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Q1 2023 Easterly Government Properties Inc Earnings Call

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Michael Albert Carroll *RBC Capital Markets, Research Division - Analyst*
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PRESENTATION

Operator

Greetings. Welcome to the Easterly Government Properties First Quarter 2023 Earnings Conference Call. (Operator Instructions) Please be advised that today's conference is being recorded.

I would now like to hand the conference over to your speaker today, Lindsay Winterhalter, Head of Investor Relations. Please go ahead.

Lindsay Winterhalter ***Easterly Government Properties, Inc. - Supervisory VP of IR & Operations***

Good morning. Before the call begins, please note that certain statements made during this conference call may include statements that are not historical facts and are considered forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Although the company believes that its expectations as reflected in any forward-looking statements are reasonable, it can give no assurance that these expectations will be obtained 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, as contained in the company's most recent Form 10-K filed with the SEC and in its other SEC filings. The company assumes no obligation to update publicly any forward-looking statements.

Additionally, on this conference call, the company may refer to certain non-GAAP financial measures, such as funds from operations, core funds from operations, funds from operations as adjusted 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 William Crate ***Easterly Government Properties, Inc. - Executive Chairman of the Board***

Good morning, everyone, and thank you for joining us for this first quarter conference call. Today, in addition to Lindsay, I'm also joined by Bill Trimble, the company's CEO; and Meghan Baivier, the company's CFO and COO.

These are transformative times in the real estate market. The office sector is under pressure, plagued by the uncertainties surrounding work patterns of the future. Our decision to concentrate on mission-critical agencies differentiates us from the largest risks facing the office sector, and we're pleased with how Easterly is positioned to create and protect value for our shareholders. We are also grateful to have built a partnership with a capital partner that shares the same long-term vision for value creation.

The forward dynamic is becoming clear, and we are well positioned to grow. Our development opportunities are moving forward at our Atlanta FDA project as well as our pipeline of new potential projects. We also see that there may be development projects that experienced some distress over the coming 18 months, as liquidity dries up for developers with overlevered balance sheets.

Lastly, recall in 2017, when our bullseye acquisition strategy was expanded to include the Department of Veterans Affairs and its recently delivered mission-critical outpatient facilities. We welcomed this new asset class, while remaining true to our goal of delivering value to shareholders through government stability.

Since then, we have kept a close eye on other opportunities, both foreign and domestic. And today, the Easterly team is at the end of another important study period. We have used our time, while seller expectations readjust to identify and underwrite facilities that share the same important attributes and characteristics of our current portfolio.

Our bullseye universe will grow with the discipline our investors have come to expect from us. And there's more to come, and we look forward to keeping you posted, but we believe the growth trajectory at Easterly is changing for the better. This will not happen overnight, as nothing what the government ever does, but we are being deliberate about seeking to create value for our shareholders over the medium and long term.

In closing, we're proud to build a portfolio that is comprised of buildings early in their life with long-dated leases with exceptional credit quality. With bullseye properties, we're uniquely positioned to have that strong visibility to future cash flows for many quarters to come, which, in turn, provides high-quality income to our shareholders through dividends.

With that, I'll turn the call over to Bill to give further insights into our portfolio.

William C. Trimble ***Easterly Government Properties, Inc. - President, CEO & Director***

Thanks, Darrell, and good morning. Thank you for joining us for our first quarter earnings call.

Looking forward several quarters, as inflation continues to show signs of cooling. Easterly will be poised to restart its growth trajectory by acquiring mission-critical assets leased to the United States federal government. We've observed bid-ask spreads in our market begin to narrow, and Easterly is prepared to use our liquidity on hand to accretively grow the portfolio.

In the more immediate term, as the Fed continues to raise rates, we are seeing signs that some developers may be looking for an exit from their recently awarded government construction projects. In these moments, Easterly stands ready.

