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Easterly Government Properties

Second Quarter 2019 Earnings Conference Call

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CORPORATE PARTICIPANTS

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

Darrell W. Crate, Chairman of the Board of Directors

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

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

CONFERENCE CALL PARTICIPANTS

Emmanuel Korchman, *Citigroup*

Jason Idony, *RBC Capital Markets, LLC*

Peter, *Jefferies*

PRESENTATION

Operator:

Greetings, and welcome to the Easterly Government Properties Second Quarter 2019 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 to your host, Lindsay Winterhalter, Vice President, Investor Relations. Thank you, Ms. Winterhalter. You may begin.

Lindsay S. Winterhalter:

Good morning. Before the call begins, please note the use of forward-looking statements by the Company on this conference call. Statements made on this call may include statements which are not historical facts and are considered forward-looking. The Company intends these forward-looking statements to be covered by the Safe Harbor provisions for forward-looking statements contained in the Private Securities Litigation Act Reform of 1995, and is making this statement for the purpose of complying with the 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 filed with the SEC on February 28, 2019, 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, 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 W. Crate:

Thank you, Lindsay. Good morning, everyone, and thank you for joining us on this second 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.

Halfway through the year we're pleased with the direction of our results. Our new acquisition effort is generating bullseye properties and long-dated leases in facilities that are early in their useful life. Our re-leasing efforts are being executed in partnership with the Government by our seasoned team. Our balance sheet is very well-positioned with long-dated obligations and plenty of available capacity under our revolver for future growth.

Our strategy of enhancing portfolio value through development continues to grow with the recent win of our third FDA laboratory in Atlanta. We have a ribbon-cutting at the Alameda lab last month; we delivered the Lenexa lab at the end of 2020; and this new award in Atlanta is targeted for delivery in 2021/2022. In our space, deploying capital into development is the most accretive use of our capital. It is a privilege to win these projects, and our team is executing admirably.

We continue to be well-positioned over the medium-term to acquire the few portfolios that match the quality of our existing portfolio. Today, our weighted average cost to capital enables us to grow accretively without needing to stretch our underwriting criteria and risk profile. With 66 properties under our ownership, 2 in development, and 1 in design, we're pleased with the quality and diversification of our assets, all with leases backed by the full faith and credit of the United States Government.

We're pleased to be on track to deliver on expectations and look forward to furthering our strategic objectives to enhance the value for our shareholders.

Now, I'll turn the call over to Bill to share more detail on the developments in the quarter.

William C. Trimble:

Thanks, Darrell, and good morning. Thank you for joining us for our second quarter earnings call. What a quarter it has been. I'm excited to share the Company's achievements in the second quarter of 2019, starting with the acquisition of the 400,000 square foot U.S. Joint Staff Command facility located in Suffolk, Virginia. This facility is comprised of two modern Class A buildings that are 100% leased to the GSA and occupied by the Department of Defense's U.S. Joint Staff Command Division. The JSC is the division responsible for the unified strategic direction of U.S. combat forces. The Government is heavily invested in this highly secured facility, as was demonstrated in the recent lease renewal for 10 years with an additional 5 year option. This is just a wonderful facility, truly a center of the bullseye acquisition, and a meaningful addition to Easterly's growing portfolio.

This quarter also marked the acquisition of FBI New Orleans, the Company's ninth FBI field office. Just like the other eight, this facility houses some of the most important missions of the FBI and serves as the headquarters for its regional operations. Specifically, FBI New Orleans overseas all of Louisiana, including six satellite offices in Baton Rouge, Alexandria, Lafayette, Lake Charles, Monroe, and Shreveport. It is important to note that this site was specifically selected by the U.S. Government as the optimal location in which to conduct its mission. In fact, the Government attempted to purchase this property from the prior owner, but was unable to do so due to budgetary constraints.

As previously mentioned, Easterly is the largest private owner of these facilities and the FBI field offices are the exact type of property we wish to own. They're highly specialized through the underlying tenant's use which aids the tenants in fulfilling the most important of missions for the U.S. Government.

