Easterly Government Properties, Inc.

Fourth Quarter and Full Year 2017 Earnings Conference Call

March 1, 2018

CORPORATE PARTICIPANTS

Lindsay S. Winterhalter, *Vice President, Investor Relations and Operations*

Darrell W. Crate, *Chairman of the Board of Directors*

William C. Trimble, *President, Chief Executive Officer and Director*

Meghan G. Baivier, *Executive Vice President, Chief Financial Officer and Chief Operating Officer*

CONFERENCE CALL PARTICIPANTS

Emmanuel Korchman, *Citigroup*

Brian Hawthorne, *RBC Capital Markets, LLC*

Michael Lewis, *SunTrust Robinson Humphrey, Inc.*

Bill Crow, *Raymond James*

Jon Petersen, *Jefferies*

PRESENTATION

Operator:

Greetings, and welcome to the Easterly Government Properties Fourth Quarter 2017 Earnings Call. At this time, all participants are in a listen-only mode. A question and answer session will follow the formal presentation. If anyone should require Operator assistance during the conference, please press star, zero on your telephone keypad. As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Ms. Lindsay Winterhalter, Vice President, Investor Relations, for Easterly Government Properties. Thank you. You may begin.

Lindsay S. Winterhalter:

Good morning. Before the call begins, please note the use of forward-looking statements by the Company on this conference call. Statements made on this call may include statements which are not historical facts and are considered forward-looking. The Company intends these forward-looking statements to be covered by the Safe Harbor provisions for forward-looking statements contained in the Private Securities Litigation Act Reform of 1995, and is making this statement for the purpose of complying with those Safe Harbor provisions.

Although the Company believes that its plans, intentions, expectations, strategies and prospects, as reflected in or suggested by those forward-looking statements, are reasonable, it can give no assurance that these plans, intentions, expectations or strategies will be attained or achieved. Furthermore, actual results may differ materially from those described in the forward-looking statements and will be affected by a variety of risks and factors that are beyond the Company's control, including, without limitation, those contained in Item 1A, Risk Factors, of its Annual Report on Form 10-K for the year ended December 31, 2017, which will be filed with the SEC on March 1, 2018, and in its other SEC filings.

The Company assumes no obligations to update publicly any forward-looking statements whether as a result of new information, future events, or otherwise.

Additionally, on this conference call, the Company may refer to certain non-GAAP financial measures, such as funds from operation and cash available for distribution. You can find a tabular reconciliation of these non-GAAP financial measures to the most comparable current GAAP numbers in the Company's earnings release and separate supplemental information package on the Investor Relations page of the Company's website at ir.easterlyreit.com.

I would now like to turn the conference call over to Darrell Crate, Chairman of Easterly Government Properties.

Darrell W. Crate:

Thank you, Lindsay. Good morning, everyone, and thank you for joining us for the fourth quarter conference call. Today, in addition to Lindsay, I'm joined by Bill Trimble, our CEO, and Meghan Baivier, our CFO and COO.

Easterly continues to strengthen its edge in the sourcing, underwriting and servicing of mission-critical real estate leased to the United States Government. We continue to execute on our proven strategy of building a strong portfolio of leased assets that are backed by the full faith and credit of the strongest credit in the world. Our expanded access to equity and the various debt capital markets supports our proven acquisition strategy and allows for us to be a leader in the development of premium assets that support the mission of the respective agency.

Our goal is to accretively scale our business, as we have done in the past. We believe consistently executing in this way will deliver a very attractive risk-adjusted return opportunity for our shareholders. For example, in 2017, we completed four accretive acquisitions, including two larger flagship assets that added meaningful scale to the portfolio. We've grown our development business by adding two new projects, both of which will provide the Company with brand new 20-year lease terms upon completion. We issued equity accretively in the Company's second successful public offering since IPO, as well as through a newly in-place ATM program. Additionally, we cultivated strong and committed partners in the unsecured private placement and secured mortgage markets, while meaningfully extending the duration of our liabilities and locking in our interest costs. We grew our base, executed our stated strategy and positioned the Company for growth.