This is not an unprecedented move for us. Years ago, we were pleased to take over a development project in Tracy, California, whereby we delivered to the government a brand-new, approximately 210,000 square foot ENERGY STAR warehouse for the Federal Emergency Management Agency with a brand-new 20-year lease. These are great opportunities for Easterly, and we believe our balance sheet is superior to many regional developers who may find themselves struggling given the current macroeconomic backdrop.

As we have previously indicated, we are maintaining an active presence in the acquisition market, but we note the market currently suffers from a decline in transaction volume. That said, we remain committed to participating in accretive acquisitions of bullseye properties that meet our strict criteria.

Further, listeners of last quarter's call heard me focus on office sector challenges. The office market has faced yet another struggle since last quarter, this time with the fallout of Silicon Valley Bank and Signature Bank, both casting doubt as to the bank markets' durability.

For that reason, I'd like to spend some more time contrasting Easterly from a typical office business. To reiterate, the Office sector is challenged by several headwinds, including: work from home trends, building occupancy percentages, local market rental rates, subleasing activity and projected layoffs in various industries that might result in real estate downsizing.

And this is really important. None of this concerns us at Easterly. In fact, if we strip away our laboratories, courthouses, VA outpatient clinics and specialty warehouses and focus only on the office aspect of our business, we have seen our facilities heavily occupied throughout the pandemic, which high level of occupancy continues to this day. The government is not at risk of future layoffs and in fact, only grows larger year after year.

And finally, if you look at the single tenant office renewals we have completed from 2020 to today, you will find that we can expect a healthy average rent renewal spread of 23%, with an average term of over 18 years.

To repeat, these are solely Easterly's office renewals from the start of COVID-19 to today. This is a very different situation as compared to the broader office market. We believe these office renewal metrics speak volumes to the Easterly strategy and the mission criticality of our assets.

In addition, it's also worth noting that only 51% of Easterly's annualized lease income comes from office assets. And this number will only shrink when we close on the two remaining VA properties in the previously announced VA portfolio acquisition.

Examples of assets in this office bucket include: 12 FBI field offices, or 31% of our office annualized lease income; 7 DEA regional offices, or 7% of our office annualized lease income. It includes ICE field offices, a specialized weather facility, a Department of Defense Joint Staff Command Center in Suffolk, and I could go on.

While Easterly has no internal aversion to owning highly mission-specific office because of our bullseye investment criteria, we recognize this may be an important statistic for index screeners of our stock. We are categorized in several indices as an office REIT. But when you consider our unique portfolio and mission, we are a category of one, focused on government infrastructure.

Finally, before turning the call to Meghan, our asset management team started the new year strong and executed a lease renewal at our courthouse in Jackson, Tennessee, for a brand-new 20-year term. We have several great assets up for renewal in the near term, and I look forward to keeping you updated on our progress.

In closing, there are opportunities in the horizon, and we believe Easterly is well positioned to take advantage of these prospects when the moment is right. With a solid NOI supporting our platform, we hope our listeners today appreciate the distinction between us and our office brethren.

With that, I thank you for your time this morning. And I'll turn the call over to Meghan to discuss the quarterly financial results.

Meghan G. Baivier ***Easterly Government Properties, Inc. - Executive VP, CFO & COO***

Thank you, Bill. Good morning, everyone. As the market continues to absorb incremental increases in interest rates, the Easterly balance sheet remains strong. In 2022, we took several strategic steps to enhance our balance sheet by recycling capital, which, in turn, strongly positions us for opportunities to come.

I'm pleased to report these efforts have continued in the first quarter of 2023, whereby Easterly significantly reduced its floating rate debt exposure by proactively and opportunistically entering into forward starting interest rate swaps to fix the interest rates on $300 million of our 2016 and 2018 term loans, including the anticipated addition of $50 million of delayed draw funds from our 2018 term loan.

