Easterly Government Properties

Second Quarter 2018 Earnings Conference Call

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CORPORATE PARTICIPANTS

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Darrell W. Crate, *Chairman of the Board of Directors*

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

CONFERENCE CALL PARTICIPANTS

Michael Billerman, *Citigroup*

Michael Lewis, *SunTrust Robinson Humphrey, Inc.*

Michael Carroll, *RBC Capital Markets, LLC*

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PRESENTATION

Operator:

Greetings, and welcome to the Easterly Government Properties Second 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. Meghan Baivier, Executive Vice President, CFO and COO for Easterly Government Properties. Thank you. You may begin.

Meghan G. Baivier:

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, Meghan. Good morning, everyone, and thank you for joining us for the second quarter conference call. Today, in addition to Meghan, I'm joined by Bill Trimble, the Company's CEO.

Easterly remains the only internally-managed public REIT narrowly focused on the acquisition, development, and servicing of mission-critical real estate leased to the United States Federal Government. Our mission has remained consistent since IPO: to provide strong risk-adjusted returns through a reliable and growing cash dividend backed by the full faith and credit of the U.S. Government. To that end, our effort in the short, medium, and long terms are all centered around this stated goal.

In the short-term, we're pleased our team is renewing existing assets and lengthening the overall remaining lease term of the Company's portfolio. Adherence to the bullseye strategy has proven itself wise in our ability to achieve strong lease renewal spreads and extend the duration of our cash flows which support our cash available for distribution.

In the medium-term, we work to cultivate a robust pipeline of new assets with the goal of accretively scaling and diversifying our portfolio, enhancing the stability and growth of our dividend. I commend the Acquisition and Development team on their success to date in consistently growing the portfolio through the acquisition and development of mission-critical assets backed by the full faith and credit of the U.S. Government.

Finally, in the long-term I congratulate the Management Team on creating strong capital partners in both the debt and equity markets which we hope will continue for many years to come. This partnership has allowed us to achieve a highly competitive cost of capital in both debt and equity which, in turn, allows us to continue to deploy capital accretively and support the next chapter of our growth, enabling us to grow a dividend for years to come.

Easterly has always been an external growth story driven by acquisitions and development. For that reason, this has been an important quarter for Easterly. With announced acquisition volume, including one of the largest portfolios in our target market, we have propelled the Company forward in a meaningful way. We have grown our public float by 34% through the completion of the successful follow-on offering. The increased liquidity from the offering puts the Company in a position of strength and allows for enough dry powder to execute on future acquisitions and remain flexible in the market.

The balance sheet is in a position where we can deploy capital accretively, allowing for future growth that remains consistent and shrewd to the fundamentals that were instilled at the time of the IPO. We believe meaningful growth that can be achieved in this manner is a success and one we consistently strive to build upon quarter-after-quarter and year-after-year.

To be clear, our priority as a Management Team is to deliver a trusted and growing dividend to our investors which is backed by the full faith and credit of the U.S. Government. We're very pleased that all of our efforts and outcomes are delivering on this fold.

With that, I'll turn the call over 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 second quarter earnings call. As Darrell mentioned, the second quarter of 2018 marked a meaningful point in the Company's trajectory. We announced the pending acquisition of a $430 million 14-property portfolio of high-quality assets that closely mirror the profile of our existing portfolio.

To review, this portfolio of 14 assets equates to approximately 1.5 million square feet of rentable space, Ninety-nine percent of the 14-property portfolio is leased with a weighted average lease expiration year of 2022. The portfolio is still relatively young with a weighted average age of just 16 years. Of the 14 properties, 79% of the assets were build-to-suit construction, meaning the design and functionality of the building was constructed to meet the specific needs of the underlying tenants. Further, these 14 assets significantly scaled the portfolio in an accretive manner and increased Easterly's already strong relationship with the U.S. Federal Government. With this portfolio, Easterly will now meet the leased real estate needs of 31 different U.S. Government tenants.

This portfolio acquisition is one we have been watching and anticipating since prior to IPO. Simply put, we feel no other potential buyer understands the makeup of this portfolio better than us. For years we have underwritten each asset and monitored the mission in each facility to mitigate against potential obsolescence. We knew this portfolio was focused in a similar manner to our existing portfolio which allows for seamless integration and growth. We are extremely excited to welcome these 14 properties into our growing portfolio and look forward to doing so throughout the remainder of 2018.

Our ability to win this portfolio acquisition in a public bidding process highlights many of Easterly's strengths that distinguish us from other potential bidders. First, we understand this very niche market of federally-leased real estate. We can underwrite each asset appropriately, thus enabling us to be very fair buyers in the process.

