30, 2018 (unaudited)	December 31, 2017
ASSETS		
Real Estate Assets		
Land	\$ 105,541	\$ 88,216
Buildings, improvements and equipment	1,833,870	1,701,287
Less: Accumulated depreciation	(434,565)	(394,823)
	1,504,846	1,394,680
Construction in progress	649,766	567,819
Real Estate Assets, net	2,154,612	1,962,499
Cash and cash equivalents	52,468	8,243
Rents and other receivables, net	50,090	47,046
Acquired intangibles, net	100,202	109,451
Deferred costs, net	44,682	41,545
Prepaid expenses	10,088	6,163
Goodwill	173,843	173,843
Other assets, net	68,880	66,266
TOTAL ASSETS	\$ 2,654,865	\$ 2,415,056
LIABILITIES		
Unsecured credit facility, net	\$ 694,751	\$ 825,186
Senior notes, net of debt issuance costs	394,406	394,178
Capital lease, lease financing obligations and mortgage notes payable	6,217	10,565
Accounts payable and accrued liabilities	109,355	113,430
Dividends and distributions payable	25,648	22,222
Advance rents, security deposits and other liabilities	29,640	28,903
Deferred income taxes	2,068	4,611
Deferred income	32,870	25,305
TOTAL LIABILITIES	1,294,955	1,424,400

EQUITY

7.125% Series A cumulative redeemable perpetual preferred stock: \$0.01 par value (liquidation preference \$25.00 per share), 4,600,000 shares authorized, 4,280,000 shares issued and outstanding as of June 30, 2018; zero shares authorized, issued and outstanding as of December 31, 2017	103,212	—
6.50% Series B cumulative convertible perpetual preferred stock: \$0.01 par value (liquidation preference \$100.00 per share), 3,162,500 shares authorized, issued and outstanding as of June 30, 2018; zero shares authorized, issued and outstanding as of December 31, 2017	304,426	—
Common stock: \$0.01 par value, 450,133,000 shares authorized, 51,140,798 and 50,701,795 shares issued and outstanding as of June 30, 2018 and December 31, 2017, respectively	511	507
Additional paid-in capital	1,056,667	1,049,176
Accumulated other comprehensive income	8,840	1,283
Accumulated dividends in excess of earnings	(223,724)	(173,552)
Total stockholders' equity	1,249,932	877,414
Noncontrolling interests	109,978	113,242
TOTAL EQUITY	1,359,910	990,656
TOTAL LIABILITIES AND EQUITY	\$ 2,654,865	\$ 2,415,056

See accompanying notes to financial statements.

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QTS REALTY TRUST, INC.

INTERIM CONSOLIDATED FINANCIAL STATEMENTS

STATEMENTS OF OPERATIONS

(unaudited and in thousands except share and per share data)

	Three Months Ended June		Six Months Ended June 30,	
	30, 2018	2017	2018	2017
Revenues:				
Rental	\$ 89,232	\$ 80,793	\$ 174,945	\$ 159,910
Recoveries from customers	10,444	8,774	21,957	17,135
Cloud and managed services	10,974	16,856	24,155	33,821
Other	1,627	1,445	4,917	2,966
Total revenues	112,277	107,868	225,974	213,832
Operating Expenses:				
Property operating costs	36,558	36,846	74,298	72,267
Real estate taxes and insurance	2,903	2,946	5,808	6,093
Depreciation and amortization	37,820	34,527	73,733	68,475
General and administrative	21,031	22,562	43,265	44,759
Transaction, integration and impairment costs	653	161	1,573	497
Restructuring	11,430	—	19,960	—
Total operating expenses	110,395	97,042	218,637	192,091
Operating income	1,882	10,826	7,337	21,741
Other income and expenses:				
Interest income	25	—	26	1
Interest expense	(8,203)	(7,647)	(16,313)	(14,516)
Income (loss) before taxes	(6,296)	3,179	(8,950)	7,226
Tax benefit (expense) of taxable REIT subsidiaries	(137)	1,429	2,265	2,950
Net income (loss)	(6,433)	4,608	(6,685)	10,176
Net (income) loss attributable to noncontrolling interests	1,002	(568)	1,031	(1,259)
Net income (loss) attributable to QTS Realty Trust, Inc.	\$ (5,431)	\$ 4,040	\$ (5,654)	\$ 8,917
Preferred stock dividends	(2,248)	—	(2,576)	—
Net income (loss) attributable to common stockholders	\$ (7,679)	\$ 4,040	\$ (8,230)	\$ 8,917
Net income (loss) per share attributable to common shares:				
Basic	\$ (0.16)	\$ 0.08	\$ (0.17)	\$ 0.18
Diluted	(0.16)	0.08	(0.17)	0.17

See accompanying notes to financial statements.

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QTS REALTY TRUST, INC.

