Easterly Government Properties

First Quarter 2018 Earnings Conference Call

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CORPORATE PARTICIPANTS

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

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

CONFERENCE CALL PARTICIPANTS

Jill Sawyer, *Citigroup*

Michael Lewis, *SunTrust Robinson Humphrey, Inc.*

Michael Carroll, *RBC Capital Markets, LLC*

Jon Petersen, *Jefferies*

Bill Crow, *Raymond James*

PRESENTATION

Operator:

Greetings, and welcome to the Easterly Government Properties First Quarter 2018 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 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 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 this first quarter conference call. Today, in addition to Lindsay, I'm joined by Bill Trimble, our CEO, and Meghan Baivier, our CFO and COO. Easterly remains the only public REIT dedicated to the acquisition, development, and servicing of mission-critical real estate leased to United States Federal Government. Our strategy has remained consistent since IPO: to apply our definable edge in the sourcing, underwriting, acquiring, and servicing of mission-critical facilities leased to and backed by the full faith of the U.S. Government. We work to cultivate a robust pipeline of new assets with a goal of accretively scaling and diversifying our portfolio.

Our predecessor company began as a private equity firm in 2010. From there we built our enterprise while the economy was recovering from financial crisis. Government agencies were financially constrained and plans to expand and modernize were put on hold. In March of this year, we saw Congress pass an omnibus bill which authorized the Federal Government to increase discretionary spending to $1.3 trillion, the highest level in history.

As we look out over the next five years, we believe increased spending will allow for many agencies that are not represented in our portfolio to finally commence a re-missioning of their facilities, which provides a meaningful opportunity for Easterly.

As you have heard us say, we seek to acquire assets that are young and on the right side of the fundamental re-missioning, not obsolete to the operational needs of the agency. We will work to align our capital with agencies that are soundly re-missioned and executing critical functions for the U.S. Government.

This trend can also materially benefit our development efforts. As you have seen, we have been a partner with the FDA as they are in the early stages of a modernization program. We began with a lab in Alameda, California that we expect to come online in the second half of 2019. We won the bid for the lab in Lenexa, Kansas, which we expect will be delivered in the first half of 2020. It is clear that as we work with an agency we can bring our learning of the agency's needs, tastes, and preferences to the agency's next project, which means increased efficiency for all the project partners. FDA is not unique, but an example of how we are sharpening our edge to be the partner of choice for our tenant, the United States Government.

In addition to development, we continue to build our reputation in the acquisition space. We have purchased $713 million of properties since the IPO. We have executed with speed and certainty. This has put us in an enviable position of seeing virtually every property that comes to market in our bullseye and provides us the opportunity to negotiate with each seller. In many instances, our reputation for execution has allowed us to win auctions when we are not the highest bidder.

We have competitive cost of capital, but will continue to not overpay. Many times you've heard us say we do not want to be the elephant in the swimming pool. That statement holds true today just as much as it did at the time of our IPO. We simply will not overpay for the sake of gaining scale. We are a Company based on the foundation of accretive acquisitions and opportunistic development.

That being said, we are now in the fortunate position where we are of the scale where we can responsibly consider the acquisition of large private portfolios of Government-leased assets. We believe there are approximately $2 billion of these assets in portfolios where approximately 85%-plus of the assets are squarely in our target bullseye. Given our cost of capital, both equity and debt, we believe we can win these assets and deliver accretion and diversity to our Investors. We expect this opportunity to play out over the next five years as the demographic trends among the owners will likely cause them to evaluate their strategy for ownership of these assets.

We could not be more pleased in how we're positioned in our areas of growth. Our existing assets are young and aligned with our bullseye. Our edge in acquisition continues to improve and our ability to add value to the Government and to our Shareholders through development is expanding materially.

With that, I'll turn the call to Bill to discuss the specifics of the quarter and to give an update on the projects we are engaged in to build Shareholder value.

William C. Trimble:

Thanks, Darrell, and good morning. Thank you for joining us for our first quarter earnings call. To echo Darrell's previous comments, 2018 is just getting started for Easterly. We maintain an actionable pipeline and are seeing high-quality opportunities, both portfolio and single-asset transactions, that are within our target market bullseye, which allow us to continue to grow our portfolio. We believe a recent uptick in interest rates and increased Government spending will serve as a catalyst for significantly increased future acquisition opportunities, which we had anticipated.

