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Q4 2022 Easterly Government Properties Inc Earnings Call

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CORPORATE PARTICIPANTS

Darrell William Crate *Easterly Government Properties, Inc. - Executive Chairman of the Board*
Lindsay S. Winterhalter *Easterly Government Properties, Inc. - Supervisory VP of IR & Operations*
Meghan G. Baivier *Easterly Government Properties, Inc. - Executive VP, CFO & COO*
William C. Trimble *Easterly Government Properties, Inc. - President, CEO & Director*

CONFERENCE CALL PARTICIPANTS

Michael Anderson Griffin *Citigroup Inc., Research Division - Senior Associate*
Peter Dylan Abramowitz *Jefferies LLC, Research Division - Equity Analyst*

PRESENTATION

Operator

Greetings. Welcome to the Easterly Government Properties Fourth Quarter 2022 Earnings Conference Call. (Operator Instructions) Please be advised that today's conference is being recorded. I would now like to hand the conference over to your speaker today, Lindsay Winterhalter, Head of Investor Relations. Please go ahead.

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

Good morning. Before the call begins, please note that certain statements made during this conference call may include statements that are not historical facts and are considered forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Although the company believes that its expectations as reflected in any forward-looking statements are reasonable, it can give no assurance that these expectations will be obtained or achieved.

Furthermore, actual results may differ materially from those described in the forward-looking statements and will be affected by a variety of risks and factors that are beyond the company's control, including, without limitation, those contained in the company's most recent Form 10-K to be 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 the tabular reconciliation of these non-GAAP financial measures to the most comparable current GAAP numbers in the company's earnings release and separate supplemental information package on the Investor Relations page of the company's website at ir.easterlyreit.com.

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

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

Good morning, everyone, and thank you for joining us for this fourth 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. 2022 as a year of change for real estate generally and office in particular. I'm going to contrast our business with office because many of the analysts who follow our company compare our performance to the office universe of REITs.

One meaningful way our portfolio is differentiated from office is our occupancy profile. As we've seen, office has been materially affected by the adoption of work from home flexibility that was born from the pandemic. For DEA, our mission-critical facilities support agency functions that require worker collaboration. You can't close down a [meth] lab from your dining room table. We also look forward and see the need for our facilities increasing.

As the population grows, the demand on our tenant agency function increases, the occupancy needs of our bullseye properties will benefit from population growth over time. Another factor affecting some office REITs is the shift in the term structure of interest rates and in particular, accelerating short-term rates. As you know, we have long-dated leases and Meghan has done a great job terming out our liabilities. We have a limited amount of floating rate indebtedness, which will serve us well through this period of Federal Reserve monetary tightening.

Lastly, the quality of our tenant credit is unwavering. All of our leases are backed by the full faith and credit of the United States federal government, we have a tenant credit profile that compares favorably with every REIT in the office universe. Our team continues to be engaged with the government lease market, and we're working to find high-quality assets to complement our existing portfolio.

Since the shift in interest rates, assets in our market are repricing. As is the case across the real estate sector, the bid and the ask between sellers and buyers widened. As one would anticipate that spread as we learn through our conversations is narrowing as the market eventually reaches an equilibrium, we are well positioned with our available capital to deploy it in a way that's accretive to our shareholders.

We're proud to have built a portfolio that is comprised of buildings early in their life with long-dated leases with exceptional credit quality. With bullseye properties, we're uniquely positioned among REITs to have a strong visibility to our future cash flows for many quarters to come, which provide high-quality, stable income to our shareholders. With that, I'll turn the call over to Bill to give further insights into our portfolio.

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

Thanks, Darrell. Good morning. Thank you for joining us for our fourth quarter earnings call. In spite of increasing headwinds in the capital markets, 2022 was another successful year for Easterly on many fronts. Easterly, either wholly owned or through its JV, acquired 7 properties, totaling just over 800,000 square feet of 100% government leased space. Staying true to our thesis of acquiring newer buildings with strong visibility of cash flows, the 2022 class of assets is both young and enduring. Based on the weighted average of an annualized lease income generated from these facilities, this subset of buildings averaged a construction delivery year of 2018 and has a lease expiration year of 2041.