Specifically, on February 3, we entered into three forward starting SOFR-based swaps, each with a notional $100 million deal. It is our belief that at a time when floating rate debt carries risk and uncertainty, it is our duty to our shareholders to minimize our exposure to this potential vulnerability.

Further, by executing these swaps, the company extended the maturity of its interest rate swaps by more than 19 months from a weighted average maturity of less than 6 months to a weighted average maturity of over 25 months at the time of execution.

Turning to our portfolio. For the quarter ended March 31, we owned 86 operating properties, comprising approximately 8.6 million leased square feet, either wholly owned or through our joint venture, with a weighted average age of 14.1 years and a weighted average remaining lease term of 10.4 years.

For the first quarter, all on a fully diluted basis, net income per share was $0.04 and core FFO per share was $0.29. Our cash available for distribution was $24.5 million. At quarter end, the company had total indebtedness of approximately $1.2 billion, at a weighted average interest rate of 3.7%, with 96% of all outstanding debt fixed at attractive levels. This represents a net debt to annualized quarterly EBITDA ratio of 7.2x, with over $400 million in capacity on our line of credit and an additional $50 million available under our

2018 term loan.

During the first quarter, Easterly issued an aggregate of approximately 2.6 million shares of the company's common stock, comprised of 250,000 shares of common stock through the company's ATM program and approximately 2.3 million shares of the company's common stock through the August 2021 underwritten public offering.

Through the use of the forward component on both our ATM and the offering, the combined approximately 2.6 million shares of the company's common stock were settled at a highly attractive weighted average price of $20.46, raising net proceeds to the company of approximately $52.4 million.

Easterly maintains a healthy balance of unsettled forward equity on our ATM. As of today, we expect to receive aggregate net proceeds of approximately $36.7 million from the sale of 1.7 million shares of the company's common stock that have not yet been settled, assuming these forward sales transactions are physically settled in full using a net weighted average combined initial forward sales price of $21.61 per share.

At quarter end, Easterly has maintained strong liquidity for future opportunistic acquisitions or developments. Further, consistent dialogue with bankers, investors and our JV partner indicates that our access to capital remains stable. With over $450 million in debt capacity and just under $37 million in unsettled forward equity, we believe Easterly has ample opportunity to execute on accretive deals without needing to go to the capital markets for the foreseeable future.

Finally, turning to the company's 2023 guidance. Recall that beginning this year and on a go-forward basis, we have transitioned to a core FFO metric. Core FFO, adjusted FFO, as defined by NAREIT, to present an alternative measure of the company's operating performance, which when applicable, excludes items which we believe are not representative of ongoing operating results.

Examples of such exclusions include liability management related costs, catastrophic event charges and depreciation of non-real estate assets. Today, the company is maintaining its full year 2023 core FFO per share guidance on a fully diluted basis in a range of $1.12 to $1.15.

This guidance assumes: one, the closing of VA Corpus Christi, a property within the VA portfolio, at the company's pro rata share of approximately $21 million; and two, up to $15 million of gross development-related investment during 2023. As a reminder, this guidance incorporates the dilution from the disposition of our 10-property portfolio in 2022, but does not yet assume any wholly owned acquisitions for the year.

We look forward to redeploying recycled capital at higher cap rates as the bid-ask spread continues to narrow. We will be sure to keep everyone informed if we begin to see strengthening opportunities to transact in this market. With that, we thank you for your time this morning and appreciate your partnership.

I will now turn the call back to Shannon.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Michael Griffin with Citi.

Michael Anderson Griffin ***Citigroup Inc., Research Division - Senior Associate***

Maybe just starting with guidance. I think the first quarter results imply kind of a run rate around your midpoint. Again, I'm curious, are there any kind of issues maybe around OpEx or G&A that we should kind of keep in mind when we're looking to kind of estimate out that forward earnings for the year, kind of a cadence?