As demonstrated in this quarter, the Easterly pipeline remains strong. With no dedicated public competitors, a highly fragmented market drives further opportunity for growth. While we have mentioned that we believe that our portfolio acquisition opportunities totaling approximately $2 billion, we still expect 2019 will be a year of incremental growth through the acquisition of one or two bull's-eye facilities at a time.

This was also a rewarding quarter for Easterly on the development side of the house. Several weeks ago we were pleased to share the news that Easterly has been selected by the GSA to redevelop a brand-new build-to-suit Class A laboratory for the Food and Drug Administration in Atlanta, Georgia. This is a tremendous opportunity for us, and we are honored, once again, to serve as the partner of choice to the U.S. Government. FDA Atlanta will be our largest laboratory to date with an anticipated size of approximately 162,000 square feet. The state-of-the-art facility is expected to have both laboratory and office space, the Atlanta district office, as well as the Southeast Food and Feed Laboratory, and the Southeast Tobacco Laboratory. The Atlanta district office oversees the regulatory operations within the Atlanta region while the Southeast Food and Feed Laboratory provides laboratory testing and regulation for the region, as well as research into new methodologies and regulatory areas within the FDA. The facility is expected to have four separate laboratories for nutritional analysis, chemistry, microbiology, and tobacco. Once this project is delivered, the GSA will commence its non-cancelable 20-year lease for the beneficial use of the FDA.

With FDA Atlanta, Easterly is on track to deliver a build-to-suit project in 2018, 2019, 2020, and now potentially 2021 or '22. FDA Alameda is preparing for the Government's acceptance (phon) to space in August of 2019, while FDA Lenexa is on track for a fourth quarter of 2020 delivery. These projects are among the best uses of capital for the Company. As mentioned, the non-speculative nature of the lease award, the minimal building expenses incurred prior to lease award, the risk-free option we place on the land or building, and the design build contract with the GC to prevent cost overruns all contribute to the Company's ability to earn attractive yields while minimizing risk.

Further, at the end of the project, Easterly will own a brand-new state-of-the-art building with an initial 20-year non-cancelable lease with the U.S. Government.

To put these opportunities into context, if we were to attempt to purchase that same exact facility rather than develop it ourselves, we would be expected to pay a much tighter cap rate than the one we are building it to. That spread between development versus acquisition is extremely compelling.

Turning to asset management, the team continues to work with the GSA and the underlying tenant agencies to constantly improve upon the existing portfolio. Tenant-funded projects are wonderful opportunities to keep our facilities up to the latest standards while also achieving a modest management fee. Further, these improvements only increase the overall NAV of the Company's existing portfolio. These improvement projects also add to the clarity and visibility of a Government agency's tenancy in our facility. It's this clarity that helps us better understand and appreciate our future lease income, which we then apply towards a quarterly dividend for our shareholders.

To conclude, this was a great quarter for Easterly. We continue to grow through bullseye acquisitions and non-speculative development opportunities with over 98% of our 100% occupied portfolio generating cash flows backed by the full faith and credit of the U.S. Government. The stability of those cash flows, we believe, distinguishes us from any other public REIT.

With that, I thank you for your time this morning and for your continued support and partnership, and I'll turn the call over to Meghan to discuss the Company's quarterly financial results.

Meghan G. Baivier:

Thank you, Bill. As of June 30, we owned 66 operating properties comprising approximately 6.1 million square feet of commercial real estate, with 3 additional projects totaling 291,000 square feet under development or in design.

The weighted average remaining lease term for our portfolio was 7.4 years. Remarkably, the portfolio has exactly the same weighted average remaining lease term as it did in the first quarter of 2015 when the Company IPO'd. This time defying statistic has been achieved by continuing to acquire young, mission-critical facilities of scale year-over-year, and through the renewal of our leases which speaks to the enduring visibility of our cash flows.

The average age of our portfolio has also defined the passage of time and remains young at 13 years. Portfolio occupancy remains at 100% and, finally, 98% of our annualized lease income continues to be backed by the full faith and credit of the United States Government.

For the second quarter, net income per share on a fully diluted basis was $0.08; 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 $19.8 million. Our portfolio has grown from 47 to 66 properties since just this time last year. With this scale also comes a more diversified stream of cash flow supporting the Company's dividend.

