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Easterly Government Properties, Inc.

First Quarter 2019 Earnings Conference Call

May 7, 2019

CORPORATE PARTICIPANTS

Lindsay S. Winterhalter, *Vice President, Investor Relations*

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

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

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

CONFERENCE CALL PARTICIPANTS

Manny Korchman, *Citigroup*

Michael Lewis, *SunTrust Robinson Humphrey*

Michael Carroll, *RBC Capital Markets*

Jon Peterson, *Jefferies*

PRESENTATION

Operator:

Greetings, and welcome to the Easterly Government Properties First Quarter 2019 Earnings Conference Call. At this time, all participants are in a listen-only mode. A brief 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.

It is now my pleasure to introduce your host, Lindsay Winterhalter, VP of Investor Relations. Please go ahead.

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, 2018, filed with the SEC on February 28, 2019, and in its other SEC filings.

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 and cash available for distribution. You can find a tabular reconciliation of these non-GAAP financial measures to the most comparable current GAAP numbers in the Company's earnings release and separate Supplemental Information Package on the Investor Relations page of the Company's website at ir.easterlyreit.com.

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

Darrell W. Crate:

Thank you, Lindsay. Good morning, everyone, and thank you for joining us for this first quarter conference call. Today, in addition to Lindsay, I'm joined by Bill Trimble, the Company's CEO, and Meghan Baivier, the Company's CFO and COO.

This quarter marks the four-year anniversary of Easterly Government Properties as a publicly traded REIT. We continue to execute with discipline the same thesis under which we launched our private equity fund: build a portfolio of leases backed by the full faith and credit of the U.S. government, comprised of facilities of mission-critical agencies, or those that are meaningful in the hierarchy of an agency mission. We've scaled the Company, achieving diversification for our shareholders, by buying quality buildings, and we have rejected many high-cap rate buildings that will not hold their NAV a decade from now.

Our economic formula is simple: we set a medium- to long-term target of delivering a 7% annual total return to shareholders, we anticipate a dividend of approximately 4.5% to 5% to the base, and add to that NOI accretion of approximately 2% per annum. That growth will come from accretive deployment of capital in acquisitions, non-speculative development opportunities and the renewal of existing leases. This growth vehicle is then supported by a prudent balance sheet, with balanced durations between assets and liabilities, unencumbered assets and reasonable total debt to enterprise value ratios. We believe there's considerable value in the balance sheet, given our cash flows and leases are backed by the full faith and credit of the United States government.

This business plan, given our current stock price, provides a return to investors equivalent to the 10-year treasury, plus approximately 450 basis points. We can easily imagine that spread to decrease as investors fully digest the power and consistency of the model over the coming years. Of course, there will be bumps, but over time we are confident that adhering our discipline will serve our shareholders well.

Given the predictable costs related to operations and re-leasing, along with the durability of tenancy, as compared to office real estate, we believe it is a prudent strategy to continue to provide high levels of distributable cash flow through quarterly dividends. We have completed a large amount of lease renewals in the past few quarters, which has given us stronger visibility into future cash flows. This added visibility only reinforces our desire to execute this approach.

Looking at the big picture, today, we have $1.4 billion in contractual cash due to us under our existing leases. Furthermore, if we assume and apply only a modest 10% increase to lease renewals over a 10-year term, the value of that contractual cash grows to $3.3 billion, backed by the full faith and credit of the United States federal government. We manage that $3.3 billion at approximately a 70% long-term margin. Hence, assuming one roll of all our leases, our shareholders own over $2.3 billion of NOI in a portfolio a decade from now, with an average age of only 23 years, in buildings that, on average, have a 40-year life. Further, this number will only grow with added scale. As such, in 2018, the Company grew significantly through the acquisition of a focused GSA-leased 14-property portfolio. Through this scale, we have been able to improve our Company's cost to capital, while simultaneously diversifying our portfolio, and improving our ability to bid on larger, more lucrative development projects. It is our goal to continue to apply this external growth engine for the acquisition and non-speculative development of high-quality buildings, which we believe increases the overall pedigree of the Company's portfolio.

In closing, our fundamentals are strong, our pipeline is robust and the credit quality of our underlying tenant remains the best of any public REIT out there. We thank you for your continued partnership and engagement as we work to build a premier portfolio of real estate assets leased by the United States federal government.

Now, with that, I'll turn it over to Bill.

William C. Trimble:

Thanks, Darrell, and good morning. Thank you for joining us for our first quarter earnings call. I would like to begin by highlighting the Company's achievements in the first quarter of 2019.

