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Easterly Government Properties, Inc.

First Quarter 2017 Earnings Conference Call

May 9, 2017

CORPORATE PARTICIPANTS

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

Darrell Crate, *Chairman of the 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

Jill Sawyer, *CitiGroup*

Michael Lewis, *SunTrust Robinson Humphrey, Inc.*

Michael Carroll, *RBC Capital Markets*

PRESENTATION

Operator:

Greetings and welcome to Easterly Government Properties First Quarter 2017 Earnings Conference Call. At this time, all participants are in a listen-only mode. A question and answer session will follow the formal presentation. If anyone should require Operator assistance during the conference, please press star, zero on your telephone keypad. As a reminder, this conference is being recorded.

I would now like to turn the conference over to Ms Lindsay Winterhalter, Vice President, Investor Relations. Thank you, Ms Winterhalter. You may now begin.

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, 2016, filed with the SEC on March 2, 2017, and 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 Crate:

Thanks, Lindsay. Good morning everyone. DEA remains the only internally managed public REIT focused on the United States government leased real estate. Our growing portfolio of young, mission critical Class A facilities are backed by the full faith and credit of the U.S. government which we believe provides our shareholders with a steady platform for strong recurring cash flows.

Before discussing the details of the first quarter, I would like to take a step back and reflect on our growth over the past year. In 2016, the Company closed on seven accretive transactions which translated into approximately $157 million in total acquisition volume. We are now just one-third of the way through 2017 and we have already made great strides towards accomplishing our stated $350 million acquisition goal for the year.

The acquisition of the OSHA laboratory along with the two announced pending VA acquisitions have a combined value of $260 million. Development continues to be a growing contributor to our growth story with FDA Alameda being delivered in 2018, and the recently announced FDA at Lenexa which will deliver in 2019.

Today, Easterly has a market capitalization of approximately $1 billion, but more importantly our float has increased 2.5 times since the IPO to over $700 million. We believe this market cap and increased float coupled with our growth derived through acquisitions and development will continue to reduce the cost of entry and exit in our stock and further enable us to broaden our shareholder base as we look to build the highest quality portfolio available in the REIT market.

Further, our team is constantly looking at attractive sources of capital to achieve strong financing for these assets. With our goal of providing shareholders with earnings growth sufficient to drive a low double-digit total return opportunity, we believe Easterly will continue to be a haven for shareholders looking for strong risk adjusted returns that rival the Russell 2000 for investors on a compounding basis.

Now I'll turn the call over to Bill to provide more information on the developments within Easterly that drove shareholder returns this quarter.

William Trimble:

Thanks, Darrell, and good morning. I would like to begin by highlighting the Company's achievements in the first quarter of 2017. We were very pleased to acquire the 75,000 square foot Sandy, Utah Occupational Safety and Health Administration laboratory which, when combined with our other properties, represents a portfolio of 44 buildings with over 97% of its annualized lease income derived from the full faith and credit of the United States federal government. OSHA Sandy well represents our focused investment discipline. This state-of-the-art laboratory serves the entire country by providing the analysis of a multitude of chemicals and maintaining OSHA's online Chemical Sampling Information database. This facility is one of three locations nationwide which also houses the Directorate of Technical Support and Emergency Management for OSHA, an important division which provides specialized technical support to the broader OSHA mission. True to Easterly's philosophy, this laboratory's mission is critical in the hierarchy of the tenant agency.

Easterly's announcement in the first quarter of its pending acquisitions of two VA outpatient clinics marks the Company's entry into an important new market which it has been following for several years. The acquisition of these two new state-of-the-art Class A VA outpatient facilities totals a combined 414,000 square feet of lease space, all backed by the full faith and credit of the U.S. government.

