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Easterly Government Properties Inc.

Third Quarter 2016 Earnings Conference Call

November 8, 2016

CORPORATE PARTICIPANTS

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

Darrell Crate, *Chairman of the Board of Directors*

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

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

CONFERENCE CALL PARTICIPANTS

Jill Sawyer, *CitiGroup*

Michael Carroll, *RBC Capital Markets*

Jon Petersen, *Jefferies*

Tom Purcell, *Lake Trail Capital*

PRESENTATION

Operator:

Greetings and welcome to the Easterly Government Properties Third Quarter 2016 Earnings Conference 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.

It is now my pleasure to introduce your host, Ms Lindsay Winterhalter, Vice President, Investor Relations and Operations. Thank you, Ms Winterhalter. You may begin.

Lindsay 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 plan, 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 end December 31, 2015, filed with the SEC on March 2, 2016, and its other SEC filings.

The Company assumes no obligation 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 the Board of Easterly Government Properties.

Darrell Crate:

Thanks Lindsay. Good morning everyone. Welcome and thank you for joining us on our third quarter 2016 earnings call. Today, in addition to Lindsay I am joined by Bill Trimble, our CEO, and Meghan Baivier, our CFO and COO.

Easterly Government Properties successfully remains the only internally managed public REIT focused on owning properties that are leased solely to the United States Federal Government. Our portfolio is young. The average age of our buildings is 12.1 years. As you know, our leases are backed by the full faith and credit of the US Government. We believe the age and quality of our portfolio provides us a platform for strong recurring cash flow well into the future.

As we turn to the quarter, we are pleased with the quality and mission criticality of the three recently acquired portfolio properties, DEA Birmingham, FBI Birmingham, and EPA Kansas City. We're also thrilled to initiate our development arm of the business with the steady progress of our FDA Alameda laboratory project.

We have a definable edge in the development of US government build-to-suit projects. In addition to strong portfolio management and acquisitions, development provides an additional opportunity to support our long-term FFO growth objective of greater than 5%.

As the size of our portfolio continues to grow and development becomes a larger focus for the Company, I am confident that we have an exceptional team capable of executing with precision and skill. We believe our team's experience in sourcing, developing and managing the US government leased properties is unparalleled. Our team has over 100 years of GSA experience, which makes the complicated and specialized language of federal leasing all but second nature to us. Understanding the leasing requirements, coupled with the superior strength of our acquisitions and development team equates to a truly exceptional firm where the company as a whole is greater than the sum of its parts.

I'm also happy to report our balance sheet remains lowly levered and we expect it will continue to support our earnings growth strategy. Long-term debt markets remain an attractive source of capital and as you've seen through our seven-year term loan execution and related swaps, we remain focused on our liabilities and taking advantage of historically low interest rates. With the efforts this quarter, our balance sheet is reset with the remaining term of our leases at 6.3 years which matches the duration of our liabilities which are also at 6.3 years.

I'm proud of the team at Easterly having exceeded our previously stated goal of delivering between $75 million and $125 million of acquisitions in 2016. While we already have met that goal, we have not taken our foot off the gas and continue to strive for future acquisitions that can produce strong earnings growth for our shareholders year over year.

Now I'll turn the call over to Bill to provide additional information on developments within Easterly that drive shareholder return.

William Trimble:

Thanks Darrell, and thank you everyone for joining us this morning. First I would like to discuss the properties we acquired over the course of the third quarter. I am very pleased to report the acquisition of three of the four properties we had previously announced as part of Easterly's first portfolio acquisition since the IPO. The fourth property, the FBI Albany Field Office, is expected to close in the fourth quarter of this year. These four properties, FBI Birmingham, DEA Birmingham, EPA Kansas City and eventually FBI Albany, all fall squarely in line with Easterly's goal of acquiring only mission critical properties for agencies that serve essential functions for the US federal government.

Beyond the acquisition of these existing assets, I am also delighted to report that we are progressing on our first development property, which is a fantastic 66,000 square foot build-to-suit laboratory for the FDA in Alameda, California. We have a 20-year lease already signed with the GSA which will go into effect upon completion of the development. This lease was signed before we even put a shovel in the ground, eliminating speculative risk.

The Acquisition team continues to source and underwrite on and off market opportunities that fit our strict set of requirements. As previously mentioned, our standards are very high when it comes to property acquisition and our team seeks out the best for our expanding portfolio. Additionally, our Asset Management team continues to provide excellent service to our existing government tenants by leading a number of exciting new value-add projects funded by the government.

In the third quarter, our Asset Management team had 17 active projects to improve the everyday performance and functionality of the property for our government tenants. By doing this we are not only improving the underlying asset but we are also working to ensure continued tenant satisfaction, mission support and strong relationships for years and decades to come. So projects like the enhanced Visitor Screening Facility at the FBI Field Office in Little Rock, Arkansas, which provides accessed controls to those entering and exiting the property create tremendous value for both the government and our shareholders.