This quarter, we closed the final three properties in our previously announced 14-property portfolio. With these properties, we've concluded a multi-staged acquisition, which was broken into three separate tranches, over the latter half of 2018 and early 2019. As a reminder, this portfolio had a combined acquisition value of $430 million and is comprised of high-quality buildings that closely mirror the profile of our existing assets. The acquired portfolio consists of approximately 1.5 million square feet of rentable space, 99% of which is leased with a weighted average lease expiration year of 2022. We feel the shortened duration provides us with a tremendous opportunity capture attractive re-leasing spreads in the near term. Additionally, 79% of the assets are a build-to-suit construction; meaning, the design and functionality of the building was constructed to meet the specific needs of the underlying tenants. We are happy to report that, now that we have all of the 14 properties under Easterly management, these buildings are performing very well and meeting the everyday missions of the underlying tenant agency. Operations are going even better than expected in our underwriting, affording us a nice opportunity to add to the overall attractiveness of this portfolio.

Turning to acquisitions, Easterly is very pleased to see such a robust pipeline of actionable targets in 2019. We are constantly vetting opportunities to ensure the overall quality of our portfolio remains strong. While we have mentioned there are portfolios totaling approximately $2 billion, we think 2019 will be a year of incremental growth through the acquisition of one or two bullseye facilities at a time. Steady growth is what this Company was built on and I think you can expect to see that from us in 2019.

As Darrell mentioned, 2018 was a big year for Easterly from a lease renewal perspective. We were pleased to have renewed every single lease to date and extend the tenancy in these important facilities. While renewing these leases, we also have added clarity of future cash flows provided by the U.S. government. This clarity helps us better understand and appreciate our cost of capital, which we put to work towards future acquisitions and non-speculative development opportunities.

Speaking of development, our team continues to make meaningful progress at our two active development sites, FDA Alameda and FDA Lenexa. Our Development Team, applying their decades of experience in this niche market, have been working hand-in-hand with the government to deliver a state-of-the-art facility that meets the exact needs of the underlying tenant agency. This expertise was recently demonstrated with the delivery of the FEMA Tracy facility in Tracy, California. I had the pleasure of visiting the FEMA Tracy facility just two weeks ago for the formal grand opening event. While there, it gave me great pride to hear the countless stories of how this facility was put to work on day one to help with the thousands of people affected by the California wildfires last fall. Later that day, I visited FDA Alameda, which remains on track to deliver late in the third quarter of 2019, and FDA Lenexa is still expected to deliver in the third quarter of 2020. As a reminder, these non-speculative development projects provide for great opportunities to see increased yield on brand new facilities with long-term lease expirations.

On the development pipeline, we continue to monitor projects of a certain scale that could provide us with an opportunity to grow the portfolio, while still adhering to our strict underwriting criteria. As previously mentioned, because our development projects are purely non-speculative and managed through a design build contract, risks typically associated with a development project are significantly reduced. We will continue to keep everyone posted if and when new development projects are awarded.

Turning to the current portfolio, we continue to upgrade and improve the existing Easterly facilities in partnership with the U.S. government. Our Asset Management Team is in constant communication with the GSA and the underlying tenant agencies to ensure that the buildings our meeting the everyday missions of the various agencies, departments and bureaus represented throughout our growing portfolio. A building that serves the tenant and provides the necessary support for an agency to conduct its mission is extremely important to Easterly and we do everything in our power to ensure the best performance out of our buildings.

To conclude, we are excited about the opportunities presented in 2019, and I think you can expect to see some great news from the Company in the near future. I thank you for your time this morning and for your continued support and partnership.

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

Meghan G. Baivier:

Thank you, Bill. Today, I will review our current portfolio, discuss our first quarter results, provide an update on our balance sheet and capital markets activities, and discuss our 2019 guidance. Additional details regarding our first quarter results can be found in the Company's first quarter earnings release and Supplemental Information Package. GAAP measures and reconciliations of non-GAAP measures discussed on this call have been provided in our Supplemental.

As of March 31, we own 65 operating properties comprising approximately 5.6 million square feet of commercial real estate, with two additional properties under development totaling 129,000 square feet. The weighted average remaining lease term for our portfolio was 7.3 years. Remarkably, the portfolio had nearly the same weighted average remaining lease term in the first quarter of 2015, when the Company IPO'ed. While four years have passed, the Company's renewal success and accretive acquisitions have allowed us to maintain the duration of our assets, which speaks to the enduring visibility of our cash flows. The weighted average age of our portfolio has also defied the passage of time and remains young at 13 years. Portfolio occupancy remains at 100%, and finally, 99% of our annualized leasing continues to be backed by the full faith and credit of the United States government.