The first facility is located in Loma Linda, California, and is a one-of-a-kind premiere asset in the VA health system. Located just two miles from the federally owned VA hospital, this brand new 327,000 square foot ambulatory care facility sits on a 37 acre campus, is surrounded by over 2,000 parking spaces and addresses the outpatient medical needs of the surrounding 72,000 veterans in the region. The facility will employ approximately 500 VA health professionals and provide 50% of VA Loma Linda's outpatient visits for the region. Services provided within the Loma Linda Ambulatory Care Center include primary care, women's health, dental, imaging, employee health and blood draw services. The facility carries an initial 20-year non-cancellable lease with the VA which will not expire until May of 2036. The VA Loma Linda acquisition is expected to close in the second quarter of 2017.

The second VA outpatient facility is located just outside of South Bend, Indiana and is currently under construction. The VA South Bend Outpatient Clinic is very similar to VA Loma Linda, but on a smaller scale of 86,000 square feet. This facility will employ 190 VA professionals and also provides outpatient services to the many veterans surrounding the region.

The VA estimates the facility will see 12,000 patients in its first year of operation, 14,000 patients in its second year of operation, and 16,000 patients in its third year of operation. The services that will be provided at VA South Bend include primary care, mental health care, audiology, optometry, radiology, cardiology, pulmonology, podiatry, urology and gastrointestinal endoscopy. When construction is completed, which we expect will occur in the third quarter of this year, this outpatient facility will be leased to the VA for an initial 15-year non-cancellable term. The VA South Bend acquisition is expected to close in the third quarter of 2017.

Both of these properties just described squarely fall into Easterly's VA acquisition and development targets. These are mission critical facilities within a highly important department of the U.S. government. These leases are backed by the full faith and credit of the U.S. government and are not subject to cancellation, and carry long, stable lease terms which results in a steady cashflow and superior risk adjusted returns for our shareholders. Also of note, pro forma for the addition of these announced pending VA acquisitions, Easterly's key portfolio performance metrics are substantially enhanced. Easterly's average portfolio age will decrease from 12.9 years to 11.6 years. Further, the remaining lease duration of the portfolio will increase from 5.7 to 7.1 years. These are highly attractive metrics for the Company's portfolio which continues to grow through the addition of accretive deals that fit within the previously mentioned "bullseye" target universe.

Turning to development, our team remains active in responding to all opportunities to develop brand new, non-speculative Class A facilities on behalf of the federal government with long, attractive lease terms. Yesterday, Easterly was pleased to announce the lease award for the development of a 52,870 square foot FDA laboratory in Lenexa, Kansas, just outside of Kansas City. This exciting project, which will be led by Mike Ibe and his team, will be a relocation of the current Kansas City District Laboratory, one of 13 critical laboratories for the FDA located strategically throughout the country. This brand new, state-of-the-art facility will be approximately 40% larger than the lab it is replacing, and will feature highly specialized and specific design features and functionality for the needs of the FDA for decades to come. The laboratory will be fully equipped to perform the chemical analyses of food and drugs regulated by the agency, which heavily contribute to the FDA's overarching mission of protecting and promoting the health and safety of the American public. This is a wonderful opportunity for the Company to deepen its relationship with the U.S. Government, now marking two active development projects with the GSA for the beneficial use of the FDA.

Additionally, our Asset Management and Development teams are currently engaged in a number of value-added projects to our existing portfolio. There are currently 15 mission enhancing projects underway for a combined total of roughly $4.7 million, fully funded by the government, which aid our tenants in their ability to perform mission while also keeping our already-young buildings updated. An example of a current government funded improvement project can be found in our ICE field office in Charleston, South Carolina. At ICE - Charleston, the government is pursuing a $2 million-plus facility upgrade to reconfigure existing space to allow both ICE and DEA law enforcement to collaborate and function more efficiently in their joint mission of investigating those in violation of federal laws.

Our current acquisition pipeline is strong as we continue to pursue opportunities to accretively grow the Easterly's portfolio for our shareholders. These acquisitions fall within what we refer to as the bullseye of our target market. To reiterate, our target market includes buildings leased to a single tenant of the U.S. federal government, are often the result of a design/build award and are usually over 40,000 square feet in size. If we find a building that meets these criteria, we then underwrite the agency and the hierarchy of mission of the prospective building before performing the traditional underwriting. We continue to see opportunities that are actionable in the near to mid term and will maintain our rigorous underwriting standards targeting 100% renewal for this class of federally leased buildings.