INTERIM CONSOLIDATED FINANCIAL STATEMENTS

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(unaudited and in thousands)

	Three Months Ended		Six Months Ended June	
	June 30, 2018	2017	30, 2018	2017
Net income (loss)	\$ (6,433)	\$ 4,608	\$ (6,685)	\$ 10,176
Other comprehensive income (loss):				
Increase (decrease) in fair value of interest rate swaps	2,563	(1,499)	8,545	(1,499)
Reclassification of other comprehensive income to interest expense	91	—	493	—
Comprehensive income (loss)	(3,779)	3,109	2,353	8,677
Comprehensive (income) loss attributable to noncontrolling interests	431	(385)	(271)	(1,076)
Comprehensive income (loss) attributable to QTS Realty Trust, Inc.	\$ (3,348)	\$ 2,724	\$ 2,082	\$ 7,601

See accompanying notes to financial statements.

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QTS REALTY TRUST, INC.

INTERIM CONSOLIDATED FINANCIAL STATEMENTS

CONSOLIDATED STATEMENT OF EQUITY

(unaudited and in thousands)

	Preferred Shares	Stock Amount	Common Shares	stock Amount	Additional paid-in capital	Accumulated other comprehensive income	Accumulated dividends in excess of earnings equity	Total stockholders' equity	Noncontrolling interests	Total
Balance January 1, 2018	—	\$ —	50,702	\$ 507	\$ 1,049,176	\$ 1,283	\$ (173,552)	\$ 877,414	\$ 113,242	\$ 990,656
Share buyback through equity repurchase plan	—	—	439	4	(1,897)	—	—	(1,893)	1,031	(862)
Increase in fair value of interest rate sensitive instruments	—	—	—	—	—	7,557	—	7,557	988	8,545
Equity-based compensation expense	—	—	—	—	9,388	—	—	9,388	1,220	10,608
Proceeds from Series A preferred stock offering	4,280	103,212	—	—	—	—	—	103,212	—	103,212
Proceeds from Series B preferred stock offering	3,163	304,426	—	—	—	—	—	304,426	—	304,426
Dividends declared on the Series A preferred stock	—	—	—	—	—	—	(2,233)	(2,233)	—	(2,233)
Dividends declared on the Series B convertible preferred stock	—	—	—	—	—	—	(343)	(343)	—	(343)
	—	—	—	—	—	—	(41,942)	(41,942)	—	(41,942)

Dividends to Common Shareholders Distributions											
Controlling Interests	—	—	—	—	—	—	—	—	(5,472)	(5,472)	
Loss	—	—	—	—	—	—	(5,654)	(5,654)	(1,031)	(6,685)	
Balance June 2018	7,443	\$ 407,638	51,141	\$ 511	\$ 1,056,667	\$ 8,840	\$ (223,724)	\$ 1,249,932	\$ 109,978	\$ 1,359,9	

See accompanying notes to financial statements.

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QTS REALTY TRUST, INC.

INTERIM CONSOLIDATED FINANCIAL STATEMENTS

STATEMENTS OF CASH FLOW

(unaudited and in thousands)

For the six months ended June 30, 2018 and 2017

	2018	2017
Cash flow from operating activities:		
Net income (loss)	\$ (6,685)	\$ 10,176
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	70,804	66,443
Amortization of above and below market leases	270	479
Amortization of deferred loan costs	1,923	1,815
Amortization of senior notes discount	—	136
Equity-based compensation expense	7,480	6,815
Bad debt expense	(1,230)	1,105
Deferred tax benefit	(2,443)	(2,979)
Loss on sale of equipment	2,846	—
Restructuring costs, net of cash paid	10,065	—
Changes in operating assets and liabilities		
Rents and other receivables, net	(1,914)	(3,599)
Prepaid expenses	(3,925)	(1,957)
Other assets	1,867	(595)
Accounts payable and accrued liabilities	3,535	(7,640)
Advance rents, security deposits and other liabilities	1,369	5,745
Deferred income	7,564	1,440
Net cash provided by operating activities	91,526	77,384
Cash flow from investing activities:		
Proceeds from sale of property	1,496	—
Acquisitions, net of cash acquired	(24,626)	(5,019)
Additions to property and equipment	(248,852)	(139,818)
Net cash used in investing activities	(271,982)	(144,837)
Cash flow from financing activities:		
Credit facility proceeds	231,000	109,000
Credit facility repayments	(362,000)	—
Debt proceeds	—	1,920
Payment of deferred financing costs	(606)	(38)
Payment of preferred stock dividends	(635)	—
Payment of common stock dividends	(40,641)	(35,958)

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Distribution to noncontrolling interests	(5,289)	(5,087)
Proceeds from exercise of stock options	18	662
Payment of tax withholdings related to equity-based awards	(1,233)	(2,464)
Principal payments on capital lease obligations	(4,316)	(6,547)
Mortgage principal debt repayments	(32)	(22)
Preferred stock issuance proceeds, net of costs	408,415	—
Common stock issuance proceeds, net of costs	—	39,011
Net cash provided by financing activities	224,681	100,477
Net increase in cash and cash equivalents	44,225	33,024
Cash and cash equivalents, beginning of period	8,243	9,580
Cash and cash equivalents, end of period	\$ 52,468	\$ 42,604

See accompanying notes to financial statements.

