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Easterly Government Properties

Third Quarter 2022 Earnings Conference Call

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CORPORATE PARTICIPANTS

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CONFERENCE CALL PARTICIPANTS

Michael Griffin, *Citi*

John Kim, *BMO Capital Markets*

Michael Carroll, *RBC Capital Markets*

Michael Lewis, *Truist*

PRESENTATION

Operator

Greetings. Welcome to the Easterly Government Properties' Third Quarter 2022 Earnings Conference Call.

Please note this conference is being recorded.

I will now turn the conference over to your host Lindsay Winterhalter. You may begin.

Lindsay Winterhalter

Good morning.

Before the call begins, please note that certain statements made during this conference call may include statements that are not historical facts and are considered forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Although the Company believes that its expectations, as reflected in forward-looking statements, are reasonable, it can give no assurance that these expectations 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 the Company's most recent Form 10-K and Form 10-Q filed with the SEC, and in its other SEC filings.

The Company assumes no obligation to update publicly any forward-looking statements.

Additionally, on this conference call, the Company may refer to certain non-GAAP financial measures, such as funds from operations, 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 Crate

Great job. Thanks, Lindsay.

Good morning, everyone, and thank you for joining us for this third 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.

During the quarter, we entered a new phase in the real estate market: rates are rising quickly, how fast is uncertain; the transaction market has slowed; and there's a gap between buyer and seller expectations. Cap rates are readjusting. Of course, none of this will adversely impact our tenant credit quality, our occupancy, or our dividend. Having rent that is backed by the full faith and credit of the U.S. government, coupled with managing the portfolio for consistency and stability, should reduce uncertainty for investors particularly during uncertain times.

That leads me to the front footed question. How can we use this period to enhance our portfolio and add value for our shareholders?

First, we are enhancing the institutional quality of our portfolio by disposing of a set of assets that are either in remote locations who are with agencies where we do not see an ability to build a defined edge in serving our agency clients. These are fine agencies, but at this time we believe concentrating on what we know best will enhance our ability to add value.

Second, we're using the proceeds from the disposition to pay down most of our outstanding floating rate debt. We have been disciplined about terming out our liabilities to match our assets, and that favors us in these times of interest rate and uncertainty.

Third, we're maintaining meaningful liquidity in order to purchase assets that may be owned by landlords experiencing some financial distress. We have found ourselves at a disadvantage relative to developers over the last several years. They have bid projects assuming an exit with ever lower cap rates that worked for them longer than we imagined; that is over. Liquidity will start to dry up. Some will need a partner to complete their projects. I'll not mentioned specifics, but we will be ready should this opportunity present itself.

Lastly, we're actively bidding on transactions in a way that reflects the new cap rate environment. I don't imagine that we'll get much done in the next quarter or two, but I do imagine the market will reprice and we will find ourselves with our liquidity ready to acquire additional accretive quality assets.

We're pleased with how our portfolio is positioned as we look forward, and we will continue to execute our business strategy with the intent to deliver safety and stability to our investors. The goal is to deliver an attractive risk adjusted return to our shareholders that's backed by tenants that represent the full faith and credit of the United States government.

With that, I'll turn the call over to Bill to give you insights into the third quarter activities.

Bill Trimble

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

Starting with acquisitions. During the third quarter, Easterly acquired a 28,900 square foot U.S. District courthouse located in Council Bluffs, Iowa. This courthouse, a build-to-suit facility that delivered in 2021, is 100% leased to GSA on behalf of the judiciary for a 20-year non-cancelable term that does not expire until 2041.

As part of the Eighth Judicial Circuit, this property serves the Western Division of the Southern District of Iowa, a district that we created over 140 years ago. This facility, located just across the river from our National Park Service and FBI Omaha facilities, provides strong geographic efficiencies for our asset management team, and with the enduring mission of the U.S. judiciary, adding another courthouse to our portfolio undoubtedly strengthens the overall caliber of Easterly's assets.

