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Q2 2023 Easterly Government Properties Inc Earnings Call

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Lindsay 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 Second Quarter 2023 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 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 attained or achieved. Furthermore, actual results may differ materially from those described in the forward-looking statements and will be affected by a variety of risks and factors that are beyond the company's control, including, without limitation, those contained in the company's most recent Form 10-K 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, core 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 William Crate ***Easterly Government Properties, Inc. - Executive Chairman of the Board***

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.

I'm pleased with the activities at Easterly Government Properties as we work to create value for our shareholders. We're seeing our pipeline of opportunities grow. Sellers are adjusting to the current interest rate environment and accordingly, we're expecting transactions to clear at higher cap rates than we've seen in recent years.

In addition, our team has been doing good work over the last year to identify property segments that are adjacent to our portfolio that improve our financial profile and add value to shareholders. We're seeking adjacencies where we find property profiles that are consistent with our thesis and where we continue to have a definable edge to create value.

One adjacency that meets these objectives is state and local government leased properties with very strong credit. Bill will talk more about the specifics. However, I observed this area meaningfully increases our pipeline opportunity set to complement our already

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improving federal pipeline. We'll continue to look for other similar adjacencies, but we believe state and local government leased properties can allow us to target elevated growth objectives for FFO in 2024.

Further, with both the consistency of cash flow from our existing portfolio and the current growth prospects, we look forward to delivering consistent and growing dividends over time to our shareholders. Exciting events are happening at Easterly, and we look forward to keeping our shareholders and partners updated in the coming months.

With that, I'll turn the call over to Bill to give you further insights into our existing portfolio as well as the future growth opportunities.

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

Thanks, Darrell, and good morning. Thank you for joining us for our second quarter earnings call. As Darrell mentioned, external growth opportunities have returned. We've observed bid-ask spreads in our market narrowing and Easterly is prepared to use our liquidity on hand to accretively grow the portfolio. Our acquisitions team is actively engaged with potential sellers of assets that meet our strict criteria and that carry long-standing leases with the government.

We look forward to providing updates on building specifics in the coming months. Stepping back, what we have learned during the first half of 2023 and what does that mean for future growth at Easterly. We have always viewed Easterly as the mechanism to buy real estate and sell credit. With that goal to date, we have chosen to center our acquisition universe around U.S. government credit.

With the goal of delivering long-term growth to our shareholders, we have spent a large amount of time expanding on that credit analysis. We learned that the U.S. government is joined by a number of states with very high credit ratings. In fact, some actually carry higher ratings than our U.S. government tenant.

We learned long-term leases renewed post pandemic carry a higher degree of comfort and security, which is a key component of the strategy we have executed all along. As we endeavor to expand our investment universe, allow me to elaborate further on the principles that have always guided and will continue to guide our investment strategy.

The first is credit. A company is only as strong as the security of the underlying cash flows and Easterly will maintain its singular focus on tenants that have and maintain a very high credit rating.

The second is lease term. Easterly intends to remain anchored by a stability of cash flows and will continue to be, as Darrell described, real estate without the drama. And finally, demonstrated resiliency. This guiding principle has served us well and allowed for strong levels of tenant retention since we started as a private company in 2010.

We remain committed to allocating capital to buildings where the tenant is dedicated to the necessity of the real estate in order to fulfill its mission. We have endeavored to provide a stable growth rate through positive renewal spreads, accretive acquisitions and targeted nonspeculative development.

We are already seeing velocity increasing in our federal bullseye sector as well as in certain state opportunities. We are targeting acquisitions this calendar year and expect next year to provide further growing pipeline opportunities. To quantify this, we believe $200 to $300 million put to work can drive run rate FFO growth rate in the 200 to 300 basis point range.

After thoroughly examining the high degree of similarities between being landlords to the United States government compared to being landlords to a state or local municipality, we are committed to pursuing this new opportunity to once again drive consistent growth in the Easterly platform.

In closing, we are seeing opportunities on the horizon, and we believe Easterly is well positioned to transact and restart its growth trajectory. With a solid NOI supporting our platform, we hope all listeners today are as excited as we are about this reinvigorated

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investment strategy and potential for added growth for our shareholders.

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

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

Thank you, Bill. Good morning, everyone. I am pleased to report that Easterly's portfolio performed solidly in the second quarter, and our balance sheet today remains strong with leverage at the midpoint of our target range, 0 drawn on our revolver and no current floating rate debt exposure.

Our attention and focus is on growing the portfolio. Turning to our portfolio. For the quarter ended June 30, we owned 86 operating properties, comprising approximately 8.6 million leased square feet either wholly owned or through our joint venture with a weighted average age of 14.4 years and a weighted average remaining lease term of 10.3 years.

Further, during the quarter, Easterly renewed its lease with GSA at DOT - Lakewood for a 15-year term, which will commence in June 2024. For the second quarter, all on a fully diluted basis, net income per share was $0.05 and core FFO per share was $0.29. Our cash available for distribution was $24.6 million.

At quarter end, the company had total indebtedness of approximately $1.2 billion at a weighted average interest rate of 3.8%, a weighted average maturity of 5.2 years and with 99.8% of all outstanding debt fixed at attractive levels. This represents an adjusted net debt to annualized quarterly EBITDA ratio of 7.1x.