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QTS REALTY TRUST, INC.

INTERIM CONSOLIDATED FINANCIAL STATEMENTS

STATEMENTS OF CASH FLOW (continued)

(unaudited and in thousands)

For the six months ended June 30, 2018 and 2017

	2018	2017
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
Cash paid for interest (excluding deferred financing costs and amounts capitalized)	\$ 14,265	\$ 11,517
Noncash investing and financing activities:		
Accrued capital additions	\$ 67,708	\$ 46,894
Increase in other assets related to change in fair value of interest rate swaps	\$ 8,545	\$ 1,499
Accrued equity issuance costs	\$ 777	\$ —
Accrued preferred stock dividend	\$ 2,576	\$ —
Accrued deferred financing costs	\$ 14	\$ —

See accompanying notes to financial statements.

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QUALITYTECH, LP

INTERIM CONSOLIDATED FINANCIAL STATEMENTS

BALANCE SHEETS

(in thousands)

	June 30, 2018 (unaudited)	December 31, 2017
ASSETS		
Real Estate Assets		
Land	\$ 105,541	\$ 88,216
Buildings, improvements and equipment	1,833,870	1,701,287
Less: Accumulated depreciation	(434,565)	(394,823)
	1,504,846	1,394,680
Construction in progress	649,766	567,819
Real Estate Assets, net	2,154,612	1,962,499
Cash and cash equivalents	52,468	8,243
Rents and other receivables, net	50,090	47,046
Acquired intangibles, net	100,202	109,451
Deferred costs, net	44,682	41,545
Prepaid expenses	10,088	6,163
Goodwill	173,843	173,843
Other assets, net	68,880	66,266
TOTAL ASSETS	\$ 2,654,865	\$ 2,415,056
LIABILITIES		
Unsecured credit facility, net	\$ 694,751	\$ 825,186
Senior notes, net of debt issuance costs	394,406	394,178
Capital lease, lease financing obligations and mortgage notes payable	6,217	10,565
Accounts payable and accrued liabilities	109,355	113,430
Dividends and distributions payable	25,648	22,222
Advance rents, security deposits and other liabilities	29,640	28,903
Deferred income taxes	2,068	4,611
Deferred income	32,870	25,305
TOTAL LIABILITIES	1,294,955	1,424,400
PARTNERS' CAPITAL		
7.125% Series A cumulative redeemable perpetual preferred units: \$0.01 par value (liquidation preference \$25.00 per unit), 4,600,000 units authorized, 4,280,000 units issued and outstanding as of June 30, 2018; zero units authorized, issued and outstanding as of December 31, 2017	103,212	—
6.50% Series B cumulative convertible perpetual preferred units: \$0.01 par value (liquidation preference \$100.00 per unit), 3,162,500 units authorized, issued and	304,426	—

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outstanding as of June 30, 2018; zero units authorized, issued and outstanding as of December 31, 2017

Common units: \$0.01 par value, 450,133,000 units authorized, 57,818,242 and 57,245,524 units issued and outstanding as of June 30, 2018 and December 31, 2017, respectively

Accumulated other comprehensive income	942,278	989,207
TOTAL PARTNERS' CAPITAL	9,994	1,449
TOTAL LIABILITIES AND PARTNERS' CAPITAL	1,359,910	990,656
	\$ 2,654,865	\$ 2,415,056

See accompanying notes to financial statements.

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QUALITYTECH, LP

INTERIM CONSOLIDATED FINANCIAL STATEMENTS

STATEMENTS OF OPERATIONS

(unaudited and in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Revenues:				
Rental	\$ 89,232	\$ 80,793	\$ 174,945	\$ 159,910
Recoveries from customers	10,444	8,774	21,957	17,135
Cloud and managed services	10,974	16,856	24,155	33,821
Other	1,627	1,445	4,917	2,966
Total revenues	112,277	107,868	225,974	213,832
Operating Expenses:				
Property operating costs	36,558	36,846	74,298	72,267
Real estate taxes and insurance	2,903	2,946	5,808	6,093
Depreciation and amortization	37,820	34,527	73,733	68,475
General and administrative	21,031	22,562	43,265	44,759
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Total operating expenses	110,395	97,042	218,637	192,091
Operating income	1,882	10,826	7,337	21,741
Other income and expenses:				
Interest income	25	—	26	1
Interest expense	(8,203)	(7,647)	(16,313)	(14,516)
Income (loss) before taxes	(6,296)	3,179	(8,950)	7,226
Tax benefit (expense) of taxable REIT subsidiaries	(137)			