In addition to the wholly-owned acquisition activity, Easterly, through our joint venture, purchased our seventh brand new VA facility located in Columbus, Georgia, which is part of our previously announced 10-building VA portfolio. From this roughly 68,000 square foot facility, the VA is able to provide an enhanced range of services to the approximately 30,000 surrounding veterans that reside close the Georgia-Alabama state line.

Like nearly all of the properties in this VA portfolio, VA Columbus sits on a brand new 20-year lease that does not expire until 2042. We continue to expect the remainder of the assets of the VA portfolio to deliver as planned, and we expect the JV to close on a total of approximately $145 million of this portfolio in 2022.

We are maintaining an active presence in the acquisition market, but with careful consideration for the changing backdrop and rising cost of capital. We acknowledge this is a moment where the markets are undergoing a transformation. Interest rates are rising this year at a pace this country has not seen in nearly two decades, there are inflationary pressures, and we feel it is prudent to stay acutely aware of opportunities, but not chase deals for the sake of portfolio growth.

That said, there are competitive advantages in this niche GSA market. As previously mentioned, the GSA lease structure protects us as landlords from inflation induced operating cost increases. Further, as Darrell mentioned, we believe in maintaining liquidity on the balance sheet as we estimate there may soon be a unique opportunity to help regional developers who have found themselves overextended and need of an exit strategy.

This is very similar to what we did with FEMA Tracy development several years ago. By pursuing only the most selective acquisition opportunities in this environment, we are strengthening the balance sheet for future development prospects, which has always been the most accretive use of our capital.

Finally, turning to this morning's announcement at a time when the transaction market is nearly paused, Easterly is pleased to report we have executed our first portfolio disposition with an experienced private buyer of GSA leased real estate. The disposition portfolio is comprised of 10 buildings, approximately

668,000 leased square feet, with a weighted average age of 14 years as a core rent. Meghan will go into further detail on use of proceeds and how this disposition was the right course of action for Easterly at this time, but the sale only makes the remaining 85 properties in the Easterly portfolio even more reflective of our Bullseye ownership strategy.

Through this sale, our weighted average remaining lease term, our annualized lease income per square foot, and visibility of cash flows are all improved, which ultimately enhances the NAV of the portfolio. This sale in turn supports our stable dividend currently at a highly attractive yield. In the end, Easterly left with a more bullseye-oriented portfolio with a tighter geographical footprint and larger average property size.

Turning to leasing updates. Our asset management team continues to secure renewals that lengthen the duration of our government backed cash flows and enhance the portfolio's NAV. In the third quarter, we renewed the DEA drug laboratory located in Dallas, Texas for a new 17-year lease term. We also renewed the FBI field office located in Little Rock Arkansas for another 20-year lease term. With a combined weighted average renewal term of 19 years, the importance of these two facilities for the U.S. government is apparent. I congratulate the asset management team on continued strong renewal executions, and we look forward to providing updates in future quarters for 2023 renewables and beyond.

Turning to operations. The third quarter of 2022 was a notable quarter for an ESG perspective, as Easterly released its inaugural ESG report. This report, which can be found in our Corporate Responsibility page, is a notable step in our Company's ESG trajectory.

For the first time, Easterly has committed itself to certain environmental and social goals, including a 10% reduction in energy and a 5% reduction in water use by 2030; a commitment to increase DEI hiring and training practices across the Company; 90% participation in charitable giving or volunteering by 2025; and finally, implementation of an employee engagement survey with at least 90% participation for Easterly employees. We feel good about establishing these important goals for our Company and continuing to be strong corporate citizens for our employees, shareholders, and the communities we serve.

You can expect this report will be updated and progress towards these goals will be tracked on an annual basis. Many thanks to our director of sustainability for leading this effort and delivering a report which captures the Company's increasing ESG initiatives so well.