For the first quarter, net loss per share on a fully diluted basis was $0.01, FFO per share on a fully diluted basis was $0.31, FFO as adjusted per share on a fully diluted basis was $0.29, and our cash available for distribution was $18.5 million. This represents an impressive 52% growth in CAD from the first quarter of last year. The portfolio has grown from 46 to 65 properties, and with this scale comes a more diversified stream of cash flows supporting the Company's dividend.

Turning to the balance sheet, at quarter end, the Company had total indebtedness of $819.8 million, including $184.5 million outstanding on its unsecured revolving credit facility. With $450 million of total capacity, availability on our revolving line of credit stood at a healthy $265.5 million.

As of March 31, Easterly's net debt to total enterprise value was 36.6%, its net debt to annualized quarterly EBITDA ratio was 6.7 times, and its adjusted net debt to annualized quarterly EBITDA ratio was 6.1 times.

As you've heard me mention previously, meaningful progress on our development projects will bring higher levels of reported leverage as we near project completion. Adjusted leverage, in part, neutralizes this leverage drag, and at 6.1 times demonstrates the strength of the balance sheet and available dry power as we continue to pursue our target of $200 million of additional acquisitions this year.

In addition to maintaining robust borrowing capacity and access to diversified sources of debt, we have and will continue to be strategically minded in managing our equity capital. With the January 2019 closure of the final tranche of the 14-property portfolio, the Company extended its June 2018 forward equity contract and physically settled 6.7 million shares to partially fund just-in-time this final stage of the portfolio acquisition, and in early March of this year, the Company put into place the $200 million ATM program which allows for the sale of equity on a forward basis. With an equity float of nearly 68 million shares, in excess of $1.2 billion, we have the equity trading backdrop, and now this increased flexibility to continue raising capital accretively in support of an evolving acquisition and development pipeline.

Turning to earnings guidance, for the 12 months ending December 31, 2019, the Company is maintaining its guidance for FFO per share on a fully diluted basis of $1.16 to $1.20. This guidance, which is forward-looking and reflects Management's view of current and future market conditions, is based on the Company completing $200 million of acquisitions separate and apart from the January 2019 closing of the final three properties in the 14-property portfolio and $75 million to $100 million of growth development-related investment in the year.

Additionally, as previously mentioned, expected growth in FFO per share, due to accounting adjustments, is masking growth, and FFO as adjusted for share, a metric which is more indicative of our operating cash flow growth. The Company's guidance for 2019 FFO per share on a fully diluted basis represents expected FFO as adjusted per share on a fully diluted basis growth of approximately 6% to 11%. We have built an incredibly strong portfolio of assets, and in 2019, 6% to 11% of expected growth in FFO as adjusted per share, we believe is indicative of a remarkable year of value creation for investors.

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

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 key.

Our first question comes from Manny Korchman with Citigroup. Please go ahead.

Manny Korchman:

Hey, good morning, everyone.

Meghan G. Baivier:

Good morning, Manny.

Manny Korchman:

You guys spoke a bit about what this Company looks like today versus four years ago when you went public, and I guess one thing that I'm a little bit surprised about not changing is the cap rates in the market on the assets you've been buying. Can you just talk about what's kept that so steady and whether you see that changing over the next four years?

William C. Trimble:

I think—yes, good morning, Manny—I think several things. First of all, it is real estate without the drama. In my entire government career, we've really seen a very small movement, even after the crisis, to what we've seen today, so it doesn't tend to move in big blocks. Secondarily, I think that there is a new focus on government properties after we've, I think, done a good job of explaining to investors what a wonderful opportunity it is. I think we have been able to acquire just what we said were doing to in that 6.5 cap rate for the normal bread-and-butter, bullseye properties that we like to purchase, and then, of course, we've seen interest rates slow down, and actually, probably, reverse. So, I think we're probably here for some time, but as we know, at a 6.5 cap rate, we can purchase very accretively, and we see a good pipeline from here out, but we're not expecting any movement any time soon.

Manny Korchman:

Thanks, Bill, and, Meghan, one for you. Just how do you think about doing issuances on the ATM versus completing the forward equity? You did a little bit of ATM in the quarter (inaudible) versus taking up the forward.

