Easterly Government Properties, Inc.

Second Quarter 2021 Earnings Conference Call

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CORPORATE PARTICIPANTS

Lindsay Winterhalter, *Vice President, Investor Relations and Operations*

Darrell Crate, *Chairman, Board of Directors*

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

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

CONFERENCE CALL PARTICIPANTS

Parker Decraene, Citi Group

Michael Carroll, *RBC Capital Markets*

PRESENTATION

Operator

Greetings, and welcome to the Easterly Government Properties Second Quarter 2021 Earnings Conference Call.

As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host Lindsay Winterhalter, Vice President, Investor Relations.

Lindsay Winterhalter

Good morning.

Before the call begins, please note the use of forward-looking statements by the Company on this conference call. Statements made on this call may include statements which are not historical facts and are considered forward-looking. The Company intends these forward-looking statements to be covered by the Safe Harbor provisions for forward-looking statements contained in the Private Securities Litigation Act Reform of 1995, and is making this statement for the purpose of complying with 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, 2020, filed with the SEC on February 24, 2021, and in its other SEC filings, and risks and uncertainties related to the adverse impact of COVID-19 on the U.S. regional and global economies, and the potential adverse impact on the financial condition and results of operation of the Company. The Company assumes no obligation to update publicly any forward-looking statements, whether as a result of new information, future events, or otherwise.

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

Thank you, Lindsay. Good morning, everyone, and thank you for joining us for the second quarter conference call.

Today, in addition to Lindsay, I'm also joined by Bill Trimble, the Company's CEO, and Meghan Baivier, the Company's CFO and COO.

It was a very strong quarter for Easterly Government Properties. We see the country opening up and as expected, we have been identifying some pent-up opportunity for our business. We have emerged from COVID stronger than we entered as measured by FFO growth, portfolio scale, age, diversification and lease duration, as well, as an actionable pipeline of excellent acquisition opportunities that materially exceeds pre-pandemic levels. This all leads us to believe that it will be a very strong end to the year.

Today we have 84 properties across 39 important tenant agencies. We have a diverse portfolio of mission critical facilities leased to the United States Federal Government. The quality of our portfolio in this space is excellent. The average age of our buildings is 13.4 years and the average duration of our leases is 8.6 years. This translates into $2.2 billion of cash embedded in our leases and is backed by the full facing credit of the United States Government.

Given the young age of our buildings and the enduring mission of our agencies, conservatively assuming one modest 15-year roll of each lease of 10% to 15%, this drives that total to over $6 billion. Again, $6 billion backed by the full faith and credit of the United States Government.

As you saw this last quarter, we increased our dividend. We anticipate that this is the beginning of a new chapter for Easterly Government Properties. Our business has matured. We are entering a period where distributable cash flow can outpace FFO growth. Today our stock trades with a dividend yield of roughly 5%. This represents a spread of over 370 basis points above the treasury that's matched to our weighted average lease term. We've anticipated growth in our cash flow. We believe we will either see this yield grow meaningfully or our stock price will increase.

We're excited for the second half of the year given how we're positioned in the market. The opportunities we see and the cash generating capacity of this portfolio.

With that, I'll turn it over to Bill to give you his view of our second quarter results and the prospects for the future.

William Trimble

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

The Acquisitions team continues to add mission critical bullseye properties with the second quarter acquisition of a national weather service central region headquarters, a 94,000 square foot facility located in Kansas City Missouri. This build-to-suit facility is 100% leased on behalf of a national weather service for a 15-year term with a 5-year fixed renewal option, which if exercised, does not expire until December of 2038.

This highly specialized facility serves as the central region headquarters for national weather service, one of six regional offices strategically located throughout the country. The facility features a radar tower, secure satellite field and houses some of the most advanced technology weather forecasting and advanced computer equipment, including doppler radar and the automated service observation system.

The acquisition of NWS - Kansas City serves as the perfect example of the type of asset we like to introduce into our expanding portfolio. Here the mission of the tenant agency cannot be performed without the real estate to support. This is the definition of a bullseye property.

In the second quarter we disposed of SSA - Mission Viejo. This is an example of a building whose agency, the social security administration, houses government employees that can one day accomplish their goals and objectives outside of this facility. Given it's relatively small size and our belief regarding it's long-term mission, we thought it best to use SSA - Mission Viejo as source of funds for future bullseye acquisitions.