As we have previously indicated, we are maintaining an active presence in the acquisition market, but we remain cautious because of the changing backdrop and rising cost of capital. Easterly will only do accretive deals. As the market is not there at the moment, we remain comfortable waiting. We will not grow the portfolio for the sake of growth, and we feel the strength of the in-place portfolio and visibility of cash flows with our U.S. government tenant distinguishes us from other office REITs in a significant way.

Other office REIT's earnings calls this quarter are centered around several themes, including work from home trends, building occupancy percentages, local market metal rates, subleasing activity and projected layoffs in various industries that might result in real estate downsizing. To be clear, these are not of concern at Easterly. We invest for the mission of the government's paramount and the federal employees need to work from our facility cannot be accomplished in their homes.

For those reasons, Easterly took a notable step in the fourth quarter of 2022 and executed its first portfolio disposition with an experienced private buyer of GSA leased real estate. The disposition portfolio was comprised of 10 buildings, approximately 668,000 leased square feet, with a weighted average age that was older than the remaining and now current portfolio. This sale enhanced the overall quality and NAV of the remaining Easterly portfolio, which in turn made those previously cited office challenges even less relevant for Easterly.

Another NAV-enhancing aspect of our business, our development arm, is making meaningful progress at our FDA Atlanta laboratory project. We have recently delivered our 65% CD submissions to the government and have started the process of procuring important materials like chillers and switchgear. We anticipate obtaining a permit for TI work this summer, and at that point, we'll begin TI construction.

We look forward to providing you with meaningful updates on future calls as we work towards building the FDA a brand-new state-of-the-art mission-critical laboratory space that sits on an initial 20-year noncancelable lease with the United States government. Turning to leasing updates. Our asset management team continued to perform in 2022 and executed on all major renewals for the year. Assets within this class included FBI Birmingham, EPA Kansas City, the DEA Drug Lab in Dallas, FBI Little Rock and ICE Louisville, all told, this represents over 320,000 leased square feet and approximately 4.7% of the company's annualized lease income in Q4 2022.

And on top of their success in renewing expiring assets in 2022, the asset management team continues to execute on another important aspect of the business, our tenant reimbursable projects. As a reminder, these projects include tenant-funded improvements that keep our buildings at peak performance and enable facilities to continue to help fulfill the important mission of the underlying tenant agencies.

In total, just under 14 million of these government-funded projects were approved in 2022, from which Easterly earns a project management fee. Examples of such approved projects in 2022 include a guard shack replacement at FBI Pittsburgh, a test bay construction project at JSC Suffolk, perimeter fencing and gate installation at USCG Martinsburg, our pharmacy conversion project at VA Mobile and the installation of new EV charging stations at DOT Lakewood. I congratulate the asset management team on all their success this past year as they work to extend the weighted average remaining lease term of our portfolio and increase our visibility of cash flows.

In closing, this has been an important year for Easterly. We've added bullseye assets, both wholly owned and through the JV, increasing the overall quality of our portfolio. We've made significant strides in our environmental sustainability and corporate responsibility efforts through the publication and establishment of formal environmental and social goal setting in our inaugural ESG report. We've executed on the company's first portfolio disposition, which simultaneously strengthened the company's balance sheet and portfolio profile and renewed our largest 2022 lease expirations for a weighted average duration of 19.3 years, reflecting the value the government sees in these facilities and providing the company with increased certainty and duration of cash flow.

The future looks bright at Easterly. There are undoubtedly challenges in the short term with a rising cost of capital and a slow transaction market but the underlying fundamentals of the business are strong. Our NOI is solid. And to echo Darrell's sentiment, if the world sees us as an office REIT, then we are thankful our smartest investors and analysts recognize the clear distinction between us and our office brethren.

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

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

Thank you, Bill. Good morning, everyone. As the market settles into a new interest rate environment and the opportunities for external growth remain muted, the strength of our balance sheet comes into greater focus. I'm happy to share the actions we've taken over 2022 and early in 2023 to recycle capital, enhance our leverage profile, reduce our floating rate exposure and position ourselves for opportunities to come.

As of year-end 2022, we own 86 operating properties, comprising approximately 8.7 million leased square feet, either wholly owned or through our joint venture, with a weighted average age of 13.8 years and a weighted average remaining lease term of 10.3 years. For the fourth quarter, all on a fully diluted basis, net income per share was $0.18 and FFO per share was $0.30 and FFO as adjusted per share was $0.29. Our cash available for distribution was $21.7 million.

