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Easterly Government Properties, Inc.

Fourth Quarter 2018 Earnings Conference Call

February 28, 2019

CORPORATE PARTICIPANTS

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

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

Jill Sawyer, *Citigroup*

Michael Carroll, *RBC Capital Markets*

Merrill Ross, *Boenning & Scattergood, Inc.*

Jon Peterson, *Jefferies*

PRESENTATION

Operator:

Greetings and welcome to the Easterly Government Properties Fourth Quarter 2018 Earnings Conference Call. At this time, all participants are in a listen-only mode. A brief question and answer session will follow the presentation. If anyone should require operator assistance during the conference call, 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 Lindsay Winterhalter, Vice President, Investor Relations. Thank you. 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 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, 2018, which will be filed with the SEC on February 28, 2019, and in 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 Operations 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 this fourth quarter conference call. Today, in addition to Lindsay, I'm joined by Bill Trimble, the Company's CEO, and Meghan Baivier, the Company's CFO and COO.

We're very pleased with the accomplishments of 2018. While we delivered a strong dividend to shareholders, we also materially advanced many of our long-term, strategic goals. As we shared at the beginning of the year, our goal is to scale the portfolio while adhering to our discipline of all deals being accretive. While much of our work was realized at the end of the year, run rate NOI increased by 32%. We are now in a position operationally where we can achieve significant growth without a commensurate increase in overhead costs, as you would expect from a REIT that has achieved scale.

As you'll recall, scale is important because it gave us the platform to bid credibly on the pipeline of development projects that are forecast over the next decade. We are pleased to have developed a cadence of delivering a project a year with FEMA Tracy in 2018, FDA Alameda in 2019, FDA Lenexa in 2020.

Development is the most accretive way to deploy our capital. Through development we have the greatest opportunity to add value to the government in assisting them through facility design to accomplish their mission. This partnership with the government continues to grow as we work together and develop even greater insights into their needs.

Further, our acquisition engine continues to deliver. As we grow, the number of high quality buildings we can source and acquire remains reasonably constant. We are very intentional about not lowering the quality bar to increase acquisition volume, however, our scale has positioned us to be able to acquire larger portfolios without derailing our everyday activities.

We also made progress on both sides of the balance sheet. Despite a year going by, we increased the duration of our leases and maintained our cost of debt in a rising rate environment. The duration of our liabilities continues to be in line with the average remaining lease term, reducing the effect of rising treasuries on the NAV of the portfolio.

As everyone on this call is aware, the end of 2018 and the beginning of 2019, the country experienced the longest shutdown in U.S. history. Even in times of political impasse, we are happy to report we received every single rent check owed to us by the federal government during this prolonged partial government shutdown. Easterly's strategy continues to be singularly focused on the strength and security of long-term stable cash flows. This strength and stability were proven during this government shutdown as the primary tenant continues to have never defaulted on a single lease payment in its long history of rental obligations. Hence, we can say that we have the highest quality credit revenue stream in the REIT universe.

With that, we're very proud of the work accomplished in 2018 and we remain excited about the opportunities to continue to grow the portfolio and deliver strong economic results in 2019 and beyond.

In closing, I want to take a moment to thank the Easterly team, the Board, our vendors and bankers for their efforts and support to move us forward materially this year. I would also like to thank our shareholders for their partnership and engagement as we continue to build the premier portfolio of real estate assets leased to the United States federal government.

Now, with that, I'll turn it over to Bill.

William C. Trimble:

Thanks, Darrell, and good morning. Thank you for joining us for our fourth quarter earnings call. As Darrell mentioned, 2018 was a year of significant growth for Easterly. In 2018 we successfully closed on 15 properties, 11 of which came from the 14-property portfolio, accretively growing our portfolio by nearly 40% while maintaining true to our bullseye acquisition strategy. Subsequent to year-end, we also closed on the remaining three portfolio properties. As a reminder, this portfolio had a combined acquisition value of $430 million and is comprised of high quality assets that closely mirror the profile of our existing portfolio.

The acquired portfolio consists of approximately 1.5 million square feet of rentable space, 99% of which is leased with a weighted average lease expiration year of 2022. Additionally, 79% of the assets are build-to-suit construction, meaning the design and functionality of the building was constructed to meet the specific needs of the underlying tenant.