Second, our cost of capital is cheaper than other bidders. Because of this we were able to purchase this large accretive deal at an attractive cap rate.

Finally, we are flexible and dependable buyers. You've heard me mention in the past that there are plenty of reasons that a seller would want to delay a closing. Because of our flexibility and our (audio interference) buyers are all attributes that help this deal ultimately come to fruition, and these are Company strengths in which we take great pride.

In conjunction with the announcement of this 14-property portfolio acquisition, we also successfully executed a public equity capital offering, raising $398.5 million of gross proceeds through an overnight equity offering. This offering further strengthened relationships with existing shareholders and allowed for the initiation of relationships with new equity partners. The deal was extremely well received in the markets we are grateful for investors' confidence and our ability to deploy the capital and drive strong returns for our shareholders. Furthermore, this was also a wonderful opportunity for us to lower our leverage and position the Company to be able to execute on acquisition and development opportunities that may present themselves in the future.

Turning to the acquisition pipeline, Easterly continues to evaluate opportunities and pursue our pipeline of actionable deals. Our position in the market continues to strengthen, but we will still see ample opportunity to grow in this highly fractured market. While the second quarter brought large scale acquisition growth, we will not stop seeking to acquire new, accretive properties.

Turning to development, I am pleased to report we are making meaningful progress of all three of our development sites. I had the opportunity to observe firsthand the progress being made at the FEMA Tracy and FDA Alameda sites just two weeks ago and I was very happy to see these projects well underway. Both projects look good with FEMA Tracy expected to deliver at the end of the third quarter of 2018 and FDA Alameda expected to deliver in the third quarter of 2019. As a reminder, these non-speculative development projects provide for great opportunities to see increased deals on brand-new facilities with long-term lease expirations.

Under the current timeline, we should expect to see all three developments, including FDA Lenexa, generating cash flows by mid-2020, and from a future development pipeline perspective, I think we can expect to see future opportunities from both FDA and FEMA, given the length and importance of these enduring missions.

Turning to lease renewals, allow me to provide a comprehensive overview of all 2017 and 2018 lease renewals thus far and to speak to upcoming near-term lease expirations for the pending 14-property portfolio acquisition. The 2018 renewals have been a blend of highly specialized bullseye properties, like DEA Riverside, and mission-critical but nevertheless more plain-vanilla office space, like IRS Fresno. You've heard me say in the past that when there's a bullseye property the lease renewal conversation centers around replacement costs. Conversely, when you have a more plain-vanilla office space expiring, the lease renewal conversation is more focused on what is considered market rent in that region. Just to be clear, less than 15% of our properties would be considered plain-vanilla.

With that, I'm pleased to announce the lease renewal of IRS Fresno for a new 15-year term. Given this is not a gun-toting agency and the space, while absolutely mission-critical, is more generic in nature, when we focused on renewal we felt lease term was a more important priority to give us flexibility to harvest value and provide enduring, stable cash flows for our investors. We're pleased to announce that this lease has been extended to 2033, a 15-year term. While the Government's exact amount of TIs are to be determined, we believe that our rent at IRS Fresno will be flat to down 5%. Renewal at this lease length for a reasonable market rent is a success. We are very excited to continue to provide the necessary housing for such an important mission to the United States, and we look forward to remaining a partner to the IRS for many years to come.

Five other properties with expirations last year just renewed at an average rental increase in the mid- to high-teens. These include SSA San Diego, DEA San Diego, DEA Riverside, DEA North Highlands, and CBP Chula Vista. In addition to this very healthy renewal spreads, we were able to achieve valuable longer-term leases. Each have been renewed for 10- and 15-year terms, thus meaningfully extending our weighted average remaining lease term and allowing us to maintain 100% occupancy with 99% of our lease income derived from the full faith and credit of the U.S. Government.

Now that Easterly has seen more lease rolls and started to establish a lease renewal history, you will notice our bullseye properties are consistently renewing at meaningfully higher rental rates increase, providing for modest internal growth of distributable cash flow.

Now, with respect to the short-term lease renewals for the pending 14-property portfolio acquisition, I would like to reiterate just how comfortable we are with this portfolio. When bidding, the team underwrote each of these properties appropriately with a very strong understanding of the strength of their tenencies in the coming years, as we focus on the portfolio's renewals we will work to continue driving value through extending lease terms and growing our portfolio of U.S. Government cash flows.