With this strong pipeline, we expect to deliver results for the acquisition and development of accretive, mission-critical opportunities. Further, our definable edge in the sourcing and underwriting of Class A mission-critical acquisitions is clear as we engage in meaningful lease renewals throughout the quarters and years. Because we adhere to our disciplined story, we're pleased to see how this strategy is proving itself for the renewals within the existing portfolio.

As an example, we are gratified to see the FBI remains centered on continuing to serve the enduring mission of protecting the American people. One may expect to see in affect for the next 40 to 50 years. We are also extremely gratified to see our existing tenants consistently partnering with Easterly to ensure our facilities can continue to help the agencies stay relevant and perform mission.

Turning to deal specifics, Easterly is pleased to announce the agreement to acquire its third outpatient clinic leased to the Department of Veterans Affairs, or VA, located in the San Jose, California. VA - San Jose is a reasonably completed outpatient clinic that delivered in the first quarter of 2018. This state-of-the-art facility is leased to the VA for an initial non-cancelable lease term of 20 years through February 2038. This facility will serve the surrounding veteran population by providing services like primary medical care, mental health care, women's health, audiology, speech pathology, podiatry, optometry, and dermatology. The facility will also offer group classes and patient education space for the 67,000 enrolled veterans within the region. We expect to close on this deal in the coming weeks.

With this acquisition, Easterly will own three new highly advanced Class A VA outpatient facilities, totaling a combined 504,000 square feet of leased VA space, all backed by the full faith and credit of the U.S. Government.

Turning to development, as previously mentioned, Easterly has acquired the rights to the 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. Upon completion, a 20-year non-cancelable lease will commence with the General Services Administration for the beneficial use of FEMA. Further, in order to meet the growing operational requirements of FDA, Easterly has recently executed a lease amendment with the GSA to expand the footprint of the FDA Lenexa laboratory. An additional 6,600 square feet of mechanical and office space has been added to accommodate increased operational demands within the building. Easterly welcomes the opportunity to build and deliver further enhanced space to the GSA, which we expect will serve the needs of the FDA for decades to come. With FEMA - Tracy and enhanced FDA - Lenexa footprint, Easterly is now actively managing the development of approximately 340,000 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 shell construction. At this time, anticipated lease commencement falls in the second half of 2019. FDA - Lenexa is currently in the design process as we work with the GSA and FDA to finalize drawings. At this time, shell construction has an anticipated start date of this spring with planned lease commencement in the first half of 2020, and construction of a core shell building and site improvements are currently underway at FEMA - Tracy with an anticipated lease commencement date in the second half of 2018.

As you can see, we're still very much underway on our three development projects. Expected spending is now estimated to be between $50 million and $75 million in total development expenditures this year. As you know, timing around projects can be a moving target as we work with the GSA and underlying tenant agencies throughout the design process, and we look forward to these projects coming online in late 2019 and 2020.

With that, I now wish to revisit the 2018 pipeline. As I mentioned earlier, we are seeing a plethora of actionable acquisition opportunities, both as individual assets and portfolio purchases, which we feel will drive significant earnings growth in the latter half of 2018. Our pipeline has never been more robust and for that reason we are once again increasing our total expected 2018 acquisition volume from $350 million to $450 million, but now heavily weighted towards the second half of this year. Meghan will speak further in her portion of the call; the timing of the acquisitions is the primary driver of our modified 2018 full-year guidance.

Part of what makes Easterly such an attractive buyer in the marketplace is our flexibility in closing. Sellers have many reasons for a delayed closing, ranging from estate planning reasons to 1031 Exchanges, and Easterly has the depth of capital to accommodate those reasons. This accommodation is part of our definable edge in this niche marketplace, which allows us to serve as an attractive buyer to the multitude of sellers of these desirable assets leased to the U.S. Government. We are very much targeting accretive acquisitions that will deliver meaningful scale to the Company in 2018 and expect to see an increased actionable pipeline to provide for that growth.

With that, we thank you for your continued partnership as we continue what we believe will be an exciting year for Easterly.

