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Easterly Government Properties, Inc.

Third Quarter 2019 Earnings Conference Call

November 6, 2019

CORPORATE PARTICIPANTS

Lindsay S. Winterhalter, Vice President, Investor Relations and Operations

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

Michael Carroll, *RBC Capital Markets*

Merrill Ross, *Compass Point*

Peter, *Jefferies*

PRESENTATION

Operator:

Greetings, and welcome to the Easterly Government Properties Third Quarter 2019 Earnings 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. Please note, this conference is being recorded.

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

Lindsay S. 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 items 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 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, 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 W. Crate:

Thank you, Lindsay. Good morning, everyone, and thank you for joining us for the third 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 strong quarter. Each area of our business performed well. We made progress on milestones that we expect will deliver solid performance over the long term. Our bullseye properties performed well; the acquisition pipeline is robust, which we expect will allow us to deliver on our $200 million plus target for the next several years, while being selective; our development effort progresses well, with the delivery of FDA Alameda, and our two additional FDA laboratories under development and on schedule; and our balance sheet is well positioned to support all these growth initiatives.

It is our goal to deliver 2% to 3% annual FFO growth over the longer term to shareholders, along with a dividend, which today is approximately 5%. We believe this provides an attractive opportunity, especially given that we have the highest quality tenant, with our rent backed by the full faith and credit of the United States government.

As our long-term shareholders know, our predecessor's founding almost 10 years ago, our mission is to be the partner of choice to the federal government, especially in mission-critical assets. All of our people understand that our enabling the U.S. government to achieve its mission, with facilities that support its workforce, is the pathway to being that best partner. We strive to be our best for the FBI, the DEA and the VA, along with 32 other agencies, each and every day. In doing so, we serve our tenant and build value for our shareholders.

With that, I thank you for your time this morning and we'll turn the call over to Bill to share more detail on the developments in the quarter.

William C. Trimble:

Thanks, Darrell, and good morning. Thank you for joining us for our Third Quarter Earnings Call.

This is another great quarter for the Acquisitions Team here at Easterly. We continue to deliver on our pipeline of actionable opportunities, with the acquisition of nearly 170,000 square foot Environmental Protection Agency regional headquarters in Lenexa, Kansas. This single-tenant, GSA-leased office building was originally constructed in 2007, and underwent a large-scale renovation-to-suit for the specific use of the EPA in 2012. At that point, the facility received a LEED Gold for new construction and a LEED Platinum Certification for existing buildings. This facility was also awarded the Energy Star, with an impressive score of 94. The building is 100% occupied by the EPA through October of 2027, under its original 15-year lease, which has a five-year renewal option, thus potentially carrying the term through

October of 2032. An acquisition like this is the perfect marriage of our bullseye strategy and our commitment to good environmental stewardship through the ownership and management of a green real estate portfolio.

Further, subsequent to quarter end, Easterly acquired the U.S. Citizenship and Immigration Services facility in Tustin, California, located in Orange County. This recently LEED-certified, fully renovated-to-suit, 67,000 square foot facility is 100% leased under a brand new 15-year lease, which will expire in 2034. The extensive renovations ensure the tenant is receiving an optimal working space for their highly important mission.

Through these two accretive acquisitions, we have not only extended our average remaining lease term, but we have also reduced the average age of the Company’s overall portfolio. In addition, the Easterly Team is nearing is stated acquisition goal of $200 million for 2019, and I think you can expect to see us continue to deliver on this goal for the remainder of the calendar year.

This was also an exciting quarter for the development side of the house, led by our Vice Chairman Mike Ibe. We were pleased to deliver the brand new state-of-the-art FDA laboratory in Alameda, California this August. FDA Alameda is now the newest of the 13 regional FDA laboratories located strategically throughout the country. Now that we’ve completed the work at FDA Alameda, the government has reimbursed us for our outstanding lump sum expenses and has commenced a brand new 20-year lease which carries the term to August of 2039. This project, completed on schedule and on budget, is another major success for our team. The laboratories at FDA Alameda are extremely sophisticated, even compared to the private sector, requiring a top-tier developer, architect and general contractor, in order to construct and deliver. Our decades of experience and our strong partnerships with the government and our builders allowed us to provide a state-of-the-art facility to the U.S. government, so that they can fulfill an absolutely critical mission for the safety and security of the American public.