In all, 2017 has been another strong year for the Company. It gives me great pride to serve as the Chairman, and I would like to thank our team for their hard work and our shareholders for their valuable partnership throughout the years. We look forward to continuing to generate value in 2018.

With that, I'll turn the call over to Bill Trimble to provide color on the initiatives in Easterly that drive shareholder return.

William C. Trimble:

Thanks, Darrell, and good morning. Thank you for joining us for our fourth quarter earnings call. To echo Darrell's previous comments, 2017 was certainly a year of growth for Easterly. Notably, such growth came in the form of four accretive acquisitions. To start, I would like to discuss the property we acquired over the course of the fourth quarter.

I'm very pleased to report the acquisition of the Department of Veterans Affairs outpatient facility in South Bend, Indiana. This new state-of-the-art facility is located just outside of South Bend, Indiana, and is now seeing local veterans on a daily basis. While under contract for some time during construction, we welcomed the highly important, mission-critical facility into our growing portfolio in November of 2017. As a reminder, the VA South Bend outpatient clinic is very similar to VA Lorna Linda, but on a smaller scale, of approximately 86,000 square feet. The outpatient facility is leased to the VA for an initial 15-year term, non-cancelable. With this acquisition, Easterly now owns two new highly-advanced, Class A VA outpatient facilities, totaling a combined 414,000 square feet of leased space, all backed by the full faith of the U.S. Government.

Turning to development, we are pleased to announce our third active development project located in Tracy, California. Easterly has acquired the rights to a lease award for the redevelopment of an approximately 210,000 square foot Federal Emergency Management Agency, or FEMA, distribution center, one of eight regional distribution centers strategically located throughout the country. The future Tracy location will be a single-story, mission-critical facility that sits on just over 19 acres of land and includes a blend of office space, warehouse and refrigerated space for full-time cold storage. This regional center will serve the extremely important function of providing supplies and support to U.S. citizens faced with disaster. This project is currently under construction and Easterly's Development Team is working hard towards delivering a final product ready for government occupancy in the fourth quarter of this year. Upon completion, a 20-year, non-cancelable lease will commence with the GSA for the beneficial use of FEMA. With FEMA Tracy, Easterly is now actively managing the development of approximately 333,000 total square feet.

As an update, all three development projects are making meaningful progress.

FDA Alameda, a state-of-the-art, Class A laboratory and office space, is currently under construction. This facility will house three independent laboratories, two chemistry labs and one microbiology lab. The facility will also include district offices, regional management, and district administration and management space. Open investigations will also be housed within the confines of FDA Alameda. At this time, anticipated lease commencement falls in mid-2019.

FDA Lenexa is currently in the design process, as we work with GSA and FDA to finalize drawings. We anticipate this facility will include different departments to include the testing of metals, pesticides, various poisons, dietary supplements, and microtoxins. Like FDA Alameda, FDA Lenexa will be a blend of both laboratory and office space. Given the sensitivity of the materials being tested in our facilities, it's of critical importance that these laboratories are built out to exact specifications and standards, in order to maintain the highest safety measures for the FDA employees that will eventually work in our facilities. At this time, shell construction has an anticipated start date of mid-2018, with planned lease commencement in the second half of 2019.

I'm extremely proud of Mike Ibe and his team for making meaningful strides in building a pipeline of development opportunities that we expect will serve us well for the next several years. Development opportunities are not only accretive, but they also give us longer, valuable leases, many being 20 years in duration, which can provide earnings stability and additional opportunities to effectively manage our liabilities.

Turning to acquisitions, our team is constantly sourcing new high-quality opportunities that mirror our average portfolio size and help drive FFO growth. In fact, with the recent uptick in interest rates, we are actually seeing an expansion in future acquisition opportunities, which we expected would occur. We also expect to see portfolios coming to the market in the near to mid-future. As a reminder, the type of assets we seek, also referred to as our bullseye opportunities, are usually over 40,000 square feet in size, are leased to a single tenant of the U.S. Federal Government, and are often the result of a design build award, where the building was originally constructed for that particular tenant agency. We feel the attributes just described are critical from a re-leasing perspective and help command larger spreads upon lease renewal.