In closing, this has been an important quarter for Easterly. We have renewed our largest 2022 lease expirations for a weighted average duration of 19.3 years, providing the Company with increased certainty and duration of cash flow for future dividends. We added both (inaudible) assets, both wholly owned and through the JV, increasing the overall quality of our portfolio. We made significant strides in our environmental sustainability and corporate responsibility efforts through the publication of our inaugural ESG report, and subsequent to quarter end, we executed on the Company's first portfolio disposition, which simultaneously strengthens the Company's balance sheet and portfolio profile.

We look forward to keeping everyone apprised of future endeavors as we close out the year.

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

Meghan Baivier

Thank you, Bill. Good morning, everyone.

At a time when the market is bringing Company's balance sheets into greater focus due in part to rising interest rates, I am pleased with the strength of our portfolio and the actions we've taken to recycle capital, enhance our leverage profile, and position ourselves for opportunities to come.

As of September 30, we own 95 operating properties comprising approximately 9.1 million leased square feet, either wholly owned or through our joint venture with a weighted average age of 14 years, and a weighted average remaining lease term of 10.1 years. Pro forma for this morning's disposition announcement, portfolio metrics look even stronger with a revised portfolio size of 85 operating properties and 8.4 million leased square feet, either wholly owned or through our joint venture. Our new weighted average remaining lease term is enhanced to 10.3 years and reflects the Company's full value investment basis.

At quarter end, the Company had total indebtedness of approximately $1.4 billion, representing a net debt to annualized quarterly pro forma EBITDA ratio of 7.4 times with approximately $177.8 million outstanding on our line of credit. In total, this represents just over 14% variable rate debt for the Company. With the completed sale of the 10-property disposition portfolio, subsequent to quarter end, we expect net proceeds will be used to pay down outstanding debt obligations, taking Easterly's adjusted net debt to annualized quarterly pro forma EBITDA ratio down to 6.9 times as of September 30.

Furthermore, we will have extinguished a mortgage with a rate well above the Company's weighted average at MEPCOM Jacksonville, we will have reduced the Company's floating rate exposure from 14.1% to 1.3% of all outstanding debt obligations, improves the Company's weighted average interest rate by eight basis points, lengthens the weighted average maturity of outstanding debt obligations to 6.1 years, and added capacity for future acquisitions and development related expenses by recycling non-(inaudible) assets. When combined with the approximately $92.5 million of unsettled forward equity, these actions translate into a well-positioned balance sheet for the Company in a time of rising rates.

Turning to our third quarter results. All on a fully diluted basis, net income per share was $0.01, FFO per share was $0.32, and FFO with adjusted for share was also $0.32. Our cash available for distribution was $28.5 million.

Finally, turning to our earnings guidance. In connection with the announced disposition and the changing reality in the capital markets, we are revising our FFO guidance per share on a fully diluted basis to a range of $1.26 to $1.28. This guidance is predicated upon a number of factors, including no additional fully owned acquisition activity beyond the approximately $107.7 million already completed year-to-date, the closing of properties in the VA portfolio totaling approximately $145 million at the company's pro rata share, the completed sale of all 10 properties in the disposition portfolio, and no additional material development related investment in 2022.

Like the majority of our REIT brethren, we plan on issuing our 2023 guidance in connection with our Q4 and Year End 2022 earnings results. Given the slowing transaction market, the increased cost of capital, and general uncertainty in the capital markets, we feel it is prudent to withhold guidance until we have greater clarity of the market and our ability to drive earnings growth for our shareholders in a rapidly evolving environment.

With that, we thank you for your commitment to our thesis and appreciate your partnership. I will now turn the call back to Shomali (phon).

Operator

Our first question comes from the line of Michael Griffin with Citi. Please proceed with your question.

Michael Griffin

Hi. Thanks. Maybe going back to the guidance comment. Just seeing if you run rate the 4Q expectations through 2023, it would imply a deceleration relative to 2022. Meghan, I know you just talked about how you didn't provide guidance for ’23. But is this how we should be thinking about it with the framework going into it? Any additional color or commentary you could provide here would be great.