As previously mentioned, our acquisition pipeline remains robust as we review single facility as well as multi-facility portfolios as a means of future growth. To reiterate our stated building requirements, we look for properties that are leased to a single tenant of the US federal government, are build-to-suit and mission critical for that current tenant and are usually over 40,000 square feet in size. We feel these properties, tenants and agency missions are less susceptible to political whims or trends and will remain relevant to the core functionality of the US government for many years. We will continue to remain diligent in these search efforts while focusing on properties that fit our defined bullseye.

I will now turn it over to Meghan for a discussion of the quarterly results and earnings guidance.

Meghan Baivier:

Thank you Bill. Today, I will touch upon our current portfolio, discuss our third quarter financial results, provide an update on our balance sheet and review our 2016 guidance. Additional details regarding our third quarter results can be found in the Company's third quarter earnings release and supplemental information package.

As of September 30 we owned 41 operating properties comprising nearly 3 million square feet of commercial real estate. The weighted average lease for the portfolio is 6.3 years and our portfolio occupancy remains at 100%. In addition, 97% of our annualized leased income is backed by the full faith and credit of the United States government.

For the third quarter, FFO per share on a fully diluted basis was $0.30. FFO, as Adjusted per share on a fully diluted basis was $0.29, and our cash available for distribution was $11.2 million. Descriptions of these non-GAAP measures and reconciliations to GAAP measures have been provided in our supplemental information package.

For the 12 months ending December 31, 2016, the Company is reiterating its expectations for FFO per share on a fully diluted basis in the range of $1.19 to $1.23 per share. This guidance assumes acquisitions of $160 million in 2016, which includes the five properties acquired to date, the closing of FBI Albany in the fourth quarter of 2016 and additional acquisition volume of approximately $10 million. This guidance does not contemplate dispositions or additional capital markets activities beyond the settlement of the Company's forward equity sales contracts entered into during the second quarter.

You will note that our 2015 acquisition volume of approximately $170 million and the 2016 estimate of approximately $160 million is ahead of our previously stated $75 million to $125 million annual target. As we look to 2017, we feel comfortable with this heightened range of $150 million to $200 million.

Turning to the balance sheet, at quarter end we had $207 million outstanding on our revolving line of credit and total debt of $288 million. Availability on our line of credit stood at $193 million. In terms of leverage, net debt to total enterprise value was 25%. At the end of the quarter, the Company entered into a $100 million seven-year unsecured term loan facility with a 180-day delayed draw period. Subsequent to the quarter end, we entered into forward-starting interest rate swaps with an aggregate notional value of $100 million to effectively fix the interest rate on future drawdowns under the term loan facility at a rate of 3.12% annually based on the Company's current leverage ratio. The forward swaps have an effective date of March 29, 2017 and extend until the maturity of the term loan on September 29, 2023.

As of September 30, 2016 on a pro forma basis, fully drawing the term loan and using all of the proceeds to repay a portion of the borrowings on the Company's revolving credit facility would have extended the Company's weighted average debt maturity to 6.3 years, in line with its weighted average remaining lease term. It would have also taken the Company's percentage of fixed rate debt from 23% to 58% and increased availability on our line of credit to $293 million.

Finally, as previously announced this week, our Board of Directors declared a dividend related to our third quarter of operations of $0.24 per share. This dividend will be paid on December 22 to shareholders of record on December 7.

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

Operator:

Thank you. We will now be conducting a question and answer session. 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 would 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 keys. One moment, please, while we poll for questions.

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

Jill Sawyer:

This is Jill Sawyer here with Manny.

Meghan Baivier:

Good morning, Manny.

Jill Sawyer:

Hey, Meghan.

Meghan Baivier:

Good morning, Jill.

Jill Sawyer:

Just to get a picture, I'd like to ask about the Company's overall strategy. How you see DEA in like one or two years from now in terms of overall size and how you're thinking about development versus acquisition over the next year? Also, in relation to that, do you foresee any change in your strategy depending on today's election outcome with one candidate versus the other?

William Trimble:

Good morning. It's Bill Trimble. First of all, I think from a standpoint of development we are beginning to see—we have a number of lines in the water. We're beginning to see more opportunity, certainly on the development front, as the federal government basically did not do anything during the 2008 until about 2012 timeframe, and I think we'll see more opportunities in the future, like we're seeing with our current FDA Alameda project, which is a wonderful opportunity to buy a property, to own a property with a 20-year lease with a mission-critical portfolio.