In closing, before turning the call over to Meghan, let me step back and commend the Easterly Team for their success of this first half of 2018. In the past six months we have either purchased or put under contract approximately $515 million of mission-critical assets leased to the U.S. Federal Government; we have renewed our second-largest lease for another 15-year term; we successfully launched a public equity offering that put us in wonderful shape for future growth; and, finally, we have enhanced our balance sheet by amending our credit facility to provide greater borrowing capacity and more favorable interest rates. For Easterly, the efficiencies have never been better and the opportunities have never been stronger.

With that, I will turn the call over to Meghan to discuss the Company's quarterly results.

Meghan G. Baivier:

Thank you, Bill. Today I will review our current portfolio, discuss our second quarter results, provide an update on our balance sheet and share our modified 2018 guidance. Additional details regarding our second quarter results can be found in the Company's second quarter earnings release and supplemental information package.

As of June 30th, we owned 47 operating properties, comprising approximately 3.7 square feet of commercial real estate with an additional 340,000 square feet under development. The weighted average remaining lease term for our portfolio was 7.7 years, the average age of our portfolio was 12.7 years, and our portfolio occupancy remained at 100%. In addition, 99% of our annualized lease income was backed by the full faith and credit of the United States Government.

Pro forma for the recently completed acquisition of VA San Jose and for the future acquisition of the previously announced 14-property portfolio, Easterly will own 62 operating properties, comprising approximately 5.3 million square feet. The pro forma weighted average remaining lease term for our portfolio would be 6.8 years and the average age of our portfolio would be 13.5 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 $0.29; FFO as adjusted per share on a fully diluted basis was $0.25; and our cash available for distribution was $10.9 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 $487.8 million, which was comprised of $100 million outstanding on our 2016 unsecured term loan facility, $175 million of senior unsecured notes, and $212.8 million of secured mortgage debt. Availability on our revolving line of credit stood at $450 million and the Company's $150 million 2018 unsecured term loan facility remained undrawn. As of June 30, Easterly's net debt to total enterprise value was 19.9% and its net debt to annualized quarterly EBITDA ratio was 3.9 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 September 27, 2018 to shareholders of record on September 13, 2018. For the 12- months ended December 31, 2018, the Company is modifying its guidance of FFO per share on a fully diluted basis to a range of $1.17 to $1.22. This modification is attributable to the anticipated timing of closing of our 14-property portfolio and the success and upsizing of our June equity offering. This guidance is based on the Company completing the $515 million of acquisitions announced to date this year. The Company currently expects to close approximately $175 million of acquisition volume in September and the remaining $255 million in December of this year. The Company's 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.

As our business matures and we begin looking to 2019 and beyond, we're going to highlight FFO as adjusted in addition to FFO on a fully diluted basis, as we believe this metric will help highlight the economic strength and cash flow generation capability of the underlying portfolio. We are choosing to take the time to do this because with the renewal of significant leases in our portfolio in the coming years, like the six Bill just discussed, there are non-cash adjustments related to the amortization of lease related assets and liabilities in our FFO per share on a fully diluted basis metric which may confuse some investors regarding the cash generating power of the FFO guidance which we have historically provided.

Our objective is to deliver a growing cash dividend backed by the full faith and credit of the U.S. Government and we believe the Company's current portfolio and in-process development will allow us to deliver on this goal.

Moving on to the Company's capital markets activities, the second quarter was marked by two noble events. The first was the completion of an amended and upsized senior unsecured credit facility. In June the Company replaced its existing senior unsecured revolving credit facility with an amended and upsized credit facility consisting of a $450 million revolver and a $150 million five-year delayed draw senior unsecured term loan for a total credit facility size of $600 million. The revolver includes an accordion feature that may provide the Company with additional capacity of up to $250 million for a total amended credit facility capacity of up to $850 million.

The revolver will mature four years from the closing date in June 2022 with two 6-month as of right extension options available to extend the maturity to June 2023. The term loan will mature five years from the closing date in June 2023. The term loan has a 365-day delayed draw period and is pre-payable without penalty for the entire term of the loan.

Borrowings under the revolver will bear interest at a rate of LIBOR plus the spread of 125 to 180 basis points, depending on the Company's leverage ratio. The term loan will bear interest at a rate of LIBOR plus the spread of 120 to 175 basis points, depending on the Company's leverage ratio. Given the Company's current leverage ratio, the initial spread to LIBOR was set at 125 basis points and 120 basis point for the revolver and term loan respectively.

In addition to the execution of an expanded credit facility, the Company completed an equity offering of 20.7 million shares in conjunction with the announcement of a pending 14-property portfolio acquisition. As Bill mentioned, in June the Company launched an overnight equity offering and successfully raised $398.5 million of gross proceeds through the issuance of 20.7 million shares of its common stock, consisting of 13.7 million shares offered directly by the Company and 7 million shares offered on a forward basis at a price to the public of $19.25 per share. The Company expects to physically settle the forward sales agreements and receive proceeds subject to certain adjustments from the sale of its shares of common stock upon one or more such physical settlements within approximately six months from the date of the prospectus supplement relating to the offering.