Meghan Baivier

Sure. With regard to this year's guidance, really the shift is due in equal parts to interest and deal volume, as well as the run rate dilution from the disposition for a large portion of the fourth quarter. Yes, as we go into 2023, considering the run rate, effective disposition, and the forward curve would be the primary two drivers of how we how we start off looking at 2023. But we'll issue formal guidance in February.

Michael Griffin

Got it. I appreciate the color on that. Maybe back to dispositions, it didn't seem to me that you necessarily needed to be a forced seller in a market like this, and I understand proactively assessing the floating rate debt side of things. But the back of my math showed about a low sevens dispo cap rate compared to where you're trading at an implied cap of, call it, about a mid-sixes. Piggybacking on that, maybe give us more clarity around why this transaction was right at this time, and any anything else you could provide there would be helpful.

Bill Trimble

Yes. Good morning. I think the first thing to realize is that while we love all of our buildings, we have a broad range of different missions, different geographies, different sizes within our portfolio. I think as you noted, when you saw the buildings we sold which we like, many of them were located in remote regions that were difficult for our asset management team to really dig into. Secondarily, they're mostly in the sort of the 30,000 to 40,000 square foot size, so really not of scale for our Company. But most importantly, I think, is if they weren't part of our bullseye strategy, and that's important.

I think that it's very important that we concentrate on agencies we know. The judiciary, we've talked about those Homeland Security agencies that have been terrific parts of our portfolio, and so we really tried to construct a great portfolio to move on, it’s a very educated buyer on the other side of this portfolio.

But I also think that there's another factor at play right now as we saw cap rates compressing at an incredible rate from last November until, basically, March of last year. Basically from the sixes down to the low fives during that period of time, and everything got compressed. I mean, the good stuff, the okay stuff, and even the bad stuff, which obviously we weren't not interested in. We're really moving down as you saw a lot of appetite in this particular sector.

Now what we're seeing is more of a return to what we've enjoyed for the last 10 years, which is there's different pricing, there's a broader spectrum, whether you have most of our buildings, it could be laboratories, FBIs, think federal courthouses; they're going to trade at a lower cap rate. But the plain vanilla sorts of buildings, which I think the Government is always going to need are beginning to gap out on that. That's why I think this would be not—these buildings are reflective of good buildings, but they're not reflective of our core portfolio.

Meghan, anything to add?

Darrell Crate

I would just also say as you look at these times of uncertainty, we want to position ourselves to have liquidity, and while we think that the price for our building was a good transaction, having that liquidity for the opportunities that are coming as we look to 2023, of course we're uncertain on the timing of those opportunities, but those opportunities are ahead of us and we just want to be very well positioned to seize on them.

Michael Griffin

It is a low-seven dispo cap rate, is that right around in the right ballpark? Give or take.

Darrell Crate

That is, yes.

Meghan Baivier

Yes.

Bill Trimble

Yes.

Michael Griffin

Great. Thanks so much, guys. Appreciate it. Yes, thanks. That's it for me.

Operator

Our next question comes from the line of John Kim with BMO capital markets. Please proceed with your question.

John Kim

Thank you. It seems like you've had more of a refined strategy on what your bullseye target is, and there's been some cap rate compression on that in recent months until recently. But just given your cost of capital and the interest rate environment, it's not really conducive for acquisition. What is your strategy on achieving earnings growth or is that really on the back burner for now?

Meghan Baivier

Yes, I think we would not necessarily agree with the premise that there isn't an opportunity for this market to normalize and our cost of capital to be in line with where that market is normalizing and our ability to go to go back and do what we've done for eight years and acquire accretively to drive external growth, John.

Darrell Crate

(Multiple speakers) more affirmatively, that is what is going to happen. Is it going to take a quarter, two quarters, three quarters; we don't know, but that is—It's very clear what the future holds, and that's why we're positioning ourselves in a way that we can take advantage of it.

John Kim

I thought Bill mentioned earlier that the plain vanilla assets is where you can see some cap rate expansion. That's where you could get some accretive acquisitions to repursue that route, but it doesn't seem like it's going that way. That's why (multiple speakers).