In total, we completed 15 acquisitions for a combined value of $410 million, encompassing 1.4 million square feet of space. We expanded our tenant base to welcome important mission-critical agencies such as the U.S. Department of the Treasury and the Federal Emergency Management Agency, or FEMA. Further, we increased our weighted average remaining lease term over the course of 2018. Our acquisition volume and remaining pipeline has never been more robust. We are constantly vetting opportunities to ensure the overall quality of our portfolio remains strong.

Similarly, acquisitions like VA Golden, DEA Upper Marlboro and Treasury Birmingham highlight the Company's continued ability to source and execute on accretive, marketed as well as unmarketed, one-off transactions.

Turning to development, our team continues to make meaningful progress at our two active development sites, FDA Alameda and FDA Lenexa. Mike Ibe, Vice Chairman and Head of Acquisitions and Development, and the seasoned development team apply their decades of experience in federally leased assets to meet the real estate needs of this important agency within the U.S. government. This expertise was recently demonstrated with the delivery of the FEMA Tracy facility in Tracy, California. We are happy to report that FEMA Tracy is fully operational and meeting the everyday needs of its employees. FDA Alameda is now on track to deliver in the third quarter of 2019, and FDA Lenexa is still expected to deliver in the second quarter of 2020. As a reminder, these non-speculative development projects provide a great opportunity to see increased yields on brand new facilities with long-term lease expirations.

On the development pipeline, we continue to monitor projects of all sizes that could provide us with an opportunity to grow the portfolio while still adhering to our strict underwriting criteria.

Turning to the current portfolio, 2018 was another great year for our Asset Management Team. Our team worked hand-in-hand with the federal government to deliver important mission-fulfilling reimbursable tenant projects totaling over $4.9 million in government investment in our buildings. They are also active in ongoing projects continuing for the beginning of 2019. Opportunities to work with the government to improve our buildings through tenant-funded projects are most welcome by Easterly. This provides us with the occasion to ensure our buildings are still assisting in the fulfillment of important government missions. It also serves as another touch point with the tenant agency and the GSA to make sure that we are doing our best to be strong partners to the federal government, because in reality we are partners with the U.S. government and we work diligently to strategize with and accommodate our tenants and the unique requirements associated with their occupancy.

Finally, it is important to note that since our founding as a private company, environmental awareness has been one of the pillars of our firm. Our tenants, the United States federal government, is at the forefront of requirements for LEED certification for new construction. From our earliest days we have viewed green buildings as an important positive while underwriting purchases. As of today, we have 16 certifications for our facilities, which we believe to be the largest number of single tenant build-to-suit properties leased by any owner to the government. The Company has long been a strong supporter of green initiatives through programs like LED lighting upgrades, LEED certified buildings, LEED certified staff, solar panel upgrades, geothermal heating and cooling, and Energy Star participation. While we are proud of our dedication to these green initiatives, it is not just environmental responsibility that drives us. It is our corporate goal to promote the health and wellbeing of our tenants and employees, support the community in which we live, work and play; provide safe and supportive working accommodations, and learn from the wealth of diversity and experience our team and our Board can offer as we seek to grow a corporately responsible company and act as the good stewards to our investors and the community at-large.

Team building through volunteerism and philanthropy is also extremely important to Easterly. Please visit Easterly's recent undertakings on the Company's website at www.easterlyreit.com under the Corporate Responsibility menu.

While ESG has been an important component of our firm since its founding, we look forward to getting better in every way when it comes to this important mission. Our internal ESG Team, which includes members of the Executive Team, Asset Management Team, Legal Team, and Investor Relations will meet on a recurring basis to seek opportunities to continue executing on this commitment.

To conclude, we are really pleased with the opportunities presented in 2018, and we look forward to executing in 2019 and beyond. This marks a meaningful point in the Company's trajectory and we thank you for joining us on this journey. I thank you for your time this morning and for your continued support and partnership.

With that, I will turn the call over to Meghan to discuss the Company's quarterly and year-end financial results.

Meghan G. Baivier:

Thank you, Bill. Today, I will review our current portfolio, discuss our fourth quarter and year-end results, provide an update on our balance sheet and capital markets activities and discuss our 2019 guidance. Additional details regarding our fourth quarter and year-end results can be found in the Company's fourth quarter earnings release and Supplemental Information Package. GAAP measures and reconciliations of non-GAAP measures discussed on this call to GAAP measures have been provided in our Supplemental Information Package.