Subsequent to quarter end, we funded the $50 million delayed draw feature on our 2018 term loan facility and used the proceeds along with cash on hand to repay all borrowings under our $450 million revolving credit facility.

Furthermore, given the company's previously announced forward starting swaps entered into in February of this year, as of today, Easterly carries no floating rate debt on its balance sheet, further insulating our shareholders from interest rate volatility.

Easterly also maintains a healthy balance of unsettled forward equity on our ATM. As of today, we expect to receive aggregate net proceeds of approximately $36.7 million from the sale of 1.7 million shares of the company's common stock that have not yet been settled assuming these forward sales transactions are physically settled in full, using a net weighted average combined initial forward sales price of $21.61 per share.

Turning to the company's 2023 guidance. The company is raising the low end of its full year 2023 core FFO per share guidance on a fully diluted basis from a range of $1.12 to $1.15 to a range of $1.13 to $1.15. This guidance continues to assume the closing of VA Corpus Christi, a property within the VA portfolio at the company's pro rata share of approximately $21 million, up to $15 million of gross development-related investment during 2023, but now also includes a third component of up to $50 million in wholly owned acquisitions for the year ended 2023.

As Darrell and Bill mentioned, a [thawing] market is expected to generate opportunities to transact in the second half of 2023. We look forward to offsetting some of the dilution from our 2022 10 property portfolio disposition and keeping our shareholders informed as Easterly resumes its new external growth trajectory.

With that, we thank you for your time this morning, and appreciate your partnership. I will now turn the call back to Shannon.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Michael Griffin of Citi.

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

Maybe going to expect the transaction activity for this year, Bill, I think you talked about narrowing bid-ask spreads, kind of (inaudible) cap rates. I mean where are you seeing these shake out relative to initial expectations from a cap rate perspective?

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

Well, I think we're finally seeing the opportunity squarely where we can purchase these buildings accretively. So we're looking in the range from 6.75 all the way to the high 7s in some of these opportunities.

And I think that it's only going to get better. I don't know how quickly interest rates are going to make the turn down. But I think we feel that we're getting some realistic movement in the cap rates overall. And if the sellers understand that this is probably not a short-term situation and are coming to the party.

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

And then just on the state agency pipeline that you talked about for a bit, are there any differences working with those state agencies relative to the government -- federal government from a lease perspective? I know we might not be as familiar with this asset class. So if you can give some kind of color around that, that would be helpful.

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

Absolutely. And it's a huge market. And obviously, so is the federal space, and we are interested in a very small subset of that market as well. And so think about missions that have to be handled by agencies that have to be in their buildings and have renewed in place in these buildings since the end of the pandemic.

But I think that from a standpoint of the size of the market, it is certainly large enough to be able to contribute, I think, substantially to our annual pipeline growth going forward. I think from a diligence standpoint, we have an incredible team here at Easterly, and we're really focusing on those states that have similar credit to the United States federal government and missions that are the same as well.

So I think you're going to be seeing more and more opportunities there from a lease standpoint. I know you're going to be very upset to hear that these leases actually have bumps. So we're going to have the opportunity to see some increasing numbers along with those opportunities. And also, I think in some cases, the leases are a lot more modern than the fixed federal GSA leases. So all in all, I think very positive from those different attributes.

Operator

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

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

Yes, thank you You mentioned the $200 to $300 million number. Is that kind of the size of the overall target market? Or was that potentially what you would be aiming for on an annual basis?

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

That's -- Pete, that is our annual happy zone that we've been on for many years, and we're very excited to get back to it next year. And I think -- it's been a frozen situation over the last 18 months and between certainly the federal opportunities, which by far are larger right now.

They're coming back to market and the increased pipeline with some of these really terrific state opportunities. We look forward to getting back to that 200 to 300 basis point FFO growth rate per year.

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

Okay. Got it. So that's kind of a combination of the new pipeline as well as what you've done in the past month?

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

Exactly.

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

Okay. Got it. And then could you just comment -- it's been early you talked about it's not every state or an agency that you want to be working with. I guess could you talk about some of the qualitative factors that went into your thinking in terms of other states that you're more or less willing to work with and who those are and why that might be?

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

Absolutely. And I think we did -- we went through a bit of a civics lesson and went through every state in the United States. We went through a lot of localities and figured out what the inventories were, figured out what the credit ratings of the various states were.

Interestingly, a number of the local governments have some of the highest credit ratings in the United -- in the world, actually. And so you look at the state, but you also look at the municipality. And then after you've gotten satisfied with those 2 attributes, then obviously looking at the importance of the building within the mission of that state and that particular federal agency.

And so we've done all of that and built up, I think, an attractive opportunity set that we will be mining over the coming quarters and coming years. I think that you should view this very much like when we entered the VA space in 2016. I think we've done our homework on that. I think it's been very, very successful, very accretive to our shareholders. And just provided another diversification within a, I think, a very attractive and very safe portfolio opportunity.

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***

Well, thanks, everybody. So thanks, everyone, for joining the Easterly Government Properties conference call for this quarter. We very much look forward to being with you at the end of the year and announcing our results and sharing our growth prospects. All the best.

Operator

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

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