I'd say from a standpoint of our acquisitions pipeline, it is very robust at this point. I think you will see us continuing to look at more opportunities in portfolio acquisitions beyond just single assets, and I think you'll continue to see us look for more development opportunities as we go forward.

Darrell?

Darrell Crate:

I'd say, just taking a five-year look at the Company—as I said in my comments, our sort of foundation threshold for growth is, if you were to draw a straight line out five years at a 5% FFO growth, we believe through portfolio management, through acquisitions and development, that's the trajectory. We're going to do that by assembling the highest quality US government federal leases. We don't need to take on any disproportionate risk. We believe that shareholders will achieve the most attractive premium over time as we scale with this high-quality portfolio. Today, we certainly note that our dividend yield is high-5, relative to a similar duration government security which is far lower and that arbitrage we believe will be recognized as we grow over time. So, delivering shareholder growth, doing that with pristine assets, and just continuing to execute consistently, we believe will get us to a place where shareholders reap rewards.

Jill Sawyer:

Great, thanks for that. One last one for me. How are you feeling about your upcoming lease expirations with the GSA? Have you started negotiations with them on renewals and are these below market?

William Trimble:

First of all, we are very confident in everything on the radar screen right now. We have one property in ’16 that we’re in active discussions and expecting no surprises there at all. In ’17, we have basically four-and-a-half renewals. One building is coming up. We’re in discussions on three of those properties right now. The final one, we have not begun discussions but we are expecting no surprises at all. In ’18, we have two projects including the Fresno renewal. We’re gratified with how the IRS seems to be behaving right now in the Fresno real estate market, and, to mention again, we are building in Fresno but the IRS that handles compliance, which we believe is a long-term important mission of the United States federal government and we certainly believe our building is well suited for that mission. So, I would tell you that I think of the 14.9% annualized leases we’re looking at, and 13% of the total square footage rolling between now and the end of ’18, we are fairly confident that everything will renew as anticipated.

Jill Sawyer:

Okay, great. Thanks, guys. That’s it for me.

Operator:

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

Michael Carroll:

Yes, thanks. Good morning. Can you guys give us some color on the health of the current investment pipeline, how many deals are you actively working on right now and what agencies are in those properties?

William Trimble:

Michael, I’m not going to give you exactly what we’re working on, but I will tell you that we have never seen more in our active pipeline since we went public. We are looking at those mission-critical agencies that we’ve talked about before. We think that’s very important. It’s a differentiating factor for us. We are very busy right now analyzing a number of different opportunities and look forward to announcing them in the coming years.

I will say one thing that we are extremely interested in are the new VA opportunities, as I’ve mentioned several times before. The Veterans Administration is doing a nationwide building project for outpatient clinics, of all sizes. We think is going to be an important opportunity certainly in the years and decades to come, as our service men and women deserve the best and possible care, and these needs will be lasting well beyond anybody on this call, and probably in the working world. So, we think that’s an area that we will be talking about more in the near future.

Michael Carroll:

Again, the incremental $10 million of acquisitions in the guidance, I’m assuming that has already been identified. Are you guys working on closing that deal soon?

William Trimble:

I would say that yes is the answer.

Michael Carroll:

Okay, and then I guess last question. Can you talk a little bit about your—I guess your financial plans? Can you talk about when do you plan on terming out the remaining $100 million on the line of credit? I mean, should we expect another unsecured term loan offering, or is this going to be done by equity? What's the plan with that?

Meghan Baivier:

Yes, I'd say a couple things, Michael. Our focus will be to continue to manage the duration of our liabilities as we continue to grow the portfolio. We're actively in dialogue with multiple sources of debt capital available to us and expect to optimize those sources of capital as we go forward. We've discussed our long term leverage targets and that has not changed.

Michael Carroll:

Okay, great. Thank you.

Operator:

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

Jon Petersen:

Great, thank you. I just wanted to follow up. I know you said on the lease expirations in 2017 and 2018 that you're fairly confident that 100% of those will renew, which is great, but in terms of the rents, I don't think you answered whether or not those rents are kind of below or above market, just given the percent of revenue versus square footage (inaudible).

William Trimble:

I will tell you we are fairly confident that we will do well on them. I think it would be a mistake, while we're in active negotiations with the federal government to be discussing what we're expecting for our rent at that time, but I don't think we're expecting any surprises from our side.

Jon Petersen:

Okay, but maybe another way that would kind of just help me do my own math on it is when were these leases originally signed? Are these five-, 10-, 15-year leases that are expiring? How long have they been in place?

William Trimble:

They're basically 10- to 15-year leases that are expiring.

Jon Petersen:

Okay. So, it's been a while since the rents have reset.

William Trimble:

Mm-hmm.

Jon Petersen:

Got it. Then, I guess in the acquisition world, I was just curious if you've seen any movement on cap rates in your target niche?