Continuing with development, this quarter marks the closing on our existing property for the future redevelopment of the FDA Atlanta regional laboratory. As mentioned, this is a wonderful opportunity for us and we’re honored, once again, to serve as the partner of choice to the U.S. government. FDA Atlanta, at 162,000 square feet, will be over twice the size of the FDA Alameda project. The state-of-the-art facility is expected to house both laboratory and office space for the Atlanta District Office, as well as the Southeast Food and Feed Laboratory and the Southeast Tobacco Laboratory. The Atlanta District Office oversees the regulatory operations within the Atlanta region, while the Southeast Food and Feed Laboratory provides laboratory testing and regulation for the region, as well as research into new methodologies and regulatory areas within the FDA. The facility is expected to house four separate laboratories for nutritional analysis, chemistry, microbiology and tobacco. Once this project is delivered, the GSA will commence its non-cancelable 20-year lease for the beneficial use of the FDA.

Starting with the delivery of FEMA Tracy in 2018, followed by FDA Alameda in 2019, and then the anticipated deliveries of FDA Lenexa in 2020, and FDA Atlanta in 2021 or ’22, Easterly has started to establish a pattern of delivering a project year, a pattern we hope to continue for years to come. We are taking advantage of these opportunities at attractive yields, with long-term lease durations starting on day one, so we are well positioned to provide long-term, predictable financial results for our shareholders.

Finally, turning to lease renewals, we are pleased to report we have signed a new lease with the GSA for the FBI field office located in Richmond, Virginia. This new lease, which will go into effect on January of 2021, will be for 20 years, 15 years firm, which carries the term through 2041. This is a center-of-the-bullseye property and we were able to earn highly attractive re-leasing spreads on this location. The bullseye renewal thesis was unequivocally demonstrated through this lease renewal exercise with the federal government and it is our pleasure to continue to serve as the government’s landlord at this mission-critical facility. This success is also reflective of our Asset Management Team demonstrating their differentiated skills and abilities to work hand-in-hand with the U.S. government to continue to provide an asset that meets the everyday needs of these important agencies.

To summarize, growth at Easterly continues. The square footage of our portfolio has tripled since the time of IPO. Our Company's market cap has grown by nearly four times and our float by over 6.5 times over that same timeframe, thus offering greater liquidity to our new and existing investors. Prudent management of our balance sheet has increased the capacity to accretively acquire and develop and assets. Our growth and scale has allowed us to diversify the portfolio, with no single asset with a near-term expiration representing more than 2.4% of the total portfolio, and we continue to grow the overall NAV of the portfolio, as the Asset Management Team works with the U.S. government on tenant-funded improvements. Further, with the stability of tenant occupancies superior to that of our net lease peers, we believe this vehicle for growth will only continue over time.

There's a lot to be proud of at Easterly, and I thank you again for your partnership and commitment to our investment thesis. I'll turn the call over to Meghan to discuss the Company's quarterly financial results.

Meghan G. Baivier:

Thank you, Bill. Good morning, everyone. Easterly's unique portfolio and business strategy allowed us, in the third quarter, to once again consistently post strong earnings, this time against the backdrop of increasing market uncertainty and volatility. As you saw in our earnings release for the third quarter, net income per share on a fully diluted basis was $0.01, FFO per share on a fully diluted basis was $0.29, FFO as adjusted per share on a fully diluted basis was $0.29, and our cash available for distribution was $20.7 million.

As of September 30, we owned 68 operating properties, comprising approximately 6.3 million square feet of commercial real estate, with two additional projects totaling 220,000 square feet under development or in design.

The weighted average age of our portfolio was12.7 years. It is through the acquisition of young, mission-critical bullseye properties and the delivery of our latest state-of-the-art FDA laboratory project in Alameda, California, that we were able to reduce the age of our portfolio again quarter-over-quarter. Looking back to our IPO, while four-and-a-half years has passed, our portfolio has only aged on a weighted average basis by 1.8 years. For these same reasons, and even with time working against us, we were also able to lengthen the weighted average remaining lease term quarter-over-quarter, from 7.4 to 7.6 years.