We believe these two activities—the credit facility and the equity offering—put the Company in a very strong competitive position going forward. We look towards the future with excitement as we continue to pursue 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. 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.

Michael Bilerman:

Hey. It's Michael Bilerman here with Manny. I don't know, Darrell, whether you want address this, but if you go back to the beginning of 2016, you were basically running at $0.30 of FFO; this quarter you put in $0.29 2.5 years later, and that's despite the fact that you've—or maybe it's because of the fact you've doubled your share base and more than doubled your asset base. I keep on hearing you guys talk about accretion. I guess, at what point are you actually going to see growth in your underlying earnings, and how do you start thinking about that level, especially given the fact that effectively now for three years you will have no growth?

Darrell W. Crate:

Super question. Meghan, why don't you start and I'll finish.

Meghan G. Baivier:

Yes. Sure. As we focus ultimately, Michael, on distributable cash flow, I think it's important to have watched our ability to increase the dividend and continue to pay cash back to investors. Obviously, at the moment we are in a position post-offering where the balance sheet is in great shape and we have capital waiting to be deployed, so as we look out to the remainder of 2018, '19, and particularly into '20, as our development comes onboard, we're confident that the portfolio's ability to continue to generate greater levels of distributable cash flow will transpire.

Darrell W. Crate:

It's Darrell. I would say, of course, these REITs compared to other businesses without retained earnings, you don't get that compounding growth. But I think certainly since IPO we've done a very nice job stepping the dividend up. We have meaningfully grown the portfolio which leads, again, to when I was speaking about diversification and stability. We are super proud of the portfolio that we've built and its ability to deliver dividends, and we've laid the groundwork with the development that continues to grow, and for the opportunities of the new development opportunities that we see on the horizon. Those can make a meaningful contribution to cash available for distribution.

So, as you look out in the model, again, we've had nice dividend increases over time, but I would certainly say by the end of 2020, quarterly dividends of $0.30 or greater, which, again, if you look over time, I think that's a nice return for shareholders and that really doesn't include us having some nice positive surprises like the large portfolio that we were able to acquire most recently.

Michael Bilerman:

Right. I mean, look, I think most investors will think about REITs on a total return perspective, right, and so if we look at the last 2.5 years, your stock is relatively flat as your earnings have been flat, right, and you've growth the equity base, you've doubled your equity base. So, at some point you can increase the payout ratio by increasing your dividend, but with earnings flat there's not much growth, which is being reflected a little bit in your stock price.

Darrell W. Crate:

Right.

Michael Bilerman:

How should the market think about, especially when you're committing such new capital, right, and you said you won in a public auction; you paid the highest price, right. So, you need to accumulate assets, it's harder to make those investments accretively.

Darrell W. Crate:

Yes.

Michael Bilerman:

I've been trying to get a sense of your mindset when your FFO has basically been flat for three years.

Darrell W. Crate:

Right. Our mindset is, again, the cash that comes out of the REIT, again, backed to full faith and credit by the U.S. Government. We look today, the yield is 5.25% or higher essentially on what are Government revenues. So, we also know that we look in the market and we look at other REITs, and who am I to tell you how to think about REITs, but I would say scale does matter and scale equals diversification. So, we have the highest credit tenant of any REIT that you cover, or any REIT that's out there, and that's stability of cash flow should be the highest value cash flow that's in the REIT world. Why has it not been most highly valued? Well, scale is probably a pretty big factor.

Our mindset, again, accounting anomalies aside, and Meghan can spend time with you and Manny going through why FFO and FFO as adjusted—as we do lease renewals, those numbers, FFO flattens out, FFO as adjusted grows and we're looking at substantial—we're not increasing our payout ratio of CAD, we're actually increasing the real CAD that's coming out of the portfolio. So, when we look at CAD growth for next year and into 2020, it's substantial. Our mindset is to have a consistently growing dividend full faith and credit of the U.S. Government. Obviously a REIT is not a Government bond, but I don't know how many basis points are reasonable for our yield to be above the 7-year Treasury, but we certainly see that over time that gap should shrink, and as long as we keep delivering what is kind of single-digit to low double-digit growth in dividend and hopefully stock price, that should put us in kind of the top 10% of return drivers for REIT investors.