William Trimble:

I'd say that we've been fairly consistent with where we've been our buying our properties, between 6.75 and 7.25, but there's a lot of opportunities we think that may be below some of those prices, as well. So, obviously, there are about 500 buildings in the bullseye. We are confident that we can continue purchasing properties where we've indicated, but we think there's some big opportunities down a little bit from where we are right now.

Jon Petersen:

Okay, great, and then maybe compare the yields on build-to-suit versus acquisitions? How much of a premium do you get doing build-to-suit?

Meghan Baivier:

Yes, we look for a 25- to 50-basis-point premium on those development opportunities which we think is quite attractive given that we have a signed lease before a shovel goes in the ground.

Darrell Crate:

I think we can't that say enough, which is a development opportunity, i.e., we've got to come up with a different nomenclature, because it's not development. We are delivering a building to a signed lease that's 100% occupied, and that lease is a 20-year, full-facing credit lease for the United States government. So, we really do have an edge in making that happen, and the degree to which we can tailor that building for the US government, that's very attractive for shareholders.

Jon Petersen:

Okay, and I guess with the election being today, I'm just kind of curious, with your relationships with the GSA, is there a decent—you said the acquisition pipeline seems to be pretty large, and I'm curious, on the build-to-suite side, if the agencies you're talking to that are—tentatively have a lot of projects they're planning on but are kind of waiting until we get past November 8th election, I guess January 20 next year to (inaudible).

William Trimble:

No, I think it's a very long-term—not surprisingly with the federal government, a very long-term process, but I will reiterate, I think the last eight years has been very difficult for build-to-suit projects because you've had I think a government that has been fairly locked up, so I think we've probably seen the worst behind us. I think there's certainly been plenty of discussion in this campaign. The one thing that the two candidates have agreed on has been an increase and need for federal infrastructure where it's important, and if you really think about what we are providing, it is federal infrastructure. So we would be fairly sanguine about the prospects for build-to-suit projects going forward.

Jon Petersen:

Okay, sounds good. Thank you.

Operator:

Thank you. Our next question comes from the line of Tom Purcell with Lake Trail Capital. Please proceed with your question.

Tom Purcell:

Hi, I just had a couple quick questions. The first was—there was an earlier question just on the medium-term growth rate and I missed the answer. I was just wondering, just in terms of FFO and AFFO, what your thoughts are medium-term.

Darrell Crate:

Thanks, Tom. So, what I had said is that our foundations were sort of minimum level for FFO growth that we aspire to, is 5%. When we originally took the Company public, we acknowledged to investors that as we had looked across the industry and looked at growth rates, we noted that REITs that grew 6% to 8% on a compound basis in FFO and provided dividends that were in the 4% range really were top decile performers and had done the best job for shareholders, and so obviously, we understand those numbers. We believe we have a strong opportunity in front of us. I think what makes us behave a little bit differently than other REITs is we're not just driving for AUM, but we're driving for earnings growth and we believe that that will deliver—that makes us a strong steward for capital and advocate for shareholders. As we look forward, that feels like, given the opportunities that we have and our size, that we can sustain that level of growth for a long period of time.

Tom Purcell:

Thanks. In the slide show, you've got a slide that talks about high renewal rates, and you have a bullet point on renewal spreads which historically have ranged about 18% to 26%. Without speaking about current buildings that you're in negotiation on, if you could give some idea of where spot rates are versus in-force rents and whether that renewal spread today looks to be consistent with history.

Darrell Crate:

Well, I think the important factor there is also the type of building that you're looking at, and it depends on which ones are renewing. Obviously, the build-to-suit, which are the bigger part of our portfolio, are going to be much more based on replacement cost, which we think is exceeding inflation, so we're fairly happy about where that's going to head. Obviously with the smaller buildings, that's going to be dependent on—they're shorter term lease renewals, and so you'll probably won't see quite as much from those properties, but over the long term I think we're fairly reasonable as to what we said before as to where they'll renew.

Tom Purcell:

Great, that's all I had. Thank you.

Darrell Crate:

Thank you.

Meghan Baivier:

Thank you.

Operator:

As a reminder, if you would like to ask a question, please press star, one now. 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 keys. One moment, please, while we poll for more questions.

If there are no further questions, I would like to turn the call back over to Mr. Crate for closing remarks.

Darrell Crate:

Great. Thank you everyone for joining us today. We look forward to continuing to build the highest quality portfolio of US government federal leased assets. We feel like we've got the resources and we absolutely appreciate your support in understanding and learning about the Company and following us in our growth. Thank you.

Meghan Baivier:

Thank you.

Operator:

Thank you. This does conclude today's teleconference. You may disconnect your lines at this time. Thank you for your participation and have a wonderful day.