Our portfolio has grown from 56 to 68 properties since this time last year, representing approximately 30% growth in the overall size of the Company's portfolio, based on square footage. By achieving our stated goal to meaningfully scale the portfolio, we have created a more diversified stream of cash flows supporting the Company's operations, earnings predictability and, ultimately, it's dividend. Given the superior credit quality of our primary tenant, the duration of the government's enduring missions within our facilities, and the prolonged nature of the average remaining lease term, we believe these factors give us unique visibility toward the future cash flows of this portfolio.

Turning to the balance sheet, at quarter end the Company had total indebtedness of $908.6 million. For the full year available, a $450 million line of credit for future acquisitions and development-related expenses. As of September 30, Easterly's net debt to total enterprise value was 32.3% and its adjusted net debt to annualized quarterly EBITDA ratio was 6 times. 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 times, demonstrates the strength of the balance sheet and available dry powder as we continue to pursue our target of $200 million of acquisitions this year and next.

As part of our goal to purchase properties through just-in-time funding, the Company was active on its ATM program throughout the third quarter and subsequent to quarter end. Since June 30 of this year, the Company has issued 4.3 million shares of common stock, raising approximately $86.3 million in total gross proceeds, at a weighted average price of $20.05.

During the third quarter, the Company closed and funded the previously announced private placement of $275 million principal amount of unregistered fixed rate senior unsecured notes. This second trip to the unsecured debt private placement market solidified existing partnerships and initiated strong relationships with new lenders. The weighted average maturity of the notes was 12.4 years at the time of closing and the weighted average interest rate is an impressive 3.85%. Extending the Company's liabilities at such an attractive fixed rate positions the Company for future growth, by deploying capital accretively into acquisitions and development opportunities.

As Darrell mentioned earlier, we achieve the majority of our growth externally through accretive acquisitions and opportunistic, non-speculative development projects. As such, efficient management of the Company's balance sheet is among our top priorities, and I am pleased to have at quarter end 6 times adjusted leverage, with a weighted average interest rate of 3.8% and a weighted average maturity of 8.3 years. I'll remind you, this compares favorably to our weighted average remaining lease term of 7.6 years.

Turning to our 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 $1.18 to $1.20. This guidance 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 gross development-related investment in the year. The Company is also introducing guidance for FFO per share on a fully diluted basis for the 12 months ending December 31, 2020 of $1.22 to $1.24. The midpoint of this guidance is based on the Company completing $200 million of acquisitions and $40 million to $50 million of gross development-related investment in the year. From midpoint to midpoint, this 2020 guidance represents approximately 3% growth from our 2019 guidance, in line with our long-term goal of delivering 2% to 3% annual earnings growth to investors. We believe that long-term steady growth, paired with a secure sector-leading dividend, is a recipe for consistently improving our cost of capital, and we'll strive to achieve this combination again in 2020.

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 Michael Carroll with RBC Capital Markets. Please go ahead.

Michael Carroll:

Yes, thanks. Bill, can you talk a little bit about what you're seeing in the acquisition market today? I know that you've previously said that there's been more broker transactions coming in, kind of looking within this space. How does that impact your volume and your pricing on these types of deals?

William C. Trimble:

Good morning. Thanks for the question. I think I will say that we are seeing more brokerage opportunities, but I think recently, we've also seen some more off-market opportunities, as well. Stepping back and looking at our pricing, I think the supply is very strong, so, Michael, I feel really good about that. I'd say that we've probably seen a 10- to 15-basis-point change in the market over the last nine to 10 months. Where we were seeing 6.50s, I think we're seeing sort of, you know, in the 6.30, 6.35 category, but I'd also say that the properties that we've been purchasing, as you've noted, have been brand new, state-of-the-art facilities that have very long lease terms, so that might be shading it a little bit, but our pipeline remains robust, and we are seeing some more off-market opportunities, now, as well.

Michael Carroll:

Great. Then, if you're looking at some of your assets that are within your portfolio, that are more of the plain vanilla, I guess, what are you kind of thinking about in terms of asset sales? Is that something that you want to pursue right now or are you happy holding those properties here in the near term?

William C. Trimble:

Well, I think, as you've seen, we've renewed, certainly, the largest of our plain vanilla assets with very long lease terms going forward, so we have a number of years, the Management Team can decide what we're going to do there. I think we're pleased with everything we have in the portfolio, but, you know, as I've mentioned before, obviously, we are always trying to refresh the portfolio, add new bullseye properties, because we believe in the long-term they're going to be the most valuable. So, I think no surprises there. As we see opportunities, we'll certainly take advantage of them.