For the year ended December 31, 2022, all on a fully diluted basis, net income per share was $0.35, FFO per share was $1.27, an FFO as adjusted per share was $1.26. Our cash available for distribution was $108.5 million. At year-end, the company had total indebtedness of approximately $1.3 billion, representing a net debt to annualized quarterly pro forma EBITDA ratio of 7.1x. With over $384 million in capacity on our line of credit, in the fourth quarter, we completed the sale of the 10 properties disposition portfolio, the net proceeds from which were used to pay down outstanding debt obligations. As a result of the transaction, we also extinguished a mortgage with a rate well above the company's weighted average at MEPCOM, Jacksonville. This sale reduced the company's floating rate exposure from 14.1% to 6.5% of all outstanding debt obligations and added capacity for future acquisitions and development-related expenses by recycling non-bullseye assets.

Subsequent to quarter end, we took another important step to manage our cost of capital in an uncertain interest rate environment. Easterly recognizes that floating rate exposure in our debt stack works against our universal strategy of being the REIT that delivers predictability to our shareholders. With that in mind, we elected to proactively and opportunistically enter into forward starting interest rate swaps to fix the interest rates on $300 million of our 2016 and 2018 term loan, including the anticipated additional $50 million of delayed draw funds from our 2018 term loan.

On February 3, 2023, we entered into forward starting SOFR-based swaps, each with a notional $100 million value. The first tranche has an effective date of June 23, 2023, and an 18-month duration with a fixed rate of 4.18%. The second tranche has an effective date of June 23, 2023, and the 21 months duration with a fixed rate of 4.01%. The third tranche has an effective date of September 29, 2023, and a 21-month duration with a fixed rate of 3.7%.

By executing these swaps, we have infused an even greater degree of visibility into our debt stack by managing our exposure to interest rate movements. As a result of the interest rate swaps entered into on February 3, the company extended the maturity of its interest rate swaps from a weighted average maturity of less than 6 months to a weighted average maturity of over 25 months, effectively extending the certainty of the company's fixed rate 2016 and 2018 term loan scheduled by more than 19 months.

Another important metric reflecting Easterly's underlying strength is its liquidity and access to capital. As previously mentioned, we believe there may be the potential to help distress developers with over $434 million in debt capacity and just under $93 million in unsettled forward equity, Easterly has ample opportunity to execute on accretive deals without needing to go to the capital markets.

And finally, before turning to our earnings guidance, allow me to spend a moment highlighting our re-leasing successes as of year-end. As previously mentioned, due to the unique nature of our leases, final renewal rents cannot be ascertained until the exact amount of tenant improvement or TI dollars required by the government at renewal as known and the TI work is complete.

As such, there can be a lag in providing re-leasing data relative to the point at which we have signed a renewal lease. As of December 31, 2022, we had executed 13 renewals for which the renewal TI work was complete and accepted by the government. This 13 includes PTO Arlington and IRS Fresno. When we exclude PTO Arlington and IRS Fresno, the average rent spread achieved on the remaining 11 renewals was 8%, including approximately $18 per square foot of TI utilized by the government.

The average total renewal term for these 11 renewal leases was 15 years.

I can also share that we currently expect our single-tenant bullseye properties that have renewed, but for which the new lease has not yet commenced or for which it has commenced, but the TI has not yet been accepted by the government to realize an average renewal rent spread of approximately 26%. This group of assets totaled 650,677 square feet across 11 properties and each have renewed for total lease terms of between 15 and 20 years with an average of 17.6 years.

Finally, I will conclude with our earnings guidance for 2023. Beginning this year and on a go-forward basis, we will be transitioning our guidance to a core FFO metric. Core FFO, adjusted FFO, as defined by NAREIT, to present an alternative measure of the company's operating performance, which when applicable, excludes items which we believe are not representative of ongoing results. Examples of such exclusions include liability management related costs, including losses on extinguishment of debt, catastrophic event charges and depreciation of non-real estate assets.

For fiscal year 2022 on a fully diluted basis, the company's FFO per share was $1.27 and its core FFO per share was $1.28. The company is introducing its guidance for full year 2023 core FFO per share on a fully diluted basis in a range of $1.12 to $1.15. This guidance assumes the closing of VA - Corpus Christi, a property within the VA Portfolio, at the company's pro rata share of approximately $21 million and up to $15 million of gross development-related investment during 2023.