As of December 31, we own 62 operating properties comprising approximately 5.3 million square feet of commercial real estate with two additional properties totaling 129,000 square feet under development. The weighted average remaining lease term for our portfolio was 7.6 years. Despite a whole year having passed, that is longer by more than half a year from where we stood at year-end 2018. Impressive.

In addition to growing the duration of our assets, the average age of our portfolio has defied the passage of time and remains young at 12.5 years. Our portfolio occupancy remained at 100%, and finally, 99% of our annualized lease income continues to be 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 $0.01. FFO per share on a fully diluted basis was $0.31. FFO as adjusted per share on a fully diluted basis was $0.29, and our cash available for distribution was $17.1 million.

For the year ended December 31, 2018, net income per share on a fully diluted basis was $0.11. FFO per share on a fully diluted basis was $1.17. FFO as adjusted per share on a fully diluted basis was $1.03, and our cash available for distribution was $54.9 million.

Underlying these financial results was tremendous scaling of our portfolio paired with disciplined growth of G&A and strong management of the balance sheet in the face of rising rates. In 2019, we grew NOI by 22% year-over-year, EBITDA by 24% and FFO by 21%. This FFO growth was generated in part by maintaining a duration of our liabilities that is in line with our assets, and a weighted average cost of debt within 10 basis points of this time a year ago, while the 10-year treasury rose approximately 30 basis points and throughout the year widened out as much as 85 basis points.

Turning in more detail to the balance sheet, at quarter end the Company had total indebtedness of $771 million which was comprised of $135 million outstanding on its unsecured revolving credit facility, $150 million outstanding on its 2018 term loan facility, $100 million outstanding on its 2016 term loan facility, $175 million of senior unsecured notes, and $221 million of mortgage debt. Availability on our revolving line of credit stood at $315 million.

As of December 31, Easterly's net debt to total enterprise value was 41.1%, and its net debt to annualized quarterly EBITDA ratio was 6.7 times. Pro forma for a full quarter of operations from the five properties acquired in the fourth quarter, Easterly's net debt to annualized quarterly EBITDA was 6.6 times.

In 2018, the Company pursued a number of capital markets transactions which have ensured that our balance sheet remains conservative and that the Company has access to capital and capacity to pursue accretive acquisitions and development, which we believe will drive earnings and distributable cash flow into 2019 and 2020.

In June, the Company replaced its existing senior unsecured revolving credit facility with an amended and upsized credit facility consisting of a $450 million revolver and a $150 million senior unsecured term loan. The revolver includes an accordion feature that may provide the Company with additional capacity of up to $250 million for a total amended credit facility capacity of up to $850 million. This is $200 million higher than the Company's prior facility. With growth in our owned portfolio and prospective pipeline of acquisitions in development, over the course of 2018 we have grown our suite of lending relationships, ensuring growth in total borrowing capacity while managing incremental availability. We have also remained conscious of managing our weighted average borrowing costs, and in the fourth quarter we swapped the base floating rate of our new $150 million 2018 term loan to a rate of 2.71% for five years.

In October 2018, we amended our 2016 term loan facility to reduce the interest rate margin applicable to borrowings by 40 to 45 basis points, depending on our leverage, and extended the maturity date by six months to March 2024.

In June 2018, the Company completed an equity offering of 20.7 million shares in conjunction with the announcement of the 14-property portfolio acquisition. The offering consisted of 13.7 million shares offered directly by the Company, and 7 million shares offered on a forward basis at a price to the public of $19.25 per share. The Company expects to physically settle the forward sales agreement not later than

June 21, 2019, and the offering is expected to result in approximately $379 million of total net proceeds to the Company, including amounts previously received.

We believe these four activities—the credit facility upsizing, the 2018 term loan swaps, the 2016 term loan amendment and the equity offering—put the Company in a very strong competitive position going forward. We have increased our borrowing capacity from our banking relationships by $200 million and at year-end had $315 million of available capacity.

We have maintained a healthy duration on our liabilities, in line with our weighted average remaining lease terms. Additionally, we have maintained a predominantly fixed rate structure with a weighted average interest rate of 3.7%.