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 first quarter results, provide an update on our balance sheet, and share our modified 2018 guidance. Additional details regarding our first quarter results can be found in the Company's first quarter earnings release and supplemental information package.

As of March 31, we owned 46 operating properties comprising approximately 3.7 million square feet under ownership with an additional 334,000 square feet under development. The weighted average remaining lease term for our portfolio was 6.9 years; the average age of our portfolio was 12.3 years; and our portfolio occupancy remained at 100%. In addition, 99% of our annualized lease income is backed by the full faith and credit of the United States Government.

Pro forma for the acquisition of the recently announced VA - San Jose, Easterly will own 47 operating properties comprising approximately 3.8 million square feet. The pro forma weighted average remaining lease term for our portfolio would be 7.2 years and the average age of our portfolio would be 12 years.

For the first quarter, net income per share on a fully diluted basis was $0.03; FFO per share on a fully diluted basis was $0.31; FFO as adjusted per share on a fully diluted basis was $0.26; and our cash available for distribution was $11.9 million. GAAP measures and reconciliations of these non-GAAP measures to GAAP measures have been provided in our supplemental information package.

Turning to the balance sheet, at quarter-end the Company had total indebtedness of $577.9 million, which was comprised of $98.8 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 $204.1 million of secured mortgage debt. Availability on our line of credit stood at $301.3 million. As of March 31, 2018, Easterly's net debt to total enterprise value was 33.7% and its net debt to annualized quarterly EBITDA ratio was 6.4 times.

As previously announced last week, our Board of Directors declared a dividend related to our first quarter of operations of $0.26 per share. This dividend will be paid on June 28, 2018 to Shareholders of record on June 11, 2018.

For the 12-months ending December 31, 2018, the Company is modifying its guidance of FFO per share on a fully diluted basis to a range of $1.27 to $1.31 to reflect the Company's target $450 million of acquisition volume being weighted towards the back half of the year. This guidance further assumes $50 million to $75 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.

The Company's acquisition pipeline remains as robust as ever and our revised FFO guidance reflects this. The Company expects to exit 2018 with greater scale and earnings potential than we entered the year with and that our original guidance for 2018 reflected. Furthermore, in addition to our acquisition prospects, our in-process development projects are expected to contribute meaningfully toward our 2019 and 2020 earnings growth.

When we first came public, our promise was to deliver consistent acquisition volume quarter-to-quarter and we have delivered on that promise. We continue to execute on signal-asset transactions; however, our business is bigger than this quarter-to-quarter pattern of execution. To be clear, our strategy has not shifted. The only change we have seen is the increase in opportunities to acquire assets in our bullseye due to the increased scale of the Company. Our in-place portfolio supports a steady dividend and we remain excited by and focused on the opportunities which we believe will drive earnings and distributable cash flow into 2019 and 2020.

With that, I will now turn the call back to the Operator for questions.

Operator:

Thank you. At this time, we'll be conducting a 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 keys.

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

Jill Sawyer:

Good morning, everyone. It's Jill Sawyer here with Manny. With the leverage levels hovering around mid-6s and the $450 million in acquisition guidance, could you just run through your funding strategy and longer-term balance sheet structure and potential appetite for larger equity issuance, especially considering the premium that the stock is trading at?

Meghan G. Baivier:

Hey, Jill, good morning. The strategy with regard to the balance sheet hasn't changed. We're comfortable with leverage levels in the 6 to 7 times on an operating basis, and we have all of the tools in our toolkit with regards to financing our future growth. So, as we continue to grow, those are the guideposts within which we will operate.

Jill Sawyer:

Got it. Thanks. You guys just mentioned that you're planning on closing in the coming weeks on the VA clinic, but could you give us more details on the pricing valuation of that?

William C. Trimble:

Sure. Hey, Jill. Good morning. It's Bill. That would be sort of in the $70 million range for that property, and that was a 20-year initial lease, 100% occupied.

Jill Sawyer:

Great. All right. Got it. Thanks, guys.

William C. Trimble:

Thank you.

Meghan G. Baivier:

Thanks, Jill.