Finally, subsequent to quarter end, Easterly acquired a roughly 61,000 square foot Class A facility located in Cleveland, Ohio that is leased to several key agencies within the U.S. Government. This Security Level III facility was substantially renovated in 2016 and again in 2021 for the Department of Homeland Security and largely fulfills important missions such as investigating criminal organizations and terrorist networks. A portion of the property also serves as Cleveland's National Weather Service forecast office. With a potential weighted average lease expiration of June 2034, the U.S. Government has invested significant tenant improvement in the facility. Specialized features include secured entry and parking, a sally port, a backup generator and an uninterrupted power supply battery system, to name a few.

To summarize, year-to-date, Easterly has acquired six properties for a combined total of $134 million. Given the pace of our acquisitions, and our clarity of pipeline, we increased our 2021 FFO guidance per share on a fully diluted basis in conjunction with increasing our acquisition volume target by 50% for the year from $200 million to $300 million. As of today, we have executed on 45% of the Company's enhanced acquisition guidance of $300 million for the year. In short, the team is "elephant hunting" and we feel confident in our ability to meet or possibly significantly exceed even this $300 million in acquisition buy in.

On a related note, the Acquisition's team continues to see an extremely robust acquisition pipeline, particularly in the VA market. With the incredibly important mission of providing superior medical care to our servicemen and women, new state-of-the-art outpatient facilities similar to the ones already in our portfolio are actively being designed, constructed and delivered. The features in these facilities and their fulfillment of long-term missions, coupled with predominately 20-year lease terms, makes VA outpatient facilities compelling opportunities for our growing portfolio.

Turning to development. We continue to make progress with the GSA and the FDA at the 162,000 square foot FDA laboratory in Atlanta, Georgia, which we expect to deliver in the third quarter of 2023. Given the highly technical mission, critical nature of these sophisticated laboratories, we appreciate the opportunity to work so harmoniously with our federal partners to ensure we deliver a state-of-the-art facility. In addition to FDA Atlanta, our team, lead by Mike Ibe and Mark Bauer are currently pursuing other opportunities that fit our non-speculative development pipeline.

Turning to leasing updates. Our Asset Management team continues to show its prowess in partnering with the U.S. Government to execute on important bullseye lease renewals and secure the tenancy for future decades. In the second quarter we renewed the lease at DEA - Upper Marlboro for a 15-year firm term that will go into effect in March 2022 and will not expire until 2037. This, combined with the successful renewals at ICE - Pittsburgh, Treasury - Parkersburg, DEA - Sterling and DEA - Bakersfield, from the first quarter. Easterly has now renewed five assets totaling over 320,000 square feet or 4.1% of annualized lease income for a weighted average lease term of 17.6 years in the first half of 2021.

In closing, we believe Easterly has chartered a course for outside growth opportunities. The acquisition pipeline coupled with the organic growth from the renewal of bullseye assets all work together to set the stage for delivering strong risk adjusted returns to our shareholders.

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

Meghan Baivier

Thank you, Bill. Good morning, everyone.

It gives me great pleasure to post another strong quarter here at Easterly. As of June 30, we owned 83 operating properties totaling approximately 7.6 million square feet of commercial real estate with one additional development project in design, comprised of approximately 162,000 square feet.

Through the acquisition of newer facilities, the weighted average age of our portfolio remains young at 13.6 years. Successful long-term renewals at existing properties have also allowed us to maintain our weighted average remaining lease term at its historic high of 8.6 years.

When compared to this time last year, we have lengthened the remaining lease term which in turn provides clarity of future cash flows while also acquiring newer assets to keep the average age of the portfolio relatively young. This combination allows us to prudently manage the Company's balance sheet and support our highly accretive acquisition and development project pipeline.

Turning to our quarterly results for the second quarter. Net income per share on a fully diluted basis was $0.10; FFO per share on a fully diluted basis was $0.33; FFO as adjusted per share on a fully diluted basis was $0.31 and our cash available for distribution was $23.2 million.

The balance sheet at quarter end reflects the Company's total indebtedness of approximately a billion dollars with $313 million available on our line of credit for future acquisitions and development related expenses.

As of June 30, Easterly's net debt to total enterprise value was 33.9% and it's adjusted net debt to annualized quarterly pro forma EBITDA ratio remained at 6.2x.

As previously mentioned with this low leverage level, numerous sources of available debt capital, access to equity sold on a forward basis and an attractive cost of equity, we are well poised to lean into future growth opportunities.