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

Meghan Baivier:

Thank you, Bill. Today I will touch upon our current portfolio, discuss our first quarter results, provide an update on our balance sheet, review our 2017 guidance and cover this quarter's capital markets activity. Additional details regarding our first quarter 2017 results can be found in the Company's first quarter earnings release and supplemental information package.

As of March 31, we owned 44 operating properties comprising nearly 3.2 million square feet of commercial real estate. The weighted average lease term for the portfolio was 5.7 years. The average age of our portfolio was 12.9 years, and our portfolio occupancy remains at 100%. In addition, 97.4% of our annualized lease income was backed by the full faith and credit of the United States government.

For the first quarter, FFO per share on a fully diluted basis was $0.31. FFO as adjusted per share on a fully diluted basis was $0.30, and our cash available for distribution was $12.2 million. GAAP measures and reconciliations to GAAP measures have been provided in our supplemental information package.

For the 12 months ending December 31, 2017, the Company is reiterating its guidance for FFO of $1.25 to $1.29 per share on a fully diluted basis. This guidance assumes acquisitions of $350 million in 2017, including the OSHA Sandy acquisition completed in the first quarter, the announced VA Loma Linda acquisition with an anticipated closing date in the second quarter of 2017, as well as the announced VA South Bend acquisition with an anticipated closing date in the third quarter of 2017. This guidance does not contemplate any dispositions. This guidance is forward-looking and reflects Management's view of current and future market conditions. The Company's actual results may differ materially from this guidance.

Turning to the balance sheet, at quarter end the Company had total indebtedness of $337.8 million, which was comprised of $158.2 million outstanding on our unsecured revolving line of credit, $100 million outstanding on our unsecured term loan facility, and $79.7 million of mortgage debt. Availability on our line of credit stood at $241.8 million. In terms of leverage, net debt to total enterprise value was 26.8% and net debt to annualized EBITDA was 4.9 times.

On March 27, 2017, the Company successfully completed a public offering of 4.3 million shares of its common stock, all offered in connection with forward sales agreements, at a price to the public of $19 per share. The forward purchasers also granted the underwriters a 30-day option to purchase up to an additional 645,000 shares at the public offering price, which was exercised in full. The Company expects to physically settle the forward sales agreements and receive proceeds, subject to certain adjustments, within approximately six months from the date of the prospectus supplement relating to the offering. Assuming the forward sales are physically settled in full, net proceeds to the Company is expected to be approximately $90 million.

Finally, as previously announced last week, our Board of Directors declared a dividend related to our first quarter of operations of $0.25 per share. This dividend will be paid on June 29, 2017 to shareholders of record on June 14.

I will now turn the call back to the Operator for questions.

Operator:

Thank you. We will now be conducting a question and answer session. If you would like to ask a question, please press star, one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star, two if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star keys.

Our first question is from Manny Korchman of Citi. Please go ahead.

Jill Sawyer:

Hey, guys, it's Jill here with Manny. I'm just wondering—so, it feels like lately you're more focused on the FDA, and more recently the VA. I'm just wondering if that's environment changed since you've started out you were focused on the DEA, or you're just diversifying?

William Trimble:

Good morning, Manny and Jill. First of all, basically, since we went public, there have only been two opportunities for build-to-suit projects within the GSA space that we would actually be interested in completing, and I'm pleased to announce that we won both awards. So, basically, if it's in the bullseye—we don't make the determination on the development opportunity. If it's in the bullseye, it could be the FDA, it could be Secret Service, or any of the mission-critical agencies that we think are important, so that's a bit random, but I will say that certainly with Mike Ibe and his Development team's expertise, it's probably not surprising after you've been engaged to build one FDA lab that they see the sort of work and the sort of background and experience you've had, that they probably look towards you to do others.

The VA opportunities, I've already discussed, and those were two wonderful opportunities, one much larger than the other, but we think that the VA is an area that we've certainly been looking at for the last several years and we're very happy to be able to get these two properties signed up.