Turning to the balance sheet, at quarter-end the Company had total indebtedness of $896.5 million, including $262 million outstanding on its unsecured revolving credit facility. With $450 million of total capacity, availability on our revolving line of credit stood at a healthy $188 million. As of June 30, Easterly's net debt to total enterprise value was 38.1% and its adjusted net debt to annualized quarterly EBITDA ratio was 6.3 times. As you've heard me mention previously, meaningful progress on our development projects will bring higher levels of reported leverage as we near project completion. Adjusted leverage in part neutralizes this leverage drag, and at 6.3 times, demonstrates the strength of the balance sheet available drag pattern as we continue to pursue our target of $200 million of acquisitions this year.

As part of our goal to purchase properties through just-in-time funding, the Company's been active on its ATM programs throughout the second quarter and subsequent to quarter-end. During the second quarter, in addition to settling the remaining 300,000 forward shares outstanding from the June 2018 equity offering, the Company issued just over 1.2 million shares of common stock through its ATM, raising approximately $27.1 million, in total gross proceeds to fund recently announced acquisitions.

Subsequent to quarter-end, the Company has issued just over 1.6 million shares of common stock for gross proceeds of approximately $29.5 million. Subsequent to quarter-end, the Company announced the execution of a private placement of $275 million principal amount of unregistered fixed rate senior unsecured notes. The Company expects the notes to close and fund on September 12, 2019. This marks the Company's second entry into the unsecured debt private placement market, which solidified existing partnerships and also initiated strong relationships with new lenders. These fixed rate interest-only notes will be issued in three tranches, $85 million in 10-year notes with an interest rate of 3.73%, $100 million in 12-year notes with an interest rate of 3.83%, and $90 million in 15-year notes with an interest rate of 3.98%. The weighted average maturity of a note is 12.4 years, and the weighted average interest rate is an impressive 3.85%. This execution is clearly the market validating our portfolio strategy and balance sheet, which profiles as (phon) investment-grade. Achieving such an attractive fixed rate for that duration presents the Company with a superior opportunity to deploy capital accretively and support an evolving acquisition and development pipeline.

Pro forma for the closing of the notes, our balance sheet only looks stronger. The execution of this deal takes our weighted average debt maturity from 5.7 years to 8.6 years, which well suppresses our weighted average remaining lease term of 7.4 years. The deal also takes our weighted average interest rate up by only 10 basis points from 3.7% to 3.8%. Quite frankly, taking 2.9 years in duration for only 10 basis points is remarkable.

The superior credit quality of our primary tenant once again resonated in the unsecured debt private placement market and, through this execution, we enhanced the Company's balance sheet by extending the duration of its liabilities and attractive interest rate environment.

Turning to earnings guidance, for the 12 months ending December 31, 2019, the Company's updating its guidance for FFO per share on a fully diluted basis to $1.18 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 3 properties in the 14-property portfolio and $75 million to $100 million of growth development-related investment in the year.

Additionally, as previously mentioned, expected growth in FFO per share due to accounting adjustments is masking growth in FFO as adjusted per share, a metric which we believe is more indicative of operating cash flow growth. 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 for approximately 8% to 11%. We've built an incredibly strong portfolio of assets; in (phon) 2019 8% to 11% expected growth in FFO as adjusted per share, we believe, is indicative of an exceptional year of value accretion for investors.

With that I'll turn the call back to Doug.

Operator:

Thank you. We will now be conducting a question-and-answer session. If you'd like to ask a question, you may 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 key.

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

Emmanuel Korchman:

Hey, good morning, everyone. I don't know who this one is to, but I'll just throw it out there. The most recent development project, was that a full-on RFP and just sort of what do you think made you win that if it was? Secondly, how many other large development projects like that are you working on right now and could become reality over the next 6 to 12 months?

William C. Trimble:

Good morning, Manny. It's Bill. Yes, absolutely, it was a full-blown competition. There were a number of very, very strong national competitors involved in that project. As you know, this lab is extremely important to the FDA. There are 13 out there. We have been awarded the first three. We cannot guarantee that we are going to win every one, but I think we've proven that we're a terrific partner with the

Federal Government. I think that we're looking at a program that could be lasting at least a decade within the FDA going forward.