Finally, the June 2018 equity offering increased liquidity in the stock and put the Company in a position of strength with dry powder to execute on future acquisitions and development.

Turning to earnings guidance, for the 12 months ending December 31, 2019, the Company is maintaining its guidance for FFO per share on a fully diluted basis of $1.16 to $1.20. This guidance, which is forward-looking and reflects Management's view of current and future market conditions, is based on the Company completing $200 million of acquisitions separate and apart from the January 2019 closing of the final three properties in the 14-property portfolio, and completing $75 million to $100 million of gross development related investment in the year.

Additionally, this guidance includes two factors which in combination diminish the Company's FFO per share results relative to the Company's 2018 performance by approximately $0.045 per share on a fully diluted basis. First, positive noncash adjustments to rental income from the amortization of above and below market leases are expected to decline by approximately $2.5 million in 2019. Second, the Company's weighted average shares on a fully diluted basis in 2019 will include approximately 1 million units that are the result of long-term incentive plan grants that were made at the time of IPO.

Pro forma for these two factors, the midpoint of 2019 guidance represents year-over-year FFO per share on a fully diluted basis growth of approximately 4.5%.

Finally, the Company's guidance for 2019 FFO per share on a fully diluted basis represents expected FFO as adjusted per share on a fully diluted basis growth of approximately 6% to 11%. This is due in part to an anticipated year-over-year change in straight line rent and above and below market lease amortization adjustment of approximately $4.5 million. More simply, expected growth in FFO per share due to accounting adjustments is masking growth in FFO as adjusted per share, a metric which is more indicative of expected operating cash flow growth.

We have built an incredibly strong portfolio of assets and in 2019, 6% to 11% of expected growth in FFO as adjusted per share, we believe is indicative of a remarkable year of value creation for investors.

Thank you, and with that I'll turn it back to Jerry.

Meghan G. Baivier:

Jerry, I'll turn it back to you.

Operator:

Thank you. We'll now begin the question and answer session. If you'd 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. One moment, please, while we poll for questions.

The first question is from Manny Korchman, Citigroup. Please go ahead, sir.

Jill Sawyer:

Hey, good morning, everyone. It's Jill Sawyer here with Manny. Bill, going back to the 2019 robust pipeline, could you give us more color on the pipeline? Maybe split into single acquisitions, portfolios and developments?

William C. Trimble:

Yes. I think that first of all we've always I think almost since our founding have had about $700 million in what I call our active pipeline, and then we try and keep a couple of hundred million in much more near-term and that's been fairly consistent.

We saw it begin to turn up last year and I think that was a factor due to interest rates and actually a lot of the initial 15-year lease terms of these buildings because there was a huge boom in federal build-to-suit construction prior to the market turndown in 2008, and so those properties are beginning to roll.

Our guidance is based on single acquisitions, not on large portfolios. There are a number of wonderful opportunities, billions of dollars in the large portfolio universe, but they do take a long time and there are a number of factors that have to come into play in order to execute on those.

From our standpoint, I think it's fairly constant and we've got a terrific pipeline for this year and hopefully we're already filling up in some ways for next year as well.

Jill Sawyer:

Great. On a similar subject, do you think the government shutdown, past or potential shutdown in the future, has any impact on the transaction markets? For example, maybe scares away some of the buyers?

William C. Trimble:

I would say no. I think that we've seen a pretty strong market. I don't think that either party probably is too interested in doing another shutdown here in the near future, but we can—as Darrell mentioned, we consistently got checks through the whole period of time. Obviously there's some minor inconveniences but we really didn't see any impact from a sales situation or an operating situation in those properties.

Jill Sawyer:

Great. That's it for me. Thank you.

Operator:

The next question is from Michael Carroll, RBC Capital Markets. Please go ahead, sir.

Michael Carroll:

Thanks. Bill, can you talk a little bit about those large portfolio transactions? I know that you've previously highlighted that there are a number that are in the market. Do these portfolios typically trade? Do you think that they will trade in 2019? If they do, I guess what type of valuation are you looking at? Is that something that you could potentially pursue, or is that something that is going to come out too high of a valuation that you'll probably be on the sidelines for now?