Jill Sawyer:

All right. Thanks, guys.

Operator:

Thank you. The next question is from Michael Lewis of SunTrust. Please go ahead.

Michael Lewis:

Thanks. Good morning. My first question, I'm going to follow up on Jill's a little bit. Over the last six to nine months, you know, we've had the election. As you look at underwriting agencies, has anything really changed for any agencies, you know, more attractive, less attractive, or do you kind of do that work as it comes up in your target universe?

William Trimble:

I think that it's probably no secret that the current administration is very much in favor of what we—the moniker being gun-toting agencies, so you think of the FBI, the DEA, ICE, CBP, the federal courts, that make up over 62 percent of our portfolio, so I think that they're certainly in favor now. Obviously, there's some agencies that are not as much in favor, but again, they're going continue to exist, they're just going to be different priorities going forward. We are very pleased to have our particular EPA laboratory—based in Kanas, by the way, an all-Republican state—because its mission is enduring and will actually endure past the current administration's tenure, not that we take a position on who's in federal office, but I think we're looking for long-term enduring missions of the agencies, and we believe every single building that we have in our portfolio certainly fits that to a tee.

Michael Lewis:

Thanks. Do you still expect everybody, all of your '17 and '18 lease expirations to renew? And kind of a part B to that question, it looks like one of the '18 lease expirations is this cosmetics company in Florida. How do we kind of think about some of those non-core properties that are still a small piece of the portfolio, but still kind of in there?

William Trimble:

Absolutely, and I'm happy to announce that we have renewed the SSA Kearny Mesa lease, which is a very small property, not in our bullseye, but we have renewed that for the next 10 years firm and 15 with a soft term at the end, at basically the current rent amount, which we would expect smaller non-bullseye properties to renew. I'm also happy to announce that we have renewed ICE Otay. Actually, we have just combined three leases that were expiring under different years and moved them all back to 11/27/22, so you might see that reflected. We're very pleased there. No cash changes on the rent, but, obviously, the government realizing that this is a long-term place for them to operate from, and it is the second busiest border crossing in California.

On our non-core assets, we've said in the past that all of these, we believe, are terrific properties, but also sources of funds as we drive—we're at I think 97.5% full faith and credit now—as we drive to 100%. So, when we see opportunities come up, we will move those properties out of the portfolio, and as we purchase portfolios in the future, there will be occasionally buildings that are either non-core or not in our bullseye, and obviously we'll want to move those out at some point accretively for our shareholders.

Michael Lewis:

Thanks. You sort of answered my last question there, but I'll try to ask it a little differently, anyway. You're kind of in growth mode here, but as far as disposition criteria, obviously we know a couple of assets that are non-core—as you think about dispositions criteria going forward, is it buildings that—is it strictly age? You want to keep the portfolio young. Do you look to maybe get ahead of some lease expirations? I don't know, it's far down the road, but maybe Trump's still President when the Forest Service comes due. You know, how do you kind of think about those decisions?

William Trimble:

Well, I think that—let's just take it in reverse order. The United States Forest Service is actually—this is its operational headquarters. They've got 198 million acres. I don't think they're just going to open up the fences and eliminate one of the greatest resources the United States has, so we're not particularly worried about that one. In fact, it's actually gaining employees as other older facilities are being consolidated into it. But I will say that we don't look just to the next lease term, we're looking two lease terms out, and when you're sort at 11—with these new acquisitions, 11 and some years old, and the average tenancy in these buildings is over 40 years, I will be all set for this conversation about 10 or 15 years from now. But, correct, as buildings do get older, we will constantly look and make sure that we can see a lot of runway for their mission for a particular building, that they're meeting missions, but, luckily, and not so luckily, that isn't a problem today.

Michael Lewis:

Great. Thank you.

Operator:

Thank you. As a reminder, ladies and gentlemen, it is star, one if you would like to ask a question.

The next question is from Michael Carroll of RBC Capital Markets. Please go ahead.