I think our expertise, certainly in Alameda—I was out there two weeks ago; we're about 99.5% finished there. I was with Mike Ibe, our Head of Development, going through the building from stem to stern. When you see what we've done and how we've worked with the FDA in partnership and the GSA, and then doing this again in Lenexa, I think that for the FDA it is a really great solution for achieving their goals because we've all been working together since the beginning on these projects. This one in Atlanta has taken, I think, almost 20 months to come to fruition, so we've put a lot of work into it.

Emmanuel Korchman:

Thanks. Then in the terms of dispositions, is there anything else that you're thinking about right now?

William C. Trimble:

We're very pleased with our portfolio. What I've said in the past is when there's an opportunity to cull or harvest the property that might be older and put that money and redeploy it into, for instance, a new development project, we'll take advantage of that. But we have a very young portfolio, and we're very pleased with what we have.

Emmanuel Korchman:

Thanks.

Operator:

Our next question comes from the line of Jason Idony (phon) with RBC Capital Markets. Please proceed with your question.

Jason Idony:

Hey. Thanks for taking my question. I'm touching on the dispositions. You previously discussed that you were interested in maybe disposing some assets and then obviously I know you had smaller sales during the quarter. But I'm wondering how we should be thinking about that through the end of 2019 and into 2020. Then, also, has that strategy changed at all, and what impact did that have on guidance?

William C. Trimble:

I'd say what I just said to Manny. I think that obviously as our buildings do get a year older every year, and, remarkably, we've actually, as Meghan mentioned, we've kept the age our portfolio fairly consistent through purchasing and building some incredible new properties. However, with the property that we sold out in California, which, by the way, we just renewed with a brand-new 10-year lease; we think it's terrific. It's Customs and Border Protection, important mission. But you're looking at one of our oldest buildings, even though hard to believe, in the 1990s. It was just a great time to maximize value.

I'd say that dispositions to us are taken when we think that there's another better opportunity for the money going forward.

Jason Idony:

Got you.

William C. Trimble:

And none of that had any effect on the guidance.

Jason Idony:

Then could you also touch on the current competitive landscape that you're seeing in the market today?

William C. Trimble:

I would say that the landscape is fairly consistent. We have no public market competitors. When we get to very large projects, we'll see sovereign wealth funds, large insurance companies, even South Korean insurance companies involved. We have several private equity funds that we've enjoyed competing with over the years. We see them on a regular basis. There was a public market competitor that was in the market last year for a property in Baltimore that I think is probably no longer participating in that market. So, it's been very consistent.

Jason Idony:

Got you. Thank you.

Operator:

As a reminder, ladies and gentlemen, it is star, one to ask a question. Our next question comes from the line of Jon Petersen with Jefferies. Please proceed with your question.

Peter:

Hi. This is Peter on for Jon. Just on the acquisition front, how high would you be willing to take your leverage if you are seeing more deals that are sort of bull's-eye acquisitions in your sweet spot at attractive cap rates?

Meghan G. Baivier:

Yes. I think we have the range that guides us. Development is going to be the best use of capital that will push leverage to the higher end of that range, but we feel confident in our ability to cull (phon) our pipeline and continue to generate growth while keeping a strong balance sheet.

Peter:

Got you. On lease maturities, do you have any update on sort of near-term maturities? I know there's not a lot of huge ones, but things that are coming up sort of where you're expecting rents to trend directionally?

Meghan G. Baivier:

Sure. As you look at the next remainder of this year and the next two years, and you look at sort of the cross-section of properties that are coming up for renewal, there's a vast majority of those that fall into the bullseye, and so every day we're working to get those replacement cost driven renewal bumps that we speak about.

Peter:

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

Operator:

There are no further questions in the queue. I'd like to hand the call back over to Darrell Crate for closing remarks.

Darrell W. Crate:

Great. Thank you, everyone, for joining the Easterly Government Properties Second Quarter 2019 Conference Call. We appreciate your time, and we look forward to getting back with you in November.

Operator:

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