Easterly Government Properties Inc.

Second Quarter 2016 Earnings Conference Call

August 8, 2016

CORPORATE PARTICIPANTS

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

Darrell Crate, *Chairman of the Board of Directors*

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

CONFERENCE CALL PARTICIPANTS

Michael Carroll, *RBC Capital Markets*

Manny Korchman, *Citi*

Bill Crow, *Raymond James*

PRESENTATION

Operator:

Greetings, and welcome to the Easterly Government Properties Second Quarter 2016 Earnings Conference Call. At this time, all participants are in a listen-only mode. A question and answer session will follow the formal presentation. If anyone should require Operator assistance during the conference, please press star, zero on your telephone keypad. As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Ms Meghan Baivier, Chief Financial and Operating Officer for Easterly Government Properties. Thank you. You may begin.

Meghan Baivier:

Thank you Melissa. 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 fact and are considered forward-looking. The Company intends these forward-looking statements to be covered by the Safe Harbor provisions for forward-looking statements contained in the Private Securities Litigation Act Reform of 1995 and is making this statement for the purpose of complying with those Safe Harbor provisions.

Although the Company believes that its plan, intentions, expectations, strategies and prospects as reflected in or suggested by those forward-looking statements are reasonable, it can give no assurance that these plans, intentions, expectations or strategies will be attained or achieved. Furthermore, actual results may differ materially from those described in the forward-looking statements and will be affected by a variety of risks and factors that are beyond the Company’s control, including without limitation those contained in Item 1A Risk Factors of its Annual Report on Form 10-K for the year ended December 31, 2015, filed with the SEC on March 2, 2016, and its other SEC filings.

The Company assumes no obligation to update publicly any forward-looking statements whether as a result of new information, future events or otherwise.

Additionally, on this conference call the Company may refer to certain non-GAAP financial measures such as funds from operation and cash available for distribution. You can find a tabular reconciliation of these non-GAAP financial measures to the most comparable current GAAP numbers in the Company's earnings release and separate supplemental information package on the Investor Relations page of the Company's website at ir.easterlyreit.com.

I would now like to turn the conference call over to Darrell Crate, Chairman of Easterly Government Properties.

Darrell Crate:

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

The second quarter was another strong one for Easterly, including a number of operational and financial milestones for the Company. The Easterly team continues to hone its definable edge in the sourcing, underwriting of mission critical federal government buildings and we continue to execute on our proven strategy, growing an outstanding portfolio of these assets and deploying capital accretively to drive material earnings growth. Easterly remains the only internally managed public REIT that focuses solely on United States government leased assets. Our leases are backed by the full faith and credit of the US government, one of the strongest credits you can find. This base of stable cash flows, supported by a robust, lowly-levered balance sheet and access to capital, pairs with an acquisition and development strategy we believe that provides an attractive risk adjusted return opportunity for our investors. I'm very proud of our team at Easterly. In the second quarter, we announced our first portfolio acquisition since IPO; were awarded a lease for the development of an FDA laboratory, and successfully completed our first follow-on equity offering. We continue to report results and activities which are consistent with the expectations that we set out at the time of the IPO, and we expect to continue executing upon our goal of delivering strong earnings growth year-over-year.

Now I'll turn the call over to Bill to provide more color on the Company's second quarter performance.

William Trimble:

Thanks Darrell, and thank you everyone for joining this morning. I am pleased with the Company's operational performance and the accomplishments of the full Easterly team in the second quarter. At the end of the second quarter, the Company's portfolio totaled 38 properties comprised of nearly 2.8 million square feet of commercial real estate. Ninety-seven percent of our annualized leased income is backed by the full faith and credit of the United States government.

On May 19, we were very pleased to acquire the 62,772 square foot National Parks Service property in Omaha, Nebraska. The property houses the NPS Midwest Regional Headquarters and serves as a visitor center for the Lewis & Clark National Historic Trail. Built in 2004, the property is leased to the GSA with eight years remaining on an initial 20-year lease.