Michael Carroll:

Okay, great, and then last one for me. Can you talk a little bit about the GSA build-to-suit opportunities? Then, I guess, Meghan, does your guidance range assume any other new starts this year or does it just assume that you complete the projects that are in your pipeline and start the project in Atlanta?

William C. Trimble:

Well, I think, from the build-to-suit opportunities, we are in a unique space, in that the government decides when they want something to be built. We're not going out and doing speculative development. So, there are two sides to that coin. I think we have mentioned that the FDA has 13 of these facilities throughout the country, laboratories. Through Mike Ibe and team's hard work, we've been awarded the first three of them. I would not be surprised to see us get awarded more of those in the future. I don't think I can guarantee we're going to get every single one of them. As we've mentioned before, there are some FBI opportunities, there's some FEMA opportunities, there's some stuff out there, so we will be certainly attuned to what's happening there, and right now, I think we're on a terrific run rate of coming up and delivering one of these new projects every year, and we hope to stay on that wave for quite some time.

Meghan G. Baivier:

Mike, our guidance contemplates the completion of Lenexa and a very small level of initial investment on Atlanta, but nothing further.

Michael Carroll:

Okay, great. Thank you.

Operator:

Our next question comes from Merrill Ross with Compass Point. Please go ahead.

Merrill Ross:

Hey, team, good morning. You know I've got to ask. The lease renewal in Richmond, what was the spread?

Meghan G. Baivier:

Yes, good morning, Merrill, this is Meghan. We're really excited about the outcome at Richmond. First of all, that renewal is being completed over a year in advance of expiration, so we're going to have good time to complete the TI work before the commencement of that lease, and while that TI work is not yet fully determined by the government, we are expecting that lease, on a net effective basis, to roll up in the area of 25%.

Merrill Ross:

Excellent, thank you. Now, you have that other property, and I know it's small, the DEA on the border in San Diego, and it looks like they're going to be leaving that building at the end of the lease. Maybe they outgrew it, I suspect. Are there any prospects to re-let that? It's clearly suited for a federal agency.

William C. Trimble:

I couldn't agree more. I've stood on that property, we've got two facilities there, and you are literally looking at the Mexican border, from one end with respect to the other, a mile a way. There are all sorts of opportunities for that building, we believe, and also it is really the only office space, along with our others, located in that position. Most of it is warehouse and industrial. So, we are sanguine about the prospects for that property, and I'm sure, in our current situation with Mexico, there'll be plenty of opportunities.

Merrill Ross:

Yes, it would seem that way. I just would like to know if you can circle, Meghan, the lump sum expense reimbursement from Alameda.

Meghan G. Baivier:

I'm sorry, if we can circle …

Merrill Ross:

(Inaudible).

Meghan G. Baivier:

We did receive the lump sum, $52 million, so that we have nothing further waiting on—we're not waiting on the government for that.

Merrill Ross:

That was how much? I'm sorry.

Meghan G. Baivier:

Fifty-two million dollars.

Merrill Ross:

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.

Peter:

Hi, yes, this is Peter on for John. Just looking at some of your lease expirations through the rest of this year and 2020, I guess, just from a higher level, what are you seeing in terms of where those leases are rolling kind of directionally, whether it be positive or negative spreads?

William C. Trimble:

Well, I think the first thing is that, certainly, where we anticipate them rolling is reflected in our guidance for next year, which I was very happy to deliver today. I'd also say that I think that we're certainly not worried about the leases going over to next year; in fact, very positive, in that we have sort of transitioned in the last two years. Where we had some plain vanilla, these are, as evidenced by our FBI Richmond, bullseye properties and you know where they renew, very favorably, for the most part. I will tell you that we are not going to begin a trend of discussing, during negotiations with the federal government, where we think the leases are going to turn out, but I think they will be as anticipated, and we're very pleased as to how it's going.

Peter:

Got it. Thank you.

Operator:

Thank you. I would like to turn the floor over to Darrell for closing remarks.

Darrell W. Crate:

Great, thanks, Stacy. Thank you, everyone, for joining the Easterly Government Properties Third Quarter 2019 Conference Call. We appreciate your time. We look forward to keeping you posted on all of our work, as we strive to build a portfolio of pristine assets backed by the full faith and credit of the U.S. government.

Operator:

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