Since our last call, we have executed on two notable debt capital markets events. First, in the second quarter, the Company entered into a note purchase agreement to issue up to $250 million principal amount of fixed rate senior unsecured notes. The notes will be issues in two tranches with a weighted average maturity of 8.5 years, and a weighted average interest rate of 2.82%

The first tranche is $50 million of seven-year notes with a coupon of 2.62%, and the second is $150 million of nine-year notes with a coupon of 2.89%. The Company has the option to increase the second $150 million tranche of the notes up to a principal amount of $200 million. The notes are expected to be issued on October 14, 2021, subject to customary closing conditions.

With significant investor subscription, this third entry into the debt private placement market was well-received by the investor community and helped fortify strong relationships with our existing and new lenders.

Subsequent to the quarter end, the Company upsized its senior unsecured credit facility. The amended and restated credit facility consists of a $450 million revolving senior unsecured credit facility, and a $200 million senior unsecured term loan facility. Up to a $50 million of which will be available on a delayed draw basis for up to 364 days post-closing.

The revolver includes an accordion feature that allows the Company to request additional lender commitments of up to $250 million for a total amended credit facility capacity of up to $900 million. The revolver will initially mature four years from the closing date in July 2025, with the option to extend the maturity to July 2026. The term loan will mature five years from the closing date in July 2026. The term loan 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 120 to 180 basis points, depending on the Company's leverage ratio. The term loan will bear interest at a rate of LIBOR plus a spread of 120 to 170 basis points, depending on the Company's leverage ratio. Given the Company's current leverage ratio, the initial spread to LIBOR is set at 125 basis points for the revolver, and 120 basis points for the term loan.

Of note, the amended credit facility also features the sustainability linked pricing component, whereby the pricing can improve by one basis point as Easterly meets certain sustainability performance targets, as determined by an independent third-party evaluation. It is our pleasure to strive to earn this discounted spread as we continue our commitment to corporate sustainability.

As of June 30, 2021, pro forma for the closing of the private placement and issuance of the notes and the execution of the Company's amended credit facility, whereby outstanding balances on the Company's existing revolving line of credit are repaid, the Company's weighted average debt maturity was meaningfully extended from 5.8 to 7.4 years, and its weighted average interest rate was 3.55%.

Turning to our quarterly ATM activities in the second quarter of 2021, the Company did not issue any shares of common stock through the Company's ATM program. As of this call, the Company has approximately 4 million shares, which are subject to unsettled forward sales transactions under the Company's ATM programs. Assuming these shares are physically settled in full at a net weighted average initial forward sales price of $23.65 per share, the Company expects to receive net proceeds of approximately $94.6 million.

Further, with the newly implemented $300 million ATM program, the Company remains well-prepared to utilize the equity markets through our preferred method of just-in-time equity funding.

Turning to our earnings guidance, during the quarter ended June 30, the Company increased its guidance for 2021 FFO per share on a fully diluted basis to a range of $1.30 to $1.32. Reflective in part of our increased actionable acquisition pipeline, the midpoint of this guidance is predicated upon completing $300 million in acquisitions, and up to $25 million in gross development related investment in 2021.

At its midpoint, Easterly would be on track to continue its track record of steady FFO growth year-over-year, when coupled with our increased dividend of $0.265 per share, which generates a run rate dividend yield of 5% based on our quarter end stock price. We are proud to be in a position to continue to deliver attractive total returns to our shareholders through underlying U.S. Government cash flows.

Finally, as Bill previously mentioned, we made progress in working through our pipeline of upcoming lease expirations. With the successful execution of DEA – Upper Marlboro, we now have approximately 515,000 square feet and nine leases up for renewal through the end of 2021. We continue to make meaningful progress with the GSA and are in active discussions regarding all properties at this time. We feel good about the long-term mission and tenancy of these upcoming expirations and will continue to keep you apprised of future renewals in the coming quarters.

In conclusion, on every operational and financial front, it has been a strong first half of 2021 for Easterly. As always, we thank you for your commitment to our thesis and continued partnership. We look forward to seeing each of you in person in the back half of this year.

With that, I will turn the call back to Joe.

Operator

Thank you. We will now be conducting a question-and-answer session.

Our first question is from Manny Korchman with Citigroup. Please proceed.

Parker Decraene

Hey, good morning, everyone. This is Parker Decraene actually on for Manny. Thanks for taking the time.

Just in terms of the acquisition market, I was wondering if you guys could touch on if you're seeing any additional competition of impact on pricing just for some of those assets that you're looking at acquiring here over the next 12 months or so.

William Trimble

Good morning. It's Bill.