William C. Trimble:

First of all, good morning Michael. Second of all, I'm not going to comment on what we're going to do this year specifically with portfolios, but I think we have proven certainly with our last acquisition of the 14-building portfolio that was right in our bullseye and very attractive in almost every metric we could think of. There are not so many portfolios out I would like to describe them. We probably have many friends on the phone today but they are known by us and we are in active discussions with them, but I think that you can view the $200 million that we've put out there as pretty much the bread and butter concentrated middle of the bullseye ones and twos that we've executed on in the past, if something comes along that is accretive and fits our bullseye, of course we'll take a look at it.

Michael Carroll:

Okay, great. Then I guess Darrell made some comments about developments and how those generate some pretty attractive returns for you. Can you talk a little bit about what you're seeing out there? Is there any new development projects that you think you can start pursuing in 2019, or should we still expect that you're just going to be completing the stuff that you've already broken ground on?

William C. Trimble:

As I said in my comments, we created this cadence of this project a year. That's indicative of the government sort of loosening the reins on facility—new facility development. We're very well positioned to win our fair share of those developments, and that's what we're anticipating going forward. Again, why we scaled the company was so that we could be in a position to take on some of the larger projects, either that are coming down the pipeline, and we will report to you if we have some good news.

Michael Carroll:

Okay, great. Then I guess finally, Meghan, could you talk a little bit about how we should be modeling G&A? I know that you've added a lot of properties and you've scaled up G&A recently. Has that pretty much done? I mean when you pursue these $200 million of acquisitions, should we be expecting a bigger G&A increase in 2019 too?

Meghan Baivier:

Mike, you're right. We did scale up for the digestion of the 14-property portfolio, so when I look to 2019 implicit in our view of guidance is organizational growth that is far more restrained than NOI growth.

Michael Carroll:

Okay, great. Thank you.

Operator:

As a reminder, if you wish to ask a question press star, one on your telephone keypad. That's star, one.

We have a question from Merrill Ross, Boenning Incorporated. Please go ahead.

Merrill Ross:

Hi, good morning. Thank you. In the lease expiry in 2019, will there be examples of renewals on bullseye properties that can provide further evidence of the value of the future organic growth implied in leasing spreads?

William C. Trimble:

Good morning. Good morning. Absolutely, would be my answer. Yes.

Merrill Ross:

Good. It's helpful to have these indicators of that future value, I think.

Meghan G. Baivier:

Yes. Merrill, as we work with the government to finalize the terms, particularly around tenant improvements associated with these renewals, we look forward to sharing with you details on the outcomes.

Merrill Ross:

Thank you.

Operator:

The next question is from Jon Peterson, Jefferies. Please go ahead, sir.

Jon Peterson:

Great. Thanks. Can you remind us on the equity offering you did last year, there was 7 million on a forward basis? Have you settled any of those so far, and kind of what's the timing on what we should expect there? Then maybe more high level, how should we think about leverage on a debt to EBITDA basis trending throughout 2019?

Meghan G. Baivier:

Hi Jon. No, as of today we have not settled that forward contract. We are looking to sort of time that to ensure our balance sheet maintains in check in the 6 to 7 times range, and would certainly be at the low end of that on settlement of equity.

As we go through the year, the tools in our toolkit, if you will, to help match fund acquisitions should allow us to continue to maintain consistent leverage in the middle point of that range, with the potential slight uptick as we near the end of the Alameda development, and we await for the lump sum reimbursement.

Jon Peterson:

What's the end date upon which you have to draw down those 7 million shares?

Meghan G. Baivier:

We have until June 21 of this year.

Jon Peterson:

Okay. Then just looking at AFFO adjustments, I mean do you have any large cap ex needs, tenant improvements or leasing commissions or anything like that we should be thinking about with some of your renewals this year?

Meghan G. Baivier:

As we look at the portfolio on a maintenance capital perspective, we see expected needs in that range of our previously stated kind of $1 to $1.50 per square foot range.

Jon Peterson:

All right, thank you.

Operator:

There are no further questions at this time. I'd like to turn the floor back over to Mr. Darrell Crate for closing comments.

Darrel W. Crate:

We appreciate you joining the Easterly Government Properties Fourth Quarter 2018 Conference Call. The Company is growing on a foundation of premier assets backed by the full faith and credit of the U.S. Government and we appreciate your continued partnership, and look forward to speaking with you all again soon.

Operator:

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