Meghan G. Baivier:

Yes, Manny, we're going to continue to use the ATM going forward as a just-in-time tool. At the end of the quarter, we had an opportunity to enter the market at an attractive level, and so added to the potential dry powder there from the June 2018 offering, with a bit more issuance on the new forward ATM, to put the balance sheet in great position for the rest of the year.

Manny Korchman:

Sorry, what was that last thing?

Meghan G. Baivier:

Just to keep the balance sheet in a strong position on a leverage basis for the remainder of the year.

Manny Korchman:

Got it. Thanks, everyone.

William C. Trimble:

Thank you.

Operator:

Our next question comes from Michael Lewis with SunTrust Robinson Humphrey. Please go ahead.

Michael Lewis:

Thank you. My first question is about the equity issuance, as well, because it looks like you tapped the ATM a little bit below the consensus NAV. I thought the strike on the forward offering was better priced than that. Maybe you can correct me if I'm wrong. Then, also, maybe you could give a little more detail on the new ATM, the capability to do forward offerings through that. Is that directly in response to the way you had to fund the recent portfolio acquisition, can you do the—how much can you do forward, that sort of thing?

Meghan G. Baivier:

Yes, Michael. The price that we entered the market on the new ATM was very attractive and at an accretive price, in terms of the pipeline we're looking at for this year, and an improved unit price relative to the June offering. As we go forward, the forward capability, functionally, is the same as the forward that we implemented on our marketed offering last year and just allows a little bit more flexibility to be nimble as the pipeline evolves and comes into more clear view as we go through the rest of the year, but, functionally, it works exactly the same way.

Michael Lewis:

Okay.

Darrell W. Crate:

All of that is in the backdrop of—remember, we have this cadence of development opportunities that we're putting into place. So, we could be fortunate with our bidding efforts and we want to be well positioned to take full advantage of that non-speculative development opportunity. Likewise, we're executing—as we said, the pipeline is robust and there's a set of opportunities out there that can be very attractive for us. We're in a moment right now where we're positioning the Company again to take advantage of these opportunities that are out there.

Michael Lewis:

Okay. I'm kind of broken record on this question, but are there any lease expirations on the horizon that you think could be potential likely move-outs? I'm guessing you might say no to that, so as a Part B, are there any rent mark-to-markets that are likely to be out of the norm in terms of rent markup or down, or capital you need to contribute?

William C. Trimble:

I think the answer—thank you for the no—is no. The second part, as I think we've already spoken of any leases right out of the box that we thought that weren't going to be renewing higher, and I think we've got a great group of buildings that are on the cusp of renewing in our bullseye strategy, so we're looking forward. When the government inks those, good news ahead.

Michael Lewis:

Okay, thanks, and then just lastly for me, I don't know if you can answer this, but it looks like you last increased the dividend in 4Q '17. Would you expect an increase in the dividend in 2019 or in 2020?

Meghan G. Baivier:

Michael, we always look forward to an opportunity to continuing growing cash flow and dividending that out to shareholders. It's what we're here every day to do.

Michael Lewis:

Okay, thank you.

Operator:

Our next question comes from Michael Carroll with RBC Capital Markets. Please go ahead.

Michael Carroll:

Yes, thanks. Bill, can you comment a little bit on the competitive landscape right now for new investments? I know that you were previously saying there's a few people bidding pretty aggressive for some of these assets. Are you still seeing those bidders out there right now, has that calmed down at all, and then, I guess, what are you doing still right now to get your mid-six-type acquisition yield?

William C. Trimble:

Good morning. I think a number of answers for that. First of all, I think that some of the folks that were entering the market for the first time and spending a great deal of money on some of these properties may have taken a break. Our usual private equity competitors continue to be out there. We do purchase a number of our facilities off market, that hasn't changed. So, I think, from a competitive standpoint, it's the same. I think for some of the larger properties, maybe it has decreased a bit. As you know, we don't really go after a lot of the smaller plain-vanilla opportunities. We're looking out several terms into what these buildings are going to be worth 10, 20, 30 years from now. So, we really care about quality. But, I will say that we have seen, probably, more opportunities over the last 12 months, and we expect that to continue.

Not surprisingly, as I mentioned before, a lot of these super-duper new buildings, build-to-suit properties, were constructed in the early to mid-2000s, before the crisis. Those buildings are coming off of their first lease roll. A lot of the owners of these properties are getting a little older and looking for opportunities to redeploy or to pass on that wealth to future generations. We're very pleased with where the pipeline is today.