Finally, Easterly, in its long-stated effort to drive towards a 100% annual leased income backed by the full faith and credit of the U.S. Government, decided to dispose of a privately leased cosmetics warehouse, known as Parbel of Florida, last quarter. As you may recall, this is one of three warehouse facilities in the Easterly portfolio leased to a private company and not the United States Federal Government. We view disposition of this non-core asset as a future source of funds, as we continue to find compelling opportunities in our primary field of owning federally leased space. With the disposition of this non-core asset, Easterly Government Properties now derives 99%, rather than 97%, of its annualized leased income from the United States Government.

Stepping back, I really want to thank our team and Board members of Easterly for their effort and dedication to our mission on behalf of shareholders. Since IPO, we've nearly doubled the size of our portfolio with acquisitions and development projects that are squarely in our target universe. We have maintained the average of the portfolio in age and we have matured our capital structure to be well positioned for changes in interest rates, and we have firmly established our reputation as a partner of choice to the United States Government. As the Company's CEO, I'm quite proud of all we have accomplished in the past year. We thank you for your continued partnership as we chart a path for growth in 2018.

With that, I will now turn the call over to Meghan for a discussion of the quarterly results and earnings guidance.

Meghan G. Baivier:

Thank you, Bill. Today, I will review our current portfolio, discuss our fourth quarter and full year results, provide an update on our balance sheet, and share our 2018 guidance. Additional details regarding our fourth quarter results can be found in the Company's fourth quarter earnings release and supplemental information package.

As of December 31, we owned 46 operating properties, comprising approximately 3.7 million square feet of commercial real estate, with an additional 333,000 feet under development. The weighted average remaining lease term for our portfolio was seven years, the average age of our portfolio was 12.1 years, and our portfolio occupancy remained at 100%. In addition, as Bill mentioned earlier on the call, with the disposition of Parbel of Florida, 99% of our annualized leased income is now backed by the full faith and credit of the United States Government.

For the fourth quarter, net income per share on a fully diluted basis was $0.03, FFO per share on a fully diluted basis was $0.32, FFO as adjusted per share on a fully duty basis was $0.27, and our cash available for distribution was $12.1 million. For the full year, net income per share on a fully diluted basis was $0.11, FFO per share on a fully diluted basis was $1.26, FFO as adjusted per share on a fully diluted basis was $1.14, and our cash available for distribution was $45.8 million.

GAAP measures and reconciliations of these non-GAAP measures to those GAAP measures have been provided in our supplemental information package.

Turning to the balance sheet, at year end, the Company had total indebtedness of $579.7 million, which was comprised of $99.8 million outstanding on our unsecured revolving line of credit, $100 million outstanding on our unsecured term loan facility, $175 million of senior unsecured notes, and $204.9 million of secured mortgage debt. Availability on our line of credit stood at $300.2 million. As of December 31, 2017, Easterly's net debt to total enterprise value was 33.4%, and its net debt to annualized quarterly EBITDA ratio was 6.4 times pro forma for a full quarter of operations from VA South Bend. Our leverage has remained conservative, as our total enterprise has grown by 41% in the last year.

For the 12 months ending December 31, 2018, the Company is reiterating its guidance of FFO per share on a fully diluted basis in a range of $1.31 to $1.35. This guidance assumes $350 million of acquisitions and $75 million to $100 million of development-related investment during 2018. The Company's 2018 FFO guidance is forward-looking and reflects Management's view of current and future market conditions.

As previously announced last week, our Board of Directors declared a dividend related to our fourth quarter of operations of $0.26 per share. This dividend will be paid on March 28, 2018 to shareholders of record on March 13, 2018.

Finally, before I turn the call over to the Operator for questions, I would like to step back and recap our 2017 corporate finance milestones.