On June 1, the Company announced the agreement to acquire a 302,057 square foot portfolio of four US government leased properties for a purchase price of approximately $97.4 million. The portfolio consists of an FBI field office and a DEA district office, both in Birmingham, Alabama, as well as an EPA laboratory in Kansas City, Kansas, and an FBI field office in Albany, New York. Subsequent to the quarter end, the Company completed the acquisition of the first three properties and FBI Albany is slated to close in the fourth quarter of this year.

Easterly's Development Team, led by Mike Ibe, remains active, and on June 18, the Company was awarded a 20-year lease for the development of a 65,810 square foot Food and Drug Administration laboratory in Alameda, California. The Easterly team has significant experience in the development of GSA leased properties, particularly laboratories, and our differentiated knowledge, experience and partnership with the GSA enabled Easterly to compete successfully for this lease award.

Our acquisition and development pipeline is robust as the Company maintains rigorous underwriting standards focused on a well-defined target market. This market includes properties leased to a single tenant agency of the US federal government, which are the result of a design-build award and are usually over 40,000 square feet in size. It is important to note that we underwrite the agency and the hierarchy of the mission of the prospective building before performing the deep dive in the actual bricks and mortar.

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

Meghan Baivier:

Thank you Bill. Today, I will review our second quarter financial results, provide an update on our balance sheet and recent financing activities, and review our 2016 guidance. Additional details regarding our second quarter results can be found in the Company's second quarter earnings release and supplemental information package.

For the second quarter, FFO was $12.1 million or $0.30 per share on a fully diluted basis. FFO as adjusted was $11.7 million or $0.29 per share on a fully diluted basis, and our cash available for distribution was $10.4 million.

Turning to the balance sheet, at quarter end we had $198 million outstanding on our revolving line of credit and total debt of $280 million. Availability on our line of credit stood at $202 million. In terms of leverage, net debt to total enterprise value was 24% and net debt to annualized quarterly EBITDA was 4.9 times. Adjusted for the closing of the first three out of our four portfolio assets, leverage is approximately 4.5 times.

In June, we successfully completed our first follow-on equity offering, raising gross proceeds of $84.9 million with an additional $27 million in gross proceeds expected upon full physical settlement of related forward sales agreements. Proceeds have and will be used in part to fund our recent acquisition of a four-property portfolio, repay borrowings outstanding under our senior unsecured revolving credit facility, to fund other potential acquisition opportunities, for general corporate purposes or a combination of the foregoing.

With regard to guidance, for the 12 months ending December 31, 2016, the Company is reiterating its guidance for FFO per share on a fully diluted basis to $1.19 to $1.23 per share. This guidance assumes acquisitions of $175 million in 2016, including the five properties acquired to date and the closing of FBI Albany in the fourth quarter of 2016. This guidance does not contemplate dispositions or additional capital markets activities. Let me walk you through this guidance in more detail.

At December 31, 2015, run rate FFO on a fully diluted basis was approximately $1.17 per share. At the end of the second quarter of 2016, having completed approximately $52 million in acquisitions, run rate FFO on a fully diluted basis was approximately $1.22 per share before considering the impact from the timing of our June follow-on equity offering.

Looking to the second half of 2016, we would expect the impact from the closing of our previously announced four-property portfolio, the equity successfully raised in June including the greenshoe and on a forward basis, as well as approximately $25 million of additional acquisitions to result in run rate FFO per share on a fully diluted basis at year-end of approximately $1.21.

Given the Company's results year-to-date and this outlook for the second half, we are maintaining our guidance range for the year of $1.19 to $1.23 with a midpoint of $1.21.

Finally, as previously announced this week, our Board of Directors declared a dividend related to our second quarter of operations of $0.23 per share. This dividend will be paid on September 13 to shareholders of record on August 26.

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 would like to ask a question, please press star, one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star, two if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star keys. One moment, please, while we poll for questions.