Michael Bilerman:

Right. But you're at $0.25 this quarter and adjusted FFO you were $0.27 the beginning of 2016, so once you measure it on FFO, adjusted FFO, FAD (phon), there's been no growth. I think that you can go through the protection of leases and things like that and Government. At the end of the day your net lease REIT that your entire job is putting out capital and raising capital, ultimately you have the underlying (phon) seeing growth and I'm just trying to understand at what point will estimates start going up rather than going down, right. Is it the back half of 2019, is it 2020, because at this point, right, all you've seen is numbers go the other way?

Darrell W. Crate:

Yes. Well, again, I'm not going to get into what our guidance is next year for next year, but, I mean, we all have the models. I think, again, given you the indication that we're going to have dividends that are $0.30 or higher per quarter within one to two years is certainly valuable. I would say—well, yes, so there you have it. I mean, remember, our leases are not one where—our leases over time should keep up with inflation, but the value of our REIT, I would say to say it in a cheeky way, we buy the real estate and sell the credit, and that is—the value, the stability of our cash flows and full faith and credit going out 5, 10, 15 years, we think is valuable and it was why we brought this REIT to the public in 2015, because it was a unique offering relative to the others that were out there.

Michael Bilerman:

Okay. Thank You.

Operator:

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

Michael Lewis:

Thank you. My first question probably for Meghan; you ended 2Q with $150 million of cash, you've got the delayed portion of the equity offering, you don't have debt maturities for years; what do you think is your runway or investment capacity after taking down the rest of the portfolio acquisition to make additional investments before you think you have to come back to the equity market?

Meghan G. Baivier:

Yes. I appreciate the question, Michael; it's an important point. As I look at the capacity of the balance sheet, given where leverage is today and where we've stated for quarters now, our equilibrium comfort level is in that 6 to 7 times. I view our ability to have $250 million to $300 million of total asset capacity is the right number today beyond the portfolio.

Michael Lewis:

Perfect. I guess a follow-up to that, I mean, how do you think about—this quarter you took the upsized equity offering, you hit the ATM a little bit—how do you kind of balance the timing of taking equity when you could get it or when it's attractive versus coming to the market with a deal when you need it and kind of managing that near-term earnings dilution?

Meghan G. Baivier:

Yes. As we approach the equity market with the announcement of portfolio, I think the balancing factor was not only ensuring that we were financing this short term, but making sure that were we had the ability to have equity to, given the strength of the offering, to provide that excess liquidity but also ensure that we were able to maintain the dividend, as we spoke to Michael about before, and look to grow it over time into the next year or two.

Michael Lewis:

Okay. Got you. The $250 million to $300 million, that's a lot of capacity to take and I guess helps explain that dilution. I mean, listening to your conversation with Michael, that dividend growth is—I mean, I'll do the math my head, I guess—20% dividend growth over, you said I guess, two-year plus call it on the long end. You know what? I'll come back to that offline.

Let me ask just two more quick ones. Bill did a good job going through the leases coming up for expiration and the portfolio you acquired. You've got three coming up in '18, two in '19; is there any reason to believe anybody would move out or downsize?

William C. Trimble:

Good morning. No. I think we're very confident in our tenants and I think we feel very good. I think we've executed where we said we would, certainly within the bullseye section, so we continue to work through. I will say that the Government is always an interesting partner to negotiate with, but in the end we have the same goals and I think we've proven we are able to keep them in our buildings.

Michael Lewis:

Then just last one for me, the portfolio acquisition, is there anything in that pool of properties that maybe is fringe on the bullseye or maybe something that's multitenant that might be a near-term disposition, or do you think that you'll hold all these for the long term?

William C. Trimble:

I'd say I think, first of all, we have underwritten, as I mentioned, this portfolio for literally years; it was one of the ones that would have gotten us to scale to go public, so I think we're very familiar and very happy with the buildings in that portfolio. You are correct; there are several multitenant buildings, however, I think they are some of the strongest buildings in the portfolio and, while we've always bought BMWs, for example, Mercedes makes a good model as well. So, if you look at Buffalo, you look at Portland, and you look at Charleston, we think that these are enduring and, actually, quite frankly, Clarksburg as well. We think we've got really enduring missions in these properties. However, I will tell you that overall—and we've tried to do this—we try to be 100% Federally leased and we try to be as close to the bullseye as possible going forward. So, if we see opportunities or we think we need to make a shift, we will certainly do it and I think we will do it decisively. However, right now we're very pleased with the portfolio.