In 2017, we grew FFO by 4%, while extending the duration of our liabilities and maintaining a well-capitalized balance sheet. Our average debt maturity has been extended by nearly three-and-a-half years, or 77%, to 7.8 years, beyond our average remaining lease term of 7.0. Additionally, one year ago our debt structure was 78% floating and today it is 80% fixed rate. Using the strength of our growing portfolio, we were active in the capital markets to term out our debt, both through the unsecured private placement market and with the secured mortgage on VA Lorna Linda. We raised equity accretively in connection with the announcement of VA Lorna Linda and VA South, that's increasing the liquidity of our stock, and we commenced an active ATM offering program. It's been a great year for the Company and we would like to thank our capital providers for their ongoing partnership.

I will now turn the call back to Melissa for questions.

Operator:

Thank you. If you would like to ask a question, please press star, one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star, two if you'd like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star key.

Our first question comes from the line of Manny Korchman with Citigroup. Please proceed with your question.

Manny Korchman:

Hey, good morning, everyone.

Darrell W. Crate:

Good morning, Manny.

Manny Korchman:

Earlier in the call, you had talked about more, I guess, volume in the marketplace, which was not unexpected, I think was your comment. Have you also seen any changes in pricing, given where rates have gone?

William C. Trimble:

I think that, Manny—good morning, by the way. I think that pricing is probably going to be shifting at some point, as it is at some point going to reflect the changes in interest rates, but right now we're seeing an increase, certainly, a large increase in opportunities, and I imagine that will follow that.

Meghan G. Baivier:

We're capitalized in a way to be able to continue to pursue those opportunities accretively.

Manny Korchman:

Meghan, maybe we'll keep going with you then. When you look at your capital plan for the year, how much equity or common equity, and in what form, whether that's ATM or secondary do you see now?

Meghan G. Baivier:

Sure. So, what I would say is, to frame that, we intend to continue to keep leverage in that six to seven times range, the higher end being in support of our future development opportunities, our in-place development opportunities, and so, as we think about the capital plan, the goal is to maintain that ratio. We have a lot of tools in our toolkit now and would be prepared to use any and all of them.

Manny Korchman:

Great, and a last one for me. It looks like your acquisition guidance went up by $100 million, at the top end, but your actual FFO guidance didn't change. Why is that?

Meghan G. Baivier:

Yes. So, as Bill said, we're seeing a lot of opportunities, particularly, in the current environment coming. We're seeing single assets, small and large portfolios. The primary driver of that is timing, Manny.

Manny Korchman:

Thanks, everyone.

Darrell W. Crate:

Thanks, Manny.

Operator:

Thank you. Our next question comes from the line of Brian Hawthorne with RBC Capital Markets. Please proceed with your question.

Brian Hawthorne:

Hi. For the $75 million to $100 million of development, is that everything that's just commenced, or are you planning to add more developments throughout the year?

Meghan G. Baivier:

Good morning. That is in support of the three developments that we've announced, FDA Alameda, FDA Lenexa and FEMA Tracy.

Darrel W. Crate:

But, I'd add to that, we're always looking at development opportunities that are right in our target group, or what we call the bullseye. We've never forecasted development activity in earnings, it's just not prudent, because these projects can take longer to work through bid and get formulated, but we certainly have a pipeline of opportunities that we're bidding on and we're hopeful, of course, that those are awarded to us sooner rather than later.

Brian Hawthorne:

Are those more of those build-to-suits?

William C. Trimble:

That's all we do.

Brian Hawthorne:

Okay, and then last one for me. The lease expirations, I know last call, you said you expected them all to renew. Has there been any change to that?

William C. Trimble:

No, there really hasn't. I wish I could discuss the leases that we think are in the final stages, but as you recall, we did announce the SSA San Diego, as well as the DEA San Diego warehouse, which had a very nice accretive uptick on its rent, but we look forward to announcing further re-leasing as soon as we are notified ourselves.

Brian Hawthorne:

Okay, thanks.

Operator:

Thank you. Our next question comes from the line of Michael Lewis with SunTrust Robinson Humphrey. Please proceed with your question.