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

Michael Carroll:

Thanks. You guys have been successful completing investments this year, but given the Company's current concentration to the DEA and FBI, are you still interested in growing with these agencies, and how do you think about that type of concentration you have with those two agencies?

Bill Trimble:

Thanks Michael. Good morning. Hi, it's Bill. Certainly I think that if you take the FBI and the DEA they're two of the most critical, mission critical agencies of the United Stated federal government, and I've said in the past that we don't think the FBI is going to be going out of business. In fact, it's doubled in size since 2001 and has a very robust budget; that we would be very pleased to acquire as many field offices of this important agency, and the same goes for the DEA as well. However, I think that just because of the different ownership in many different places, including some owned by the United Stated federal government, that it won't be at the size that I think it would be too much, but we are very positive on those two agencies.

Michael Carroll:

Okay. What are you actually tracking on the investment side right now? Are there any other smaller portfolio transactions, similar to the one you announced a few months ago, on the market?

William Trimble:

I think that what I'd like to state is that our $700 million I've spoken of before in pipeline remains robust. We do have about $200 million that we're actively sourcing right now and we continue to do that. Just to sort of remind, most of our transactions are off-market. In fact, we just did one or two last year that were marketed. So I think we continue to meet with our owners. We know the 500 buildings, who owns those properties, and chip away at them. There are some portfolios out there and obviously we are engaged in conversations with those that have the portfolios, and if it's the right time and the right price obviously we'll consider doing something.

Michael Carroll:

Are those smaller portfolios like the four or five type property portfolios, or are there any larger ones out there?

William Trimble:

There's a few larger portfolios out there, but most of them are ones and twos owned by various owners throughout the country.

Michael Carroll:

Okay, great. Then can you give us some color on your upcoming lease expirations? I know it's fairly modest over the next few years, but in 2017 I think it picks up a tiny bit. Who are these tenants and have you started renewal discussions with them?

William Trimble:

Obviously we interact with the GSA and the underlying agencies constantly. I think that's where we differentiate ourselves, but we have not gotten in any direct negotiations with the larger leases that will be rolling in the next several years but we are confident that the federal government will remain in the buildings. We think we are the best solution for them long term and as they come up we'll obviously engage serious with the GSA at that time.

Michael Carroll:

Do you have the net of the mark-to-market on those leases? Are they well below market right now?

William Trimble:

I think the fact that—basically they are below market right now, yes.

Michael Carroll:

Okay, great. Thank you.

Operator:

Thank you. Our next question comes from the line of Manny Korchman with Citi. Please proceed with your question.

Manny Korchman:

Good morning everyone.

William Trimble:

Good morning Manny.

Meghan Baivier:

Good morning.

Manny Korchman:

Meghan, G&A looks like it's running sort of above recent run rate as well as above your guidance if I were to annualize it. Can you just give us color on what's happening there and maybe provide guidance for G&A?

Meghan Baivier:

Yes. Manny, as we continue to grow the business and increase the scale of the business, I think you're going to see modest increase in cash G&A; obviously nothing that outpaces the growth of our top line. The level in the third quarter is in line—excuse me, in the second quarter is in line with our guidance for the year.

Manny Korchman:

Then, Bill or Darrell, can you just give us sort of some color, let us in on how long the process to land the new FDA development, and if you can at all give us some idea of where you are in the process for other developments?

William Trimble:

Sure. I will say to begin with, we were quite gratified to win the FDA Alameda—and by the way, it's the only development that would fit within our bulls-eye since we went public, the only one. It took well over a year in discussions, and obviously with Mike Ibe who runs our Development and Acquisition Team, who's developed over 25 of these properties, we were confident that we were going to come up with a good bid and work well with the federal government.

When it comes to pipeline, obviously we do have a number of lines in the water at all times and are entertaining buildings that would fit within that very targeted area that works for us. Consider, basically, we're building in this case to a 20-year firm term lease with 100% occupancy on this property, and it's very difficult for us to forecast projects as the government needs and timing are not necessarily congruent with quarterly earnings, but you can certainly assume that the Easterly team over the next four to five years are going to be doing some terrific development projects that I think will be quite accretive to our earnings going forward.