Darrell W. Crate:

This is Darrell. As we've mentioned in the last conference call, there are a series of portfolios that are out there. Strongest compliments to Bill; since the IPO we have continued to distill and focus and really kind of push our bets onto the bullseye and there are many—I mean, as anyone who runs these REITs knows and you as the analyst community particularly, there are plenty of properties you could kind of pick up along the way that are at a higher cap rate or you could rationalize as part of your strategy, and we've been defined as much by the deals that we don't do as those that you have come to see.

So, as we move forward and look to other portfolios, there certainly will be very high-quality buildings that are attractive but may not be in our bullseye, and I think as we concentrate to a greater and greater degree on bullseye properties and the dynamics that we best understand around those properties, that will be our focus over the next 5 to 10 years.

Michael Lewis:

Great. Thank you.

Operator:

Thank you. Ladies and gentlemen, as a reminder, if you'd like to join the question queue, please press star, one at this time.

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 on the investment market; what type of deals you're currently tracking? I noticed that your guidance doesn't really assume any more incremental investments; is that because you're working to complete this large portfolio transaction or do you think that there's other deals that you could potentially complete before year-end?

William C. Trimble:

Well, a couple of things, and good morning. I think that it's not a mystery we are in the eighth month of the year, and I just want to make the analyst community realize that we've got to make sure we put them all in the different quarters correctly. This portfolio is taking a fair amount of our time, but that doesn't mean that we are slowing down in any way on what we're seeing out there. Even if we were to buy something absolutely terrific at the end of the year, it's obviously not going to be working for us until next year, so I think that's an important point to put out there. But I think from a quality standpoint we continue to see wonderful opportunities. Individually, we're seeing small portfolios and, as Darrell mentioned, we're also seeing large portfolio opportunities. I think that the increase in interest rates, as I've said before, is actually giving us more opportunities going forward as these sellers—and I reminder you, there are really about 500 GSA properties and 50 VA properties; we know where every single one of them are and these owners' cost of capital are different than ours, and, as interest rates increase, I think many of the conversations that in some case we've been having for years, will come to fruition as these owners realize that Easterly is probably a better home for these properties.

We're probably going to be more successful renewing them as they come up for renewal. We have a wonderful team of folks that can do that and have great relationships that we really provide a lot of extra value there. So, from our standpoint I think everything is steady as she goes with probably a positive bias on what we're seeing for opportunities.

Michael Carroll:

Great. Then, Meghan, can you talk a little bit about how the leverage target going forward. I know the recent offerings have probably reduced you below the long-term target range. Is 6 to 7 still a goal and are you comfortable near that 7 times or would you prefer to stay near the low end of that expectation?

Meghan G. Baivier:

No, nothing has changed from our perspective there, Michael. Six to 7 times is still our comfortable range. Development and timing of development, as we've discussed particularly with the portion of the development budget that is lump sum, can push us towards the higher end, up towards that 7 times where we're comfortable because that's for a temporary period of time.

Darrell W. Crate:

Look, it's Darrell. I'd just lay on top of that with these very successful lease renewals, I mean, when you look at these 10- and 15-year terms, I entirely get the 6 to 7 times as the right range and that's the expectation, but as we've said again and again and again, the quality of our cash flows is higher than other folks out there. In theory they should be more leverageable, but we govern our leverage ratio so that we stay within the pack among REITs. But that said, our leverage, even if we were to get to that 7 times level, is an even more credit worthy supported 7 times than it ever has been in our history.

Michael Carroll:

Okay. Then can you give more details on the recent renewal with the IRS; is there any capital that you committed to that lease or any free rent associated with it?

Meghan G. Baivier:

With regard to Fresno, there is one month of free rent in that renewal and we are working with the Government to finalize their TI requirements, and we would expect capital in the $2 million to $5 million range.

Michael Carroll:

Okay. Then finally for me, the PTO lease that comes due soon, I think in the supplement it says 2019/2020; is there two lease expirations with that asset?

William C. Trimble:

Yes, there're two portions in the property. Actually, (Inaudible) owns the first floor and then we have two different—it's Federal (inaudible). So we, as a retail section on the bottom, I know you visited with us, and then there're two different sections within the building that are leased to PTO that is ongoing, but we do expect that we will renew that property. That'll really come about fruition in January of 2020, I think, over the next lease for them.

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 question.

Jon Petersen:

Great. So, just one question; you guys talked earlier about potential for dispositions and around a lot of non-core properties, so I was curious specifically about IRS Fresno. You put a 15-year lease on that property. I don't know if you can remind us how old of a building that is or if that now that it has a 15-year lease on it if that's something that is primed to be sold and reinvest that capital somewhere else.