Meghan G. Baivier ***Easterly Government Properties, Inc. - Executive VP, CFO & COO***

Yes. Mike, as we march through the year, as you said, we are run rating at a level that's just shy of the midpoint of our guidance range. I think we're looking forward to our renewals continuing to come online and the TI work continue to be completed with a small offset headwind from our expiring interest rate swaps.

Michael Anderson Griffin ***Citigroup Inc., Research Division - Senior Associate***

Awesome. And then just maybe on the macro. I mean I know you were talking Washington around the debt ceiling limit and potential implications of kind of that. Is there any potential adverse impact on your business if we see something like a government shutdown or sequestration? I think some in the House are calling for these budget talks to coincide maybe with some spending cuts. But anything you can maybe illuminate there would be helpful.

William C. Trimble ***Easterly Government Properties, Inc. - President, CEO & Director***

Sure, Mike. I'm just looking at the New York Stock Exchange this morning, basically, which I think that it was even more than I thought. Since 1960, the government has done it 78 separate times. And I think we've had the same result every time.

I know we have more concern at this juncture. The good news is we're funded right through until the end of the fiscal year for all of our properties. And we don't believe that this is going to -- it's going to be a lot of theater. I think we might see some which will be very sad this summer, potential national parks being closed, some other things, Kabuki theater. But from a standpoint of Easterly Government Properties, I'm fairly confident that you're not going to see any issues.

Michael Anderson Griffin ***Citigroup Inc., Research Division - Senior Associate***

And Bill, to your buildings shut down concurrently with the government shutdown, like you can't enter the building or anything like that?

William C. Trimble ***Easterly Government Properties, Inc. - President, CEO & Director***

No, they don't. No.

Michael Anderson Griffin ***Citigroup Inc., Research Division - Senior Associate***

Cool. And then just one last one on transaction activity. I think you talked about maybe being opportunistic if deals make sense. I think your implied cap is around in the high 6s now. I mean what cap rates would you need to be looking at in order to get those kind of bullseye properties that you always talk about to look more attractive? Is it 7? Is it north of 7?

William C. Trimble ***Easterly Government Properties, Inc. - President, CEO & Director***

I think no. I think that we're looking at the highest 6s will be fine for us. And I think we also have to mention that with our strategic partner, we have the ability to really purchase stuff as it becomes available, especially the highest quality assets.

So from our standpoint, business is open. We're ready to go. We're seeing some narrowing in the market, and our teams are out visiting. So I think we've been sort of glum for the last two quarters, but I think there is a sea change at this point. And we're busy here. So looking forward to getting the stuff done.

Operator

(Operator Instructions) Our next question comes from the line of Michael Carroll with RBC.

Michael Albert Carroll ***RBC Capital Markets, Research Division - Analyst***

Bill, can you talk a little bit about the investments that you're targeting today? I know you kind of highlighted to Mike in the prior question and in your prepared remarks. Are you looking more at developments or broken development deals that you could acquire? I mean, I guess, what's out there today?

William C. Trimble ***Easterly Government Properties, Inc. - President, CEO & Director***

Yes. Well, I think the first thing to take away, and it was separate. I think the first thing -- let's take all three. I think from the development side, our team has never seen as many opportunities as we're seeing right now. And those would be amongst all the sorts of agencies, the bullseye agencies that we care about.

And so they're on the road. And I think that it makes sense because, guess what, the population is growing, the mission-critical needs are increasing. And our building service those needs. And the old buildings had not been replaced in some cases, decades. So from that standpoint, our most accretive area, which is raw development from our standpoint, I think is seeing a healthy uptick in opportunity.

From a broken deal standpoint, and that's something that we've, I think, been very good at doing, and that's a wonderful marriage of our acquisition team here in Washington and our group at and development team in San Diego, we are looking at potential opportunities there as well, and we think they're only going to increase. Certainly, as we head into potential recession here in the fall, I'm not calling that. I'm not an expert on that. But from that standpoint, that's all good from our standpoint.