At this time, our guidance incorporates the dilution from the disposition of our 10-property portfolio, but does not yet assume any wholly owned acquisitions for the year. We look forward to redeploying that recycled capital at higher cap rates when the market stabilizes. We will be sure to keep everyone informed if we begin to see strengthening opportunities to transact in this market. With that, we thank you for your commitment to our thesis and appreciate your partnership. I will now turn the call back to Shannon.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from Michael Griffin with Citi.

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

Meghan, maybe starting back on 2023 guidance. I was curious if you could give some color around maybe some of the other moving pieces. I think about maybe operating expense for the year, kind of interest expense, G&A, any color you can kind of give around that sort of bridge the delta between '22 full year and the expectation for '23?

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

Good morning, Michael. What I would remind everyone of is that the disposition, obviously, in the low 7 cap rate range, contributed approximately $15 million of NOI on an annualized basis last year. And the debt that we were -- that was available for repayment with that disposition was running at about a 2.5% interest rate annualized last year. When we think of the bridge of removing that and then getting to our 2023 guidance, the residual is coming from inflationary expectations in the environment on both our commodities and our people cost.

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

Okay. Great. And then just on transaction expectations, I mean, it seems pretty muted for at least the outset of 2023. I'm just wondering if you're seeing any assets out there trading in the market. I seem to recall a VA asset that might have been in your wheelhouse trade sort of recently. But Bill, maybe any commentary or clarity you could give around you buyer expectations, seller expectations, that would be pretty helpful?

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

No, absolutely. Good morning, Michael. I'm looking forward to seeing you next week. On those assets, there have not been really any assets within our bullseye of trade. And I think it's important to mention to note that there were 2 VA assets that did trade. One of them not being tax compliant. And as you may know, I think we've discussed all of our VA facilities are -- especially all the ones in our new portfolio are tax compliant, which is a requirement of the VA going forward.

And as you know, if we don't see at least another couple of lease turns left in that building, we're not going to buy it. So that property would not qualify just on underwriting a loan to be within our portfolio. So that's why we did and they came as a pair. So that's why we did not participate.

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

And Bill, where would cap rates have to get to in or to get you more, I don't know, accretive acquisitive, so to say?

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

Well, I think it's interesting. We've obviously spent a lot of time. We had a great meeting with all of the top brokers in the sector earlier in this year. And as Darrell mentioned earlier in the call, I think we're seeing movement between the sellers and the buyers. I think you're going to see in the high 6s to 7 is probably where you're going to see us execute. And I think we haven't quite gotten there yet, but I'm sure we will.

And you can be rest assured that we are participating in anything we see. We're traveling around. We're visiting everything, talking to all the owners. As you recall, we actually have the luxury of knowing all the owners within our space and are confident that we'll be able to do something. But as you mentioned, it's a little slow right now.

Operator

(Operator Instructions) Our next question comes from the line of Peter Abramowitz with Jefferies.

Peter Dylan Abramowitz ***Jefferies LLC, Research Division - Equity Analyst***

Just one. I wanted to ask about the acquisition guidance. I noticed that you said it will be Corpus Christi that closed this year. Sorry, if I missed this. Have you closed Jacksonville yet as well? Or is that assumed later on?

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

No, we have not closed Jacksonville. That is assumed to be later on at this point.

Peter Dylan Abramowitz ***Jefferies LLC, Research Division - Equity Analyst***

Okay. So that won't be in '23. Got it. And then, I guess, I'm just trying to get a sense here, but also on the acquisition guide, it assumes none beyond Corpus Christi. But I think Darrell's comments were pretty positive that the market is starting to open back up. So just trying to get a sense of how, kind of, is that -- would you say the guide is just more on the conservative side and you just are waiting for things to open up?

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

Yes. I'd say that it's not a surprise, I think, conservative in Easterly Government Properties are probably synonymous in a lot of ways. And so the last thing we need to do is get everybody revved up. I think we've always tried to over deliver. So you can be rest assured that when the market does open up, we will be participating if not driving it.

So -- but I can tell you that I think Darrell is correct. It is moving in the right direction, but the velocity is very marginal right now.

Operator

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

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

Great. Thank you, everyone, for joining the Easterly Government Properties Fourth Quarter 2022 Conference Call. I'd like to thank our Board, our vendors, our shareholders and particularly our Easterly team for their dedication and support during the year. We hope this call has been helpful, and we look forward to speaking with you all again soon.

Operator

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