Michael Lewis:

Thank you. It seems like everybody is reading right off my list of questions, but I have a couple more. Back to the question about the acquisition guidance up and the FFO not, it sounds like that's timing related. I was going to guess cost to capital, right, because it sounds like you don't think the equity is cost-prohibitive right here, but the stock price obviously is down, you're not alone in that respect, and of course interest rates are up. My question really is about the cost to capital and how that impacts you guys and kind of filters into your guidance.

Darrell W. Crate:

I think, clearly, you know, markets will be what markets will be, and we have—what we're indicating in our guidance is that acquisition volume is up, opportunities are up, pipeline is more robust. It's just not prudent for us to up our guidance and be trying to amplify expectations at a time where REIT prices and stock prices are moving. But, as has always has been our pledge, is that everything that we do is accretive to shareholders, we feel very good about where the stock price is today. Meghan's done an unbelievable job of giving us access to the different debt capital markets, in addition to continuing to build strong relationships with shareholders, and we believe that shareholders very much understand exactly what we do. As we moved our portfolio to 99% full faith and credit of the U.S. Government, we continue to execute on our strategy, in our bullseye, and it's very clear to investors the value proposition. So, as we bring, you know, what's in our guidance, and maybe even extraordinary portfolios to the market, or development opportunities, we believe that they'll continue to be well received.

Michael Lewis:

Thanks, and then just my second question. The comfort level with the amount of opportunities for you to go ahead and raise the guidance $100 million, is there anything identified within that guidance? Are you expecting to do a portfolio in 2018?

William C. Trimble:

I think there are large portfolios, there are small portfolios that'll probably be in the market soon or later on during the year, and obviously we are going to be a major player and the best-equipped player to do the underwriting, and to be with, we believe, the best cost of capital to take advantage of those opportunities.

Darrell W. Crate:

Again, I think it's silly for us to try and amp up expectations, it's just our job to deliver. What you hear in our comments is that we've spent three years building this Company, from launching in the public markets to having plentiful excess of capital. Again, and I'll say it, our liabilities are longer duration than our leases, which is an enviable position to be in, as folks are thinking about interest rates. All of that was in mind for there to be big opportunities that would emerge. Like you saw this last year, Lorna Linda, that is a significant asset, it's a premium asset, and I think it's a bigger, better scale, higher quality than anything folks imagined in the IPO that we'd be acquiring in such short order. We've positioned ourselves for luck and good fortune, and I hope it comes forward, but, again, it doesn't benefit us at all to be raising guidance or pumping up people's expectations about what we intend to do. We've been very deliberate about just bringing things forward and we continue to want to be positioned that way with our investors.

Michael Lewis:

Sounds good. Thank you.

Operator:

Thank you. Our next question comes from the line of Bill Crow with Raymond James. Please proceed with your question.

Bill Crow:

Hey, good morning, folks. Congratulations on a pretty darn good 2017.

Darrell W. Crate:

Thanks, Bill.

Bill Crow:

On the acquisition front, how large a portfolio do you think you could get your arms around? Are we talking about—

William C. Trimble:

It just depends on the size. I think we've proven in the past that we can—when we did the combination of Mike Ibe's Western Devcon portfolio, that was 14 buildings that were done in less than a quarter, with the underwriting. So, whatever may appear out here, I think we will be well positioned to analyze it, and if it comes and is accretive, we'll buy it.

Bill Crow:

Do you anticipate that a portfolio transaction would be priced at a higher or lower cap rate than your one-off deals?

William C. Trimble:

I think it depends.

Meaghan G. Baivier:

Yes.

Darrell W. Crate:

There's no clear answer. Obviously, these may be different than other REITS. As you know, most of our sellers are, believe it or not, individuals, folks who finance these things in the private market, so they all need a tailored solution to what we buy, how we buy it, what we're going to do with it, and so that's why we just try to keep it simple and say our pledge is to be accretive. We've stated one of our key strategic goals is to scale this business. It's not lost on us that REITs of larger scale, attract lower cost to capital. We're, again, in a range of cost to capital that we think is very attractive relative to the opportunities that are presented in the market, so we can sustain ourselves this way as far as the eye can see, but we think there's more, and so we will pursue—we have the manpower, the skill, the expertise, in order to digest really anything of any size, and we want to be able to do that in an accretive way, just as we've done in the past.