Michael Carroll:

Are there opportunities out there to buy assets with shorter lease terms, where you can probably get a better valuation, where you have maybe more knowledge or know if those leases are going to renew and at what type of rate they're going to renew?

William C. Trimble:

Absolutely. In fact, I think we pointed out that our portfolio last year, which we think is terrific, the 14-property portfolio does not have a long-term on the lease renewals, and obviously, for us, there's obviously a lot of expectation that we'll see some value there. We are looking at all different lease terms. Obviously, there's value. Depending if you're putting together a laddered bond portfolio or constructing a set of cash flows, that we are not only consistent, that we have full faith in, but also where we see some organic growth, as well, and that's where the short-term leases come to the fore. The pricing on those, it's interesting. I think when there's three or four years left, you'll see the drop. When it gets down to the one- or two-year period left, owners often will hold onto the properties, because obviously, with a 94% success rate if you don't do anything else at renewal, at that point, they tend to just hold on through the transition. But, those three to seven years, we think are a wonderful opportunity.

Michael Carroll:

Okay, and then I guess last question for me. The two development projects, I guess you're saying it's right on time, but it looks like it kind of got delayed a quarter. Is that just timing, it maybe got pushed back a month or so?

William C. Trimble:

No, it's basically at the end of—we've always said at the end of the third quarter, and we're just trying to be transparent, that what would happen if it happened on October 1. So, I mean, we're talking, I think we can be there.

Michael Carroll:

Okay.

William C. Trimble:

But, I've got to reiterate. I was, with Mike Ibe, our Head of Development, and the team, out at Alameda, California, and this building is absolutely spectacular. It is coming along very well. The FDA folks are extremely pleased, as are the GSA folks. It is a real trophy asset. We look forward to doing the same thing on Lenexa and perhaps in other areas around the country.

Michael Carroll:

Great, thank you.

Operator:

Once again, if you would like to ask a question, please press star, one on your telephone keypad.

Our next question comes from Jon Peterson with Jefferies. Please go ahead.

Jon Peterson:

Great, thanks. Just sticking with the lease expiration schedule for a minute, you have about seven years of average duration, but there's a little bit of a barbell there. I think you touched on this a little bit with Mike's question. There's a lot of near-term maturities and then there's a lot of really like really long-term maturities. I guess, as we get through the renewals, should we expect this barbell to kind of go away or is there always going to be a certain level of kind of shorter term leases that you'll be dealing with? Then, as kind of a follow-up along those same lines, should we expect elevated CapEx over the next couple of years, I guess through 2021, when you get—in asset value, you kind of get the lower renewals, or should CapEx moderate to a more reasonable level at that point?

Meghan G. Baivier:

Jon, we're obviously always working to renewing to long 10- to 15-year lease terms, and so the maturities that are coming to us in the next two to three years will create, likely, another wave, obviously, 10 to 15 years forward from that, and then, as Bill said, we're not targeting any particular lease term, but we should have a reduced level post 2021, depending upon what comes to us from the acquisition side of the house. We look forward to the opportunity to be able to renew these in the bullseye properties in that high-teens to low-20s, and put the appropriate capital to work to do so as we go through the next three years.

Jon Peterson:

Okay, that's helpful. Then, any of the upcoming maturities, do they require Congressional approval? Do you have any thoughts on—I guess our Executive and Legislative Branches don't seem to be able to focused or productive on anything at the moment, but do you have any fears, I guess, over the next couple of years that things can get held up in Congress?

William C. Trimble:

Interestingly, we've seen, on the prospectus level, things begin to move—I know it sounds incredible, but, actually, move quicker over the last several years. To remind folks, it's basically the two committees handle it and basically it's passed on a voice vote, so it's a fairly rapid process from that standpoint. I think the government is also realizing that it's to their benefit to get these up to 27 months in advance, to get these things going from a prospectus side. We do have an FBI facility coming up, one of our absolute best properties within our portfolio, which will be prospectus, and we are looking forward to a terrific renewal down there in San Antonio. But, you can expect that at the $3 million level, that's the number, above it, it's going to be a prospectus, and below it, it's going to be handled by the region.

Jon Peterson:

Okay, thank you.

Operator:

There are no further questions. I would like to turn the floor over to Darrell for closing comments.

Darrell W. Crate:

Thank you, everyone, for joining the Easterly Government Properties First Quarter 2019 Conference Call. The Company is growing on a foundation of premier assets backed by the full faith and credit of the U.S. government. We appreciate your continued partnership and look forward to speaking with you again soon.

Operator:

This concludes today's teleconference. Thank you for your participation.