Darrell W. Crate:

Yes. Good morning, Jon. It's a 2003 build and it was built basically for the IRS in Fresno, which is one of 10 super centers, you should know, in the United States, and it handles compliance for nine states, including California, so incredibly important mission. It's actually getting upgraded within the IRS to handle some other fraud stuff as well. That's the thing that is so important to point out: not only do we get a 15-year lease with the Federal Government—I don't know how many people on this call will be here when I announce that it's renewed for another 15 years, 13 years from now, but I welcome you then—but the deal is these buildings have incredible value with these long-term leases, and anything over 10 years tends to be reflected with a high valuation right now. So, of course, we're going to take the opportunity over the three or four years to decide as to whether we think that IRS's mission is going to continue to be as important, how this facility fits into it, but that's the wonderful thing about getting these longer-term extensions. It gives us a lot of flexibility and a lot of value for our shareholders.

Jon Petersen:

Yes. Okay. I guess a follow-up on that, you guys talked about the value or, I guess, the impact on your stock price of gaining scale. I guess at what scale do you kind of get to the point where you can move to capital recycling rather than you need to come to the market an issue more equity?

Darrell Crate:

I mean, as we look to total assets of somewhere between $2 billion and $3 billion, we will certainly be at a place where we think strategically we have the scale to provide the diversification and strong stability for this portfolio. You already hear it, though, in some of what we are saying—and super smart question around the flexibility that's inherent in these 15-year leases. You've heard what we've learned, right, when we step back. What have we learned since 2010 is that the bullseye strategy for us works. The insights that we have into those buildings, and the ability to harvest value. Again, very hard to get rent growth in the types of leases that we have with the U.S. Government; however, with the bullseye properties you can see we've been extremely successful.

We look to our plain-vanilla properties, so obviously our strategy on the margin is to get a longer-term lease and to give us the flexibility to the degree to which we want to distill what we're doing around the bullseye, the area, the target that we set out and have always known best, we're positioning ourselves for that option. Meghan's done such a fantastic job financing these buildings that the real opportunity to remain flexible and recycle capital just whenever there's an opportunity to, again, concentrate on the bullseye where we find the greatest value for shareholders will certainly be an opportunity for us.

Jon Petersen:

Great. I apologize if you guys already said this, but just speaking about Meghan and financing, the delayed draw or the—not the delayed draw, the kind of deferred equity that you guys have—can you remind us how we should be thinking about when you pull that down throughout the rest of the year?

Meghan G. Baivier:

Yes. It's $7 million. We have six months just to settle that. I think you can expect us to settle that at the very end of this year, December timeframe.

Jon Petersen:

Okay. Thank you.

Meghan G. Baivier:

Mm-hmm.

Operator:

Thank you. Our next question is a follow-up from the line of Manny Korchman with Citigroup. Please proceed with your question.

Darrell W. Crate:

Manny, Michael?

Michael Bilerman:

Sorry about that; still learning the phones after 20 years. Yes. Can you talk a little bit about dividend coverage? You're running about $0.26 today, whatever metric you want to use, (inaudible). When you look at $0.29 of FFO, $0.25 of FFO as adjusted, and then, let's call it, $0.22 of CAD, adding back acquisition costs and the principal amortization, right, so your pay our ratio is 90% of FFO over 100% of FFO's adjusted and 120% of your cash available for distribution, again, adding back the acquisition costs and the principal amortization. How is that sustainable and not too high of a payout ratio?

Darrell W. Crate:

Yes. Thanks for the question because obviously as we've been scaling we've been in a bit of a period of transition and there's been some anomalies in timing on how acquisitions come through. But when you look at these renewals, this portfolio that we are purchasing in September and in December, as we look forward, our intent is to dividend out, obviously reserving for capital and what else we need to do in order to renew leases and keep our buildings in top shape, but to be dividending out 95% to 100% of that cash that's available for distribution. When I talked about $0.30 a quarter in 2020, the throttle is on 95% to 100% and that is the way the math works.

I would encourage the analysts to look at that CAD and work their models backwards. Maybe we could do a better job communicating NOI? I don't know. It's crazy to me with the stability of our cash flows that we can miss a number, and I would say that I'd really encourage folks to tweak their model and let's talk about CAD between here and 2020 and work it backwards, because as we renewed these leases and the anomaly of the accounting of when we went public, there are above and below market leases which maybe is a little different.

To Michael Bilerman's fantastic point, FFO is not going to the metric that actually indicates to investors our growth. As you know, we're kind of private equity people and we focus on cash and cash returns and that's why we're just going to keep cash, cash, cash, dividend, dividend, dividend; get the money into our investors' hands. I would encourage everybody to look at $0.30 of CAD or greater in fourth quarter of 2020 and we will help people work it backwards either on these calls, or if we have non-material things to share, we would certainly share them in conversations with any investor who wishes to give us a ring.