Operator:

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

Michael Lewis:

Thanks. I believe your original acquisition guidance was $250 million. You took that up last quarter. You took it up another $100 million this quarter. It sounds like deals maybe are taking a little bit longer and so in that environment you might expect maybe some stuff spills into '19, maybe you'd be taking that guidance down. Could you talk about the rate at which you're ahead in project acquisitions, potential acquisitions to the pipeline and kind of your confidence in closing this much volume in 2018?

William C. Trimble:

Thanks, Michael. Good morning. I would say that this is a lumpy business. We've been, I think, very good, but also lucky in getting something almost every quarter since we started. As we've gotten larger, and obviously our cost of capital is very attractive, we are seeing larger opportunities. There are reasons that sellers have to move things around. We are confident, however. We would not be raising our numbers unless we thought that there was a good reason to do so, and so we're not really looking at having to move anything into 2019 at this time.

Michael Lewis:

Okay. Thanks. Could you maybe also give a little more color on why the lower development spend this year—I think about $25 million lower—you know, I've heard in other sectors some things about more competition for workers and projects taking longer to develop—is it just a slower process? I don't think you moved back the timeline on anything, so maybe you could just talk about why that spend is going to be a little lower?

Meghan G. Baivier:

Yes. No. The dynamic you speak of, Mike, is not quite the dynamic we work with. Most of the shift in timing is due to just a push out of the design phase of the Alameda and Lenexa. In fact, FEMA - Tracy, if you look at our comments last quarter to this quarter, it's actually being pulled forward. So, it's just the timing of investments. The projects are continuing to grow and what we don't spend in '18 will move into '19.

Michael Lewis:

Thanks. Then lastly for me, do you guys expect the dividend to be covered by cash flow this year? I know the policy has kind of been to keep a tight payout ratio supported by the predictable nature of your cash flows, but it looks especially tight now after the first quarter. Do you think about giving yourself a little more cushion in the future and do you think it's covered this year?

Meghan G. Baivier:

Yes, Mike. We're confident in our dividend and we agree with you on the quality of these cash flows and the ability to sustain a higher ratio.

Michael Lewis:

Okay.

Darrell W. Crate:

Michael, this is Darrell. As we look to these buildings coming online in '19 and '20 and we look at the opportunity for acquisition but also the opportunity to partner with these agencies and grow development, we feel very good about that FFO growth. As we've said, we want that cash that's available for distribution, we want to pay out as much of that to Investors as we can and we think our strategy in our portfolio allows for that to be the case.

Michael Lewis:

Thank you.

Operator:

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

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

Michael Carroll:

Yes, thanks. Bill, can you talk a little bit about what you're seeing in the acquisition market today, and out of that $400 million acquisition target that you laid out, is that largely comprised of portfolio deals and some of those deals are being delayed and that's the reason why the change in the guidance expectations?

William C. Trimble:

Michael, I would say it's a blend of everything that we're seeing out there. We do see everything at this point that becomes available, but I will say that I'm highly confident in that number at this point and I will also say that it will be accretive transactions and that they will all fit, or certainly a super majority will fit, into the bullseye.

Michael Carroll:

Then how do you put together that $400 million target, do you have deals that already identify that you think will close or you just are working on a number of deals and you expect to close 50% of those by the end of the year?

William C. Trimble:

Well, first, I'm going to take you all the way back up to $450 million, and, second of all, I think that, of course, we have identified.

Michael Carroll:

Now, those deals that are identified, are they portfolio deals or individual deals, or just a mix of both?

William C. Trimble:

Michael, they're all of them. We're seeing everything out there and you can be assured that whatever we get will fit nicely into what we've been doing certainly since 2010 and will not be a surprise to the market.

Michael Carroll:

Okay. Then the portfolio deals that you highlighted in your prepared remarks that you're kind of looking at right now, do those usually come to the market or is this just the first time that you were able to think about them given your increased size?

William C. Trimble:

Well, I think, Michael, that we've always—you know, we mentioned when we went public, we have seen a number of opportunities in the market and obviously we're going to wait and find the ones that fit within our very strict criteria, and when they appear, whether they're single, multiple, or larger, we will act on them.