Finally, in the acquisition market, I think we are seeing a narrowing. We are talking to the sellers of these properties, which is something that we really weren't seeing as much of in the last few quarters.

I think there's a realization that interest rates are probably not going to drop precipitously. It's going to be a slow decline. And I think a number of these sellers are getting a lot more realistic about what's going to be happening in the future.

So from our standpoint, we're busy. Is it full speed ahead? Yes. Are we seeing incredible opportunities now? I think we will. And I wanted to signal that because that's a very different situation than we saw about a year ago.

Michael Albert Carroll ***RBC Capital Markets, Research Division - Analyst***

And then are the cap rates on these deals, I guess, how different are they from one another? I mean I'm assuming development cap rates are significantly higher than acquisition cap rates. But if you're looking at the broken acquisitions or the broken development deals, I mean, are those higher than maybe stabilized acquisitions?

William C. Trimble ***Easterly Government Properties, Inc. - President, CEO & Director***

Yes. I think you're absolutely correct. There's always been a very healthy accretive aspect to our development area. I think you've got to realize, too, that a lot of the competition that was in this business heretofore is no longer there.

They don't have the financing. It's difficult for them to do the TIs as you and I know, that the government will come up with at the last juncture, which, by the way, is very profitable for us. So that's the most accretive. I've said the broken deals. And if we -- I talked about that Tracy deal is one of the best deals from an accretion standpoint we've ever done.

It takes tough negotiating, but that's not a problem for us. And then I think, finally, the regular way deals that we will do, they will always be accretive. And as mentioned, not only from our balance sheet, but if we add our terrific partner, gives us a lot more flexibility.

Michael Albert Carroll ***RBC Capital Markets, Research Division - Analyst***

Okay. And then is the government prepared to break ground on new developments? I know the FDA Atlanta building has been kind of just in the planning stages for a while.

William C. Trimble ***Easterly Government Properties, Inc. - President, CEO & Director***

Absolutely. Absolutely. All over the country. COVID is over and finally realizing everybody else has gone back to work.

Michael Albert Carroll ***RBC Capital Markets, Research Division - Analyst***

Okay. And then just last for me. Can you talk to us about the dividend coverage and how comfortable you are with that rate? I know this quarter, I guess, AFFO, if you take out CapEx, TIs and maintenance, it kind of dropped below the current dividend rate. I mean, I guess, how are you thinking about that going forward?

Meghan G. Baivier ***Easterly Government Properties, Inc. - Executive VP, CFO & COO***

Yes. Mike, it's Meghan. As we've discussed many times, we've maintained a consistent dividend policy and continue to rely on the strength of our underlying U.S. government-backed cash flows, right? We've got the -- one of the longest visibilities we've had ever with a visibility over 10 years. And our comfort around the dividends built around the strength and the stability of that NOI. That's definitely taken into account by management and the Board as we look at setting the dividend.

Michael Albert Carroll ***RBC Capital Markets, Research Division - Analyst***

Okay. So is there anything lumpy in the maintenance CapEx charges, I guess, in the first quarter? I mean do you expect that to drop? Or do you expect cash flow to increase to kind of get the dividend back covered off of that metric?

Meghan G. Baivier ***Easterly Government Properties, Inc. - Executive VP, CFO & COO***

Yes. Q1 CapEx is not materially off a run rate level. But as I said in my prior comments, we do look forward to renewals in the business to continue to drive cash flow before CapEx.

Operator

I would now like to turn the conference back to Darrell Crate, Chairman of Easterly Government Properties, for closing remarks.

Darrell William Crate ***Easterly Government Properties, Inc. - Executive Chairman of the Board***

Great. Thank you, everyone, for joining the Easterly Government Properties First Quarter 2023 Conference Call. We hope this call has been helpful, and we look forward to speaking with you all again soon.

Operator

This concludes today's conference call. Thank you for participating. You may now disconnect.