Manny Korchman:

Maybe you can help me just reconcile two things you just said. Mike has done 25 of these, and yet you've done one since IPO that matches sort of your underwriting or your desires. Was it easier to do in the past? Is it more competitive now? Are there just less projects out there? Less RFPs? What's going on that sort of Mike's momentum has slowed since you guys have gone public?

William Trimble:

Well, I don't think Mike's momentum has slowed, knowing Mike Ibe pretty well. I'd say the federal government's appetite for new buildings certainly was curtailed with that little incident that occurred between 2008 and 2010 with the massive slowdown. But I will say that the federal government has its needs, buildings are getting older. Obviously our buildings are very young in our overall portfolio but there are important facilities, certainly laboratories and I'd also mention FBIs and so forth where the government continues to invest in their important mission critical infrastructure. So, I think we will begin to start seeing some more development projects going forward. Obviously we're seeing a lot of really terrific product in the VA area as that's an agency that understands the importance of our servicemen and women over the decades to come, so we are seeing some development there, but you can be assured that we are concentrating on anything that would fit within our bulls-eye and we do believe that we're going to start seeing some more projects, certainly in the next two to three years.

Manny Korchman:

Thanks Bill.

William Trimble:

Thank you.

Operator:

Thank you. Ladies and gentlemen, as a reminder, if you would like to ask a question, please press star, one at this time. Our next question comes from the line of Bill Crow with Raymond James. Please proceed with your question.

Bill Crow:

Good mornings folks. The question really is as follows. If you look back since the IPO, were there acquisitions that you bid on that you did not, and if you did not, what was the reason for that?

William Trimble:

Bill, I'd say that, once again, to mention that 85% of our purchases were off-market. So, there were obviously conversations with people on buildings and maybe there was a couple that we did not close because obviously we're price sensitive. We said to the Street that we want to purchase buildings between 6.75 and 7.25 and I'm pleased to say we've done that.

From a standpoint of marketed deals, we did win the FBI Richmond and I think that was—we were very gratified to get that. There were some other properties that were larger that we felt—that we did participate in from a marketed standpoint and did not purchase them because we're very disciplined on what we're going to pay for the property.

Darrell Crate:

Bill, it's Darrell. During the IPO it was something that was very clear that we were going to be defined as much by the deals that we do do as those that we did not. The portfolio that we're building today is one that while we brought what we think is a very strong portfolio forward during IPO, the acquisitions and the opportunities that we have in front of us lead to a even higher quality portfolio.

Bill Crow:

Appreciate that. Do you—obviously yields at 6.75, 7.25 is very attractive today, especially where the 10-year has gone since the IPO. Are you sensing more competition? Are you sensing any upward pressure on pricing that would cause you to fall out of that range?

William Trimble:

I think as we look at the properties we can certainly continue doing what we've told the Street and indicated, for the foreseeable future in the range that we're talking about. Obviously there will be opportunities as we go forward for buildings that are perhaps 20-year leases, 15-year leases that might be at the lower end of that range, and obviously if the cost of capital is appropriate we will consider them. But from a standpoint of competitives, that's what our team does all day long is going out, meeting with the owners and I think we have a terrific relationship with them. We like to get there certainly ahead of others. We do not see any new competitors from where we started. We've been doing this for about five years now, same usual folks, and we're very gratified to be sort of in that middle zone where we are not competing against the largest REITs, and again, not competing against the lower end, the doctors and dentist syndicators.

Bill Crow:

Okay. Appreciate it. That's it from me. Thanks.

Operator:

Thank you. Mr. Crate, there are no further questions. I'd like to turn the floor back to you for final remarks.

Darrell Crate:

Great. Thank you everyone for joining DEA's second quarter conference call. We're very excited about our execution path with the goal to build the highest quality portfolio of the US government leased assets and providing investors with attractive compounding risk adjusted returns over time.

Operator:

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