Bill Trimble

No, we aren't. No, I think we are not going that direction, and I think most of the acquisitions that you see in that area for us have been part of a portfolio. We've always been, John, bullseye, bullseye, bullseye. I don't know how many times appears it appears in my speech every time, but we really like to drive to that. There's been questions I've been asked, I think one note came out asking about occupancy, or when is the government going to get back. The government has been in our buildings the entire time, which I'd like to point out to folks, and they have important missions.

But I think the world is changing. At some point—I can't forecast what's going to happen 15 years from now, or 10 years from now with that, but we do know that the FBI, the laboratories, the courthouses are going to continue to be occupied and extremely valuable, and even more important, very expensive and difficult to replace. That's the area that we're going to spend our time in, and it just seemed a natural moment to also build some liquidity for the balance sheet.

John Kim

On the rising operating expense this quarter, I realized something that's probably widely related. But I was wondering if you had that figure on a same store basis, and how you feel about managing those costs, constituent '23?

Meghan Baivier

Can you repeat the first half of the question, John? What about on same store basis for the quarter?

John Kim

Yes, the Opex you have on the total portfolio basis, but I was wondering if you had that on the same property basis?

Meghan Baivier

Yes, so in the quarter, same store NOI quarter-over-quarter due to that spike in utilities in August—which we, by the way, have seen moderate in September—really fully offset the contribution of the deals we had done in the second quarter in the annual inflation, so $1.3 million offsetting $1.3 million. Obviously, the rising interest rates netted about $0.01 quarter-over-quarter FFO decline.

John Kim

Do you expect inflationary pressures next year keeping that expense number elevated.

Meghan Baivier

I think we all appreciate the inflationary environment we're in, but over time our leases, we will reiterate they do provide for that inflation protection, and they may not be able to insulate for a one-month spike, such as we had happened in August. But over the arc of time, our bases will match to our expenses, and we are effectively keeping off X growth inside of current inflation levels.

John Kim

That's great. Thank you.

Operator

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

Michael Carroll

Yes. Thanks. Meghan, just staying on the Opex question that John was asking about, it looks like Opex was up about $2.6 million, sequentially; but your recoveries roughly about $700,000. Was that difference just really driven by the seasonal nature of August or is that going to continue going forward?

Meghan Baivier

Mike, remember, the tenant reimbursements line item you see in our financials is not the Opex space reimbursement that is embedded in rental income, that's related to those interim tenant improvement projects that we perform on behalf of the government. Nevertheless, to get at your question, we are—same store Opex growth this year is sub 8%, and we do expect to be able to, as I said in my prior comment, continue to effectively hedge that with our base.

Michael Carroll

It looks like total revenues are up about $1.4 million, so there's still a pretty big gap between what has increased in Opex. I'm assuming that is just driven by the seasonal nature of it and as we move forward into 4Q or 1Q, you're going to be able to—that Opex increase is not going to be as significant, so you should see some benefits of that going in the fourth quarter. Is that correct?

Meghan Baivier

Yes, so again, just to keep the details tight here, our same store NOI quarter-over-quarter did decline $1.3 million nearly entirely by the utility spike. We do expect that to revert as we move into the fourth quarter.

Michael Carroll

Okay. Just related to the asset sales, did you change your definition of bullseye properties? I was surprised that you had so many non-bullseye properties within your portfolio. Outside of these sales, how many do you have left that you would consider selling and that you don't want in your portfolio, or it doesn't fit your criteria?

Bill Trimble

Well, I think we feel good where we are now. Obviously, we had renewals of our largest plain vanilla assets with very extensive terms in the last few years, as in 15-year terms, so this really would cover most of those assets that we would put into that category. But we've always, as I said, (inaudible) the same discipline, and we always have said that we want to concentrate on those build-to-suit mission critical bullseye properties, and that's what you're going to see us buy, and that's what you're going to—I think if you see sales in the future for any reasons, they will probably be in the plain vanilla category.

Michael Carroll

Would you consider these assets plain vanilla, or would you consider them just non-bullseye properties?