Darrell W. Crate:

Michael, this is Darrell. I mean, obviously what we're trying to communicate in our prepared remarks and will say again and again is that we are—our scale today is different than it was at the IPO. I mean, that sounds so obvious, but we're seeing the benefits of it, which is we can be working on these portfolios and the degree to which they come into the Company. It does not put stress on our books, it doesn't materially change the portfolio, it just contributes to nice growth. We're working on a couple of development projects, but we can do more. We're seeing the opportunity each time that we are working with an agency and work with them again, we have greater clarity on the economics of how projects will work, and obviously that's all about reducing the risk, and there are portfolios out there where—again, we mentioned the demographics of the owners. It's not unreasonable for them to start thinking about is this portfolio—what is their strategy for that portfolio. So, things are aligning very nicely for us, which is the capital and the confidence that we've received from Investors, the quantum of properties and opportunities that are out there, and our scale and our ability to execute.

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 questions.

Jon Petersen:

Great. Thanks. I was just kind of curious on the build-to-suit side, how conversations have trended with the Government recently and kind of it in your time dealing with the GSA. Maybe just kind of along those same lines, the Government passed a budget a few months ago; it's kind of the first time in a long time that they've done that. Are they getting easier to deal with? Is there kind of better visibility for them in terms of their needs? Maybe just kind of some higher-level comments on how those things have trended.

William C. Trimble:

Good morning, Jon. I would say that deal with the Government, obviously a very valuable partner to us and I think we appreciate their important mission. But I would say that they don't necessarily have the ability to predict things out as long as maybe the private sector would be in some cases. But I think this budget did cement what that they were able to focus on some of the things, the backlog of opportunities and missions that they needed to get updated, and this goes back to 2010 basically. So, we believe we're going to start seeing, whether it be additions to our existing buildings or whether it be new projects that they think are extremely important, I think that's going to put sort of a little bit of a wind at our back in that area. With our existing properties, I mean, that's a steady-state sailing well, doing well, so that's really not going to change much except for those upgrades that we see. Obviously in the VA space, that is a fully funded area that will continue to grow for the next 5 to 10 years as they finish out the $62 billion program that they've been acting on.

Jon Petersen:

Is there any rule of thumb to think about in terms of how long after a budget's been allocated until it flows over into the real estate world; is it six months, is it a year?

William C. Trimble:

I would say longer than you could possibly think. I mean, I think it would take longer. I mean, from us it's more of just keeping positive pressure on the overall market that we're ensconced in. But from that standpoint, it's just further good news that I think that we're targeted on the right things and certainly within the mission-critical area. The Government is making up for stuff that they haven't tended to basically since 2008.

Jon Petersen:

Great. All right. Appreciate the color. 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. My question is pretty simple. I'm just curious whether you're seeing increased competition from private investors given some of the challenges we're seeing in other sectors, whether they're fundamental challenges or return challenges based on valuations. I'm just curious whether people are turning more toward your Government-leased, net lease structure.

William C. Trimble:

Good morning, Bill. I would say that the answer, certainly as you pointed out and you asked on the private side, and it's important to point out there is nobody on the public side that we tussle with. From a standpoint of the private side, I would say that we're probably—I feel that we're pulling away from most of those other players because our cost of capital is more attractive. I think the sellers appreciate what we can do. The level of underwritings that we understand exactly what their assets are worth, and they have the comfort to know that when we make a bid we're being very serious on that. I would say that there are several private players out there. We do see them, but I think we tend to beat them whether we're in an auction environment or whether we're in a one-off environment. Scale is important as well and I think we've gotten to a point that our scale is meaningful and allows us to basically transact more efficiently than anybody we're seeing in either market.

Bill Crow:

Some of the new entrants, has that put pressure on you at all?

William C. Trimble:

We don't have any new entrants in the…

Bill Crow:

No private new buyers?

William C. Trimble:

No; no private new players, same old, same old.

Bill Crow:

Okay. But you're not seeing much impact on yields I guess if the playing field hasn't changed; is that fair?

William C. Trimble:

I think that's probably—we're pretty much been a steady-state there right now.

Bill Crow:

Yes. All right. That's it for me. Thank you.

William C. Trimble:

Thank you, Bill.

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. Thank you, everyone for joining the Easterly Government Properties First Quarter 2018 Conference Call. We appreciate your interest and support and we look forward to speaking to you again soon as we continue in our effort to deliver strong compounding returns to Shareholders going forward.

Operator:

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