Michael Bilerman:

But that $0.30 you're looking at it inclusive of acquisition cost and amortization so this quarter with the $0.19 I gave you a little bit of a benefit of a doubt that those are, while they're cash items, they're more debt oriented and capitalized typically to an acquisition. So when you're talking 95% to 100%, are you comparing $0.19 going to $0.30 or you're comparing $0.22 going to $0.30 and, again, you're paying $0.26 today, so you're (cross-talking).

Darrell W. Crate:

Over-disclose, Meghan. We're already writing an 8-K about this, so just keep jamming it out.

Meghan G. Baivier:

Yes. Your point is taken upon sort of the nature of amortization, but when we think about that, that's going be the threshold of the business, so we're talking about CAD post that.

Michael Billerman:

You want to grow from $0.19 a quarter to $0.30 by 2020? I mean, I think having the building blocks of getting there would be helpful.

Darrell W. Crate:

Let's do an Analyst Day. I don't know what we need to do.

Michael Billerman:

I mean, I don't know how you have that amount of growth in 2019 and 2020 from what you have in place today. It just seems like an awful large amount of...

Darrell W. Crate:

Right. It's not coming from FFO growth, let's just be super clear, because of how these leases roll.

Meghan G. Baivier:

We can certainly walk through your model, but obviously we've got the equity and, therefore, an acquisition that we do not have any cash flow from yet. We have not closed any of those buildings, so I think you're looking at a quarter a little too myopically.

Darrell W. Crate:

Right. Remember, we just took on a ton of shares and the way we source, we could put a ton of money to work, we think, accretively for investors. Obviously, I think we've been deliberate about how we put our hands on the throttle since we've been public, and we were very mindful, again, of looking out and understanding where our dividend capacity is and, through this offering, we're deliberate about the amount of capital that we were able to take, timing we could put to work, and making sure we can be on a very clear path around the dividends.

I think some of the numbers may seem strange this quarter, but will certainly see as we move through the end of the year and into next year how we get to this $0.30 or greater by the end of 2020.

Michael Bilerman:

Yes I mean, if you're talking about 60% growth, right, which is (cross-talking) was not weighted down too much by the equity, right? Your equity was late and in the back half of the year you're running about $0.30 based on your guidance which should drop down to the same $0.19, $0.20 on CAD. So, growing from that level to $0.30 by the end of 2020 just seems like a pretty strong growth rate that would need some more details behind it.

Darrell W. Crate:

Great. Yes. We've got to give you those, so let's just make sure we have an Analyst Day or a teach-in or whatever else we need to do, or we can do a webinar, all those fancy things that we can do to communicate, because we do have to get analysts' models synced up with what's going on at the Company. I am entirely empathetic that a big portfolio and an equity raise can make the numbers tough to track, and there's nothing gargantuan when I talk about $0.30 fourth quarter of 2020. I mean, it is what we've got in place, plus just doing our day jobs. Yes. Let's figure it out. Meghan remains open. Her line is open and we are happy to work through stuff and get the information out to investors.

Michael Billerman:

Great. Thank you.

Darrell W. Crate:

Thank you.

Operator:

Thank you. Our next question is another follow-up from the line of Michael Carroll with RBC Capital Markets. Please proceed with your question.

Michael Carroll:

Yes. Thanks. Meghan or Bill, can you talk a little bit about the lease spreads you expect over the next two years? Then, I know Loma Linda has a pretty big rent bump also. When does that come in and how big is that rent bump again?

William C. Trimble:

Sure. I think the renewal spreads are going to be consistent. What we've said is depending whether they are plain-vanilla or whether they are bull's-eye gun-toting sorts of properties. Again, sort of high-teens for those bull's-eye properties and plain-vanilla is going to be very much in line with the market. I think that's probably what we will see there. Loma Linda's bump, Meghan, is...

Meghan G. Baivier:

Yes. That's in the first quarter of 2019.

William C. Trimble:

How much is that bump?

Meghan G. Baivier:

Thirty percent.

William C. Trimble:

Thirty percent increase.

Michael Carroll:

Okay. Great. Thank you.

Operator:

Thank you. Mr. Crate, there are no further questions at this time. I'll turn the call to you for any final comments.

Darrell W. Crate:

Great. Thanks everyone for joining the Easterly Government Properties Second Quarter 2018 Conference Call. We appreciate your continued support and we strive to provide strong risk adjusted returns to our shareholders through dividend growth, and we look forward to getting together now or on the next conference call. All the best.

Operator:

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