Bill Trimble

They're non-bullseye—I think we really consider the same thing.

Darrell Crate

Bullseye isn't a binary thing, so there's some that are closer to the edge than others, and this was an opportunity to trim along the edge of bullseye properties, and as we said, concentrate on a couple of agencies where we really can have a defined edge competitive advantage in serving the client. Again, in times of adversity, it's time to trim it in a little bit, make sure we're focused on what we do for our very best, create liquidity for the opportunities that are coming, and it's in the context of all of that, that the actions of the last really three months and six months have been taken place.

Michael Carroll

Okay, so then the non-bullseye properties are playing in on the properties that you still have in the portfolios. What? Probably, what? The IRS building in Fresno, some other social security buildings that you are happy with.

Bill Trimble

Exactly.

Michael Carroll

You're happy with those because of the lease term?

Bill Trimble

Yes, we're very happy with the lease term, and I think you probably know that the IRS just got a $80 billion check, and that building is right in the front of it. By the way, I'll remind everybody in the call that it is the last place you ever want to get a call from, because they're financial compliance. But yes, that would be an example of a plain vanilla property.

Michael Carroll

Okay. Great. Thank you.

Bill Trimble

Thanks.

Operator

Our next question comes from the line of Michael Lewis with Truist. Please proceed with your question.

Michael Lewis

Thanks. This is good timing because I wanted to follow up on Mike Caroll's question. I had some of the same thoughts. When I looked at the portfolio of 10-properties, one of these is an SBA, 81,000 square feet in College Park, Maryland; one of them is a VA, 30,000 square feet in Baton Rouge; one of them is leased to ICE, 25,000 square feet in Pittsburgh. I think those are probably bullseye agencies. I'm just wondering how this portfolio came together, did you market this and found a buyer? Or did you negotiate with the buyer, what properties were in the portfolio and which ones were out? I'm just curious how it came together.

Meghan Baivier

Yes. Mike, it was a well-considered, well-compiled portfolio, and it was competitively put into the market. We had a lot of interest from mainly competitors we speak out regularly and feel very good that we found a very efficient fair value perspective on the portfolio.

Michael Lewis

Okay, so you didn't swap properties in and out?

Meghan Baivier

No, we did not.

Michael Lewis

Okay, and then on the guidance, does it assume that all of the sales proceeds are used to repay debt? As part of that, I'm wondering what debt can you get at, and at what cost? Because you don't have any maturities for the next 12 months, and there was only $6 million of debt on the portfolio.

Meghan Baivier

Yes, that's right, Mike. It is our plan to pay down our line with proceeds. We, obviously, had $177 million outstanding at the end of the quarter, and when you look through to the end of the year and the closing of the 10-property, also with the consideration of completing our VA portfolio acquisition target; that does nudge you to $50 million on the revolver, so adequate capacity there. Should we need it, a lot of continued following of us in the unsecured markets.

Michael Lewis

Okay, that makes sense. Just lastly for me, again, another guidance question. You lowered the guidance for this year by $0.08, and I think you mentioned half of that related to the lower acquisitions and capital markets, and then half on the dispositions. When I look at the dispositions, only two months' impacts and you're going to be—and that's before you even redeploy the proceeds is probably about (multiple speakers) before you.

Meghan Baivier

Mike, sorry if you misheard that, but it's roughly $0.04 due to rates, $0.03 on wholly owned transactions that are no longer in our guidance, and just about $0.01 for the disposition impact on 2022.

Michael Lewis

Okay, I missed that. Yes, that answers my question. Perfect. All right. Thank you.

Meghan Baivier

No problem. Thank you.

Operator

We have reached the end of the question-and-answer session. I'll now turn the call back over to Darrell W. Crate for closing remarks.

Darrell Crate

Great. Thank you, everyone, and thanks for joining the Easterly Government Properties Third Quarter 2022 Conference Call. We hope this call has been helpful, and we look forward to speaking to you all again soon.

Operator

This concludes today's conference, and you may disconnect your line at this time. Thank you for your participation.