I think that the story is, first of all, that we're seeing more opportunities than we've ever seen before in the acquisition pipeline. I think from the standpoint of the pricing, if you look where we came out on our most recent four acquisitions, we're right where we would think they'd be, sort of in the low 6's on average, but I will say that I think from a competition standpoint, we're not seeing any new players in the market. We do have some strong competitors in the private equity space. I think we have a better cost of capital, so when we want to buy something, we seem to still be able to equatively get what we need to do.

I will say, though, that as we're looking towards more and more brand-new buildings, and you've seen some of those in the past, those cap rates are going to be a little further below the 6 cap range, just because I think people understand what 20-year leases on brand new mission critical properties are worth. But form that standpoint, no new competition.

Parker Decraene

Thank you. Then just in terms of the SSA facility sale this quarter, I understand that it's strategic sale, and you guys gave some comments in your opening remarks, but should we just anticipate other sales like this one over the next 12 months as you look to sort of, in a way, recycle capital and try to reposition some of your portfolio altogether?

William Trimble

Yes, I think the real answer there is we are so pleased with our portfolio of 83 buildings that there are very few that are not young, conducting mission for very important government agencies right in the middle of the bullseye. We do have a few properties, and this would be one of them, that was part of a portfolio acquisition that we just felt the time was right to move it along. I would never really think of our dispositions as an important part of our overall strategy. Let's talk about that in 10 years, but right now, I think we own the best buildings we possibly can own.

So, we will move things along when we think either they don't fit in, or maybe a source of funds for something better, but I don't think you're going to see a steady drum beat of sales within this very young portfolio.

Parker Decraene

Okay. Thanks, Bill. Appreciate it.

Operator

Thank you.

Our next question is from Michael Carroll with RBC Capital Markets. Please proceed.

Michael Carroll

Thanks. Bill, can you highlight the type of agencies DEA sees the most opportunities to expand with today, and if there are any new agencies, like the National Weather Service, you'd like to add to the portfolio that's currently not in the portfolio?

William Trimble

Yes, good morning, Michael.

Yes, I think the ones that you're going to see the most of, and I've mentioned with all the opportunities that are our there today, the only real major building program with brand new facilities going on within the Federal Government, or in the FDA laboratories, and we're building them. The other is in the VA space, and I think you are going to see more of these brand-new outpatient clinics available in the coming years, and so I imagine we get our fair share of those wonderful opportunities in that space.

Other than that, I think with new agencies, it's always going to be ones that we care about the most that are not political footballs, not the poster child or either the Democrat or the Republican party. So, I think you can expect anything in law enforcement will always be popular with us; mission critical facilities within agencies like these National Weather Service. It's an amazing facility that we picked up in Kansas City. Basically, if you've been in an airplane, any kind of aircraft, you've been getting your weather from this particular facility, and it might be one of the most important facilities in the country.

You can expect to see, no matter what the agency, if you've got to build it with a hierarchy of mission like this, we're going to go ahead and take advantage of it. But, the usual, I think you'll see a lot of law enforcement, FBI, DEA, the usual suspects going forward.

Michael Carroll

Then what is the growth opportunity with the National Weather Service? How many buildings are out there that kind of fits your bullseye target, and are you able to out there and acquire some of those?

William Trimble

I think you saw it. That would be the Kansas City facility. There are six, and the rest are just not of this scale, in that this one is the new facility handling all their traffic, as weather for the United States. The others are smaller facilities, so probably not as much of interest to us.

Michael Carroll

Okay, great.

Then Meghan, related to the sustainability linked facility, can you briefly talk about what targets DEA needs to achieve to reduce those spreads, and what's the Company doing today to hit those targets?

Meghan Baivier

Sure. Out of the box, we are linking to our ISS environmental quality score, and we are able to achieve that one basis point with, one basis point rather, with a 10% improvement in that score. We think that's a great incentive and are working throughout the portfolio on numerous energy efficiency projects to be able to obtain that.

Michael Carroll

Great. Thank you.

Operator

Thank.

Ladies and gentlemen, there are no more questions. So, I would like to turn the call back over to Darrell Crate for closing remarks.

Darrell Crate

Great. Thank you, everyone, for joining the Easterly Government Properties Second Quarter 2021 Conference Call. We appreciate your time and will continue to work hard to deliver strong risk adjusted returns for our shareholders for years to come.

Operator

This ends today's conference. You may disconnect your lines at this time. Thank you very much for your participation and have a great day.