Michael Carroll:

Yes, thanks. Bill, can you comment on the type of deals that you are currently tracking? I know you kind of made some mention about your pipeline currently, but specifically I'm looking at the VA type deals, and how big you want to grow that exposure and what you could complete in the near term to expand that small part of your portfolio.

William Trimble:

I'd say that—Michael, good morning, by the way—I'd say that there's no changes at all. VA is just like adding FBI or DEA, or another of the federal courts to our set of opportunities. We're looking at lots of opportunities in the GSA, and you'd expect most opportunities in the end to be the GSA because it's a much larger universe. However, I will say that, as we mentioned, the federal government is on a 10-year, $63 billion program to update and build new VA facilities for our 22 million veterans out there. So certainly, as we drive towards new buildings, there are going to be more opportunities than usual within the VA space, and we try to figure out the sizing of that, and that's probably those opportunities we figure expands our bullseye from 500 to 550, and perhaps $3 billion to $4 billion worth of opportunities there. But, I think you're going to see a fairly consistent path going forward.

Michael Carroll:

Yes, that leads me to my next question, I guess, on the build-to-suite type activity. I now the VA, they have a lot of build-to-suits out there, or build-to-suit requirements. Should we expect your development pipeline or those capital committed to that pipeline to increase in the near term, as you increase focus on those assets?

William Trimble:

Well, I think that, certainly, there will be opportunities there. We would love to develop some VAs. I will tell you that it is a very competitive market, as you can imagine, and we will—with our team led by Mike Ibe, I can think of no better person to be able to take advantage of winning some of those awards, but I'd also like to get back to the fact that we said that we're going to sort of do 10% to 15%, max being sort of 15%, of entire portfolio in development. I will say it is an incredibly accretive attractive opportunity for us, whether it be in VA or in mission-critical GSA facilities, as we are usually getting brand new, 15- to 20-year, full faith and credit leases on buildings that are squarely in the middle of our bullseye. We will have built them. We certainly the know the quality our team puts forward with our wonderful design/build contractors out there. So, little risk and a lot of upside.

Michael Carroll:

Okay, great. Then, Darrell, maybe you can touch on the Company and how the Company plans to run the balance sheet going forward. Mainly, I'm interested in the long-term leverage targets. I guess with the announced VA deals, it does look like leverage is going to increase a bit here. Are you comfortable with that range and how high do you want bring leverage?

Darrell Crate:

I'll turn it to Meghan to talk about the specific balance sheet, but then I can talk about the general capitalization of the Company.

Meghan Baivier:

Yes, Mike, as we've shared in the past, we're very comfortable with leverage levels for full faith and credit U.S. government cash flows as ours in the 40% to 50% range, which would triangulate to 6 to 7 times EBITDA. With the addition of these two new VAs, and the duration they bring to the asset side of the portfolio, you know, continue to be comfortable with both those leverage levels.

Darrell Crate:

I'd just to add to that—and I think our longest term shareholders understand this—we're very focused on getting cost to capital low, and we do that by working every aspect and every channel of the debt market, and we also believe that we get the lowest cost of equity by always working on reducing the cost of entry and exit in the equity market, such that we can have the broadest base of shareholders as possible. As you look at our shareholder list, you'll see a large universe of traditional REIT investors, but also these growth investors, and so each and every day, as you look over the next five years, we're very focused on this very high-quality portfolio and achieving Russell 2000 returns for our investors. We believe that this stock should be well positioned as an anchor for any growth or growth and income investor in addition to doing a great job relative to the REIT universe.

Michael Carroll:

Okay, great. Thank you.

Operator:

Thank you. There are no further questions in the queue at this time. I would like to turn the conference back over to Mr. Crate for closing remarks.

Darrell Crate:

Great. So, thank you, everyone, for joining the Easterly Government Properties First Quarter Conference Call. We appreciate your interest and your support, and we look forward to continuing to build a very high-quality portfolio of leases backed by the full faith and credit of the U.S. government in our effort to deliver strong compounding returns to shareholders going forward.

Operator:

Thank you. Ladies and gentlemen, this does conclude today's teleconference. You may disconnect your lines at this time and thank you for your participation.