Bill Crow:

Great. I have two other questions here. The latest development deal that you announced, you said there was refrigerated storage section. It sounds like a little bit more of a complex warehouse distribution center. Will you be responsible for ownership and maintenance of the equipment? How is that structured within the lease terms?

William C. Trimble:

Actually, it'll probably be one of our least sophisticated buildings in development right now. When you're running the laboratories, you're dealing with, I mean, incredible systems for air handling, different water filtration, and so on and so forth. This facility would not be particularly complex. Obviously, we have top-rated engineers that can handle that property management, so it'll be normal course.

Bill Crow:

Okay. Then, finally, I think you've got 18/19% of your rents rolling through '19. It's really the first opportunity for us to see the spreads at re-leasing. You've had great success historically. If you just kind of look in aggregate, just remind us on what sort of rent roll-ups we should expect to see over the next year or so.

William C. Trimble:

Well, I think, as we've said in the past, obviously, in our bullseye properties, and those are the build-to-suit opportunities, we expect to see sort of in the high teens, and that's what we have delivered in that area. As you are in more plain vanilla office space, they're going to have probably closer to market sort of rolls, which we have said in the past. But, I will say that, as far as we know, everything is on track and doing well, and we look forward to announcing the re-leasing when it occurs.

Bill Crow:

Great. That's it for me, thank you.

Operator:

Thank you. Ladies and gentlemen, as a reminder, if you would like to join the question queue, please press star, one on your telephone keypad at this time.

Our next question comes from the line of Jon Petersen with Jefferies. Please proceed with your question.

Jon Petersen:

Great, thanks. A question on the FEMA Tracy development, and just kind of how we should—as we're kind of building our models, how we should be thinking about that. It's a redevelopment opportunity. I guess I'm curious if there's any NOI being received on it now, or kind of in the near term, is it a drag until it comes back online in the second half of 2018. I'm trying to think about what the impact is to earnings over 2018 on that project specifically.

Meghan G. Baivier:

Good morning, Jon. So, FEMA Tracy, currently under development, would not generate rental revenue and NOI until it does come online, but obviously the project is not speculative in anyway. We will be financing it through 2018, and it will cash flow commencing late in 2018.

Jon Petersen:

I guess, can you give—you didn't give an acquisition price, but can you give us any kind of understanding on how much—kind of a breakdown into how much you paid upfront versus how much is left to spend on the property?

Meghan G. Baivier:

The total project currently, we would expect to be in the range of about $45 million. As we acquired it already in process, we've put approximately $15 million to date into that project.

Jon Petersen:

Got it, and can you remind us when the FDA lab in Lenexa comes online?

Meghan G. Baivier:

Lenexa, that would be the back half of 2019.

Jon Petersen:

Okay, and then just one other quick question. On your income statement, I noticed that real estate taxes were up about $1 million sequentially. Is there anything one-time in there, unique?

Meghan G. Baivier:

No, there's nothing unique in that. Occasionally—you know, recall, there's typically an equal offsetting reimbursement line item when we may have a true-up in real estate taxes in a particular quarter, but, no, there's nothing out of the normal there.

Jon Petersen:

All right, sounds good. All right, that's all for me. Thank you, appreciate it.

Darrell W. Crate:

Thank you.

Operator:

Thank you. Mr. Crate, there are no further questions at this time. I'll turn the floor back to you for any final comments.

Darrell W. Crate:

Great, thanks. Thank you, everyone, for joining Easterly Government Properties Fourth Quarter Call. We, obviously, appreciate your interest and your support, and we look forward to continuing to build a very high-quality portfolio of leases backed by the full faith and credit of the U.S. Government in our effort to deliver strong compounding returns to shareholders going forward. Thanks very much.

Operator:

Thank you. This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation.