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Easterly Government Properties, Inc.

Fourth Quarter 2021 Earnings Conference Call

February 28, 2022

CORPORATE PARTICIPANTS

Lindsay Winterhalter, *Vice President, Investor Relations*

Darrell Crate, *Chairman*

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

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

CONFERENCE CALL PARTICIPANTS

John Kim, *BMO Capital Markets*

Michael Carroll, *RBC Capital Markets*

Emmanuel Korchman, *Citigroup*

PRESENTATION

Operator

Greetings. Welcome to Easterly Government Properties' Fourth Quarter 2021 Earnings Conference Call.

At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. Please note this conference is being recorded.

I will now turn the conference over to Lindsay Winterhalter, Vice President of Investor Relations. Thank you. You may 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 Reform Act 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, 2021, to be filed with the SEC on February 28, 2022, and in its other SEC filings, and risks and uncertainties related to the adverse impact of COVID-19 on the U.S. regional and global economies, and the potential adverse impact on the financial condition and results of operation of the Company.

The Company assumes no obligation to update publicly any forward-looking statements, whether as a result of new information, future events, or otherwise.

Additionally, on this conference call, the Company may refer to certain non-GAAP financial measures, such as funds from operations, funds from operations as adjusted and cash available for distribution. You can find a tabular reconciliation of these non-GAAP financial measures to the most comparable current GAAP numbers in the Company's earnings release and separate supplemental information package on the Investor Relations page of the Company's website at ir.easterlyreit.com.

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

Darrell Crate

Thank you, Lindsay.

Good morning, everyone, and thank you for joining us for this fourth 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.

2021 was another strong year for the Company and the portfolio. The year was defined by a record level of acquisition volume, increased FFO per share guidance, an increased dividend, strong capital markets execution, both debt and equity, the formation of a joint venture with a leading global investor, and successful releasing efforts with our primary tenant, the United States Federal Government.

We continue to rigorously maintain our investment discipline of purchasing mission-critical facilities that are early in their lifecycle. We've been building this portfolio of 89 buildings for the last 12 years, and, today, the average life of our buildings is just 13 years.

While maintaining our focus on long-term quality, we were able to grow FFO per share in 2021 by a strong 4%. As you know, this cash flow is backed by the full faith and credit of the U.S. government.

While we spend a significant amount of time talking about growth through acquisition, I would like to highlight the outstanding effort that produces strong, consistent results by our re-leasing and asset management group. This team has developed a definable edge in how they work with our tenant, the U.S. government, to meet their unique set of needs.

As we've seen over the last 20 years, there have been groups that have built GSA portfolios and chosen to service the government with folks who are trained in operating commercial office. This is not a match. The government, by definition, must have a different set of tastes and preferences to achieve their goals, as compared to a commercial tenant. Our team is steeped in understanding these unique needs, with the goal of being the private landlord of choice to the United States government. We are certain this platform creates enduring long-term value for our shareholders.

Further, we're pleased that we can consistently deliver a strong dividend to our shareholders. Our cash available for distribution continues to grow and reduce our payout ratio as we emerge from a period of re-leasing in 2020 and 2021. We are pleased that this favorable reporting trend will continue through 2022.

We'd like to take a moment to thank our Board. We have an exceptional group of Directors who have achieved significant success in their business endeavors, and we're grateful for their enduring engagement and guidance.

Lastly, I'd like to thank our investors for their support and interest in Easterly Government Properties. We'll continue to work to deliver high-quality dividends and growth from a portfolio with the highest credit-worthy tenant, the United States Federal Government.

With that, I'll turn the call over to Bill to further describe the activities of the quarter.

William Trimble

Thanks, Darrel.

Good morning. Thanks for joining us for our Fourth Quarter Earnings Call.

2021 was an incredibly successful year for Easterly on many fronts; $412 million in mission-critical acquisitions, the launch of a new joint venture partnership with a prominent global investor, the renewal of a number of leases, and the bolstering of our bullseye portfolio metrics on every measure, all combined, put Easterly Government Properties in a very strong position at year end. This was a year where our Acquisition Team broke all records dating back to our IPO in 2015. It was a year where we raised expectations and delivered. 2021 also saw the strengthening of our teams, the new CAO, a new Head of Sustainability, and a Manager of HR and DEI initiatives.

I will now break down the accomplishments and milestones.

In total, Easterly completed, either directly or through its new JV, 12 accretive acquisitions totaling approximately $412 million at a weighted average acquisition cap rate of 6% for the year. The weighted average remaining lease term of these 12 buildings is 16.6 years, assuming all options are exercised, further demonstrating the long-term cash flows and stability of these assets. All 12 buildings are either built-to-suit or renovated-to-suit for the underlying tenant agency. We've said it before, but the successful accomplishment of mission is the guiding requirement for agencies, and the ability of our facilities to aid that mission is why we have seen such a strong renewal profile since our predecessor fund bought its first building in 2010.

The highlight of our Acquisition Team's accomplishments in 2021 was the successful announcement, and subsequent initial closings, on our brand new, state-of-the-art, 1.2 million square foot, 10-building portfolio, leased entirely to the Department of Veterans Affairs. To date, we have closed on four of these 10 properties and expect to acquire the remaining properties during 2022 and 2023. This unique portfolio, a natural addition to our growing organization, provided the perfect opportunity for the creation of our joint venture with a global asset allocator who understands the enduring nature of these assets and the meaning of full faith and credit. With a weighted average lease duration of 19.6 years, this portfolio only further differentiates us from any of our private competitors. As previously mentioned, this portfolio materially reduces the average age of our already young portfolio and extends its weighted average remaining lease term. We were pleased to add to our cash flow to investors for the long term, while opening up new strategic opportunities in the future. At this time, the JV is just these 10 properties, but we look forward to further conversations.

In addition to the four VA Outpatient facilities acquired by the JV in the fourth quarter, Easterly acquired a nearly 500,000 square foot facility, primarily leased to the United States Citizenship and Immigration Services, or USCIS, located in the metropolitan region of Kansas City, Missouri, with a total weighted average lease expiration date of February of 2036, and this property serving as USCIS's National Benefits Center, we believe the long-term tenancy in this facility is predictable.

Finally, in the fourth quarter, Easterly acquired an 80,000 square foot leased VA Outpatient Clinic located in the Midwest Region of the United States. VA Midwest is a built-to-suit outpatient clinic that was recently completed in 2021. This state-of-the-art, two Green Globe certified facility is leased to the VA for an initial non-cancellable lease term of 20 years that does not expire until May of 2041. The Outpatient Clinic provides a wide range of medical and ancillary services, including, but not limited to, primary care, mental health, audiology, optometry, dermatology, radiology and prosthetics.

On our development status, we had previously reported that the government has reached a determination on its new program requirements for the future FDA Atlanta Laboratory Development Project. The GSA and the FDA has spent the past several months working together to ensure maximum benefit from this facility, and we are pleased to re-engage with the government and actively proceed with next steps. Since the time of our last call, Easterly has proceeded with the redesign of the project in collaboration with the FDA and the GSA, and completion of the project is now anticipated in the second quarter of 2024.

Turning to leasing updates, our Asset Management Team continues to secure meaningful renewals that lengthen the duration of cash flows. In the fourth quarter, we renewed the Small Businesses Administration, or SBA, lease in a multi-tenanted facility located in Buffalo, New York. With a lease commencement date of August of 2022, Easterly has the opportunity to proceed with tenant improvement work in advance of its start date. Once the new lease commences, a brand new 17-year term, 15 years firm, will begin, that can take SBA's tenancy into August of 2039. This renewal, combined with other assets year to date, translate into nine successful re-leasing exercises totaling approximately 574,000 square feet, or just under 7% of the annualized lease income, for a weighted average lease term of 16.2 years in 2021.

In closing, we, at Easterly, had a very productive last quarter of 2021, including another strong year for the Company. We have meaningfully and accretively scaled the Company's portfolio through the acquisition of bullseye assets, we executed on our highest acquisition volume year on record as a public company, we have a formed a new joint venture with an experienced global partner, and we have even further refined our investment discipline of owning assets primarily backed by the full faith and credit of the United States government.

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

Meghan Baivier

Thank you, Bill. Good morning, everyone.

It gives me great pleasure to post another strong quarter and close out a very successful year here at Easterly.

As of December 31, we owned 89 operating properties comprising of approximately 8.6 million leased square feet, either wholly owned or through our joint venture, with one additional development project in design totaling approximately 162,000 square feet.

In 2021, we acquired 12 properties and sold two. Through the acquisition of newer facilities, the strategic disposition of non-core assets and the successful long-term renewals in existing properties, the weighted average age of our portfolio remains young at 13.6 years and the weighted average remaining lease term has grown to 9.7 years.

Turning to our quarterly results for the fourth quarter, all on a fully diluted basis, net income per share was $0.08, FFO per share was $0.33, and FFO as adjusted per share was $0.32. Our cash available for distribution was $26.3 million.

For the year ended December 31, 2021, all on a fully diluted basis, net income per share was $0.36, FFO per share was $1.31, and FFO as adjusted per share was $1.24. Our cash available for distribution was $100 million.

At $1.31 per share, on a fully diluted basis, Easterly delivered at the stated midpoint of its previously increased guidance. This represents an impressive 4% growth rate year-over-year. When coupled with our roughly 5% dividend yield, we believe Easterly presents a unique opportunity for investors to receive a robust current yield backed by the full faith and credit of the U.S. Government, alongside long-term inflation protection.

On that note, let me actually take a moment to remind those on the call that while the typical GSA lease does not provide for shell rent bump, it does contain an operating expense base which protects us as landlords from bearing the burden of increased operating expenses and, thus, diminishing NOI in an inflationary environment.

Turning to the balance sheet, at quarter end, the Company had total indebtedness of approximately $1.2 billion, with nearly full capacity on our line of credit for future acquisitions and development-related expenses. As of December 31, Easterly's net debt to total enterprise value was 34.1% and its adjusted net debt to annualized quarterly pro forma EBITDA ratio was 6.7 times. With a weighted average debt maturity of 6.7 years and 97.5% of all outstanding debt fixed at attractive levels, I'm particularly pleased with our Company's positioning as we enter a potentially rising rate environment.

On the debt side, in the fourth quarter, Easterly issued the previously announced $250 million principal amount of fixed rate senior unsecured notes. The notes were issued and sold in two tranches: Series A senior notes in the amount of 50 million with a seven-year maturity and Series B notes in the outsized amount of 200 million with a nine-year maturity. Together, the weighted average maturity of these notes is 8.6 years and the weighted average interest rate is 2.84%. We believe raising long-term unsecured debt at such an attractive weighted average rate and maturity is an extremely powerful tool in generating value for shareholders.

In terms of equity, during the fourth quarter, Easterly issued just under 4 million of the 6.3 million shares the Company sold on a forward basis in connection with an underwritten public offering that took place in the third quarter at a net price to the Company of $21.64 per share. With the settlement of these shares in the fourth quarter, Easterly received approximately $85 million in net proceeds, delivering the funding needed to continue pursuing our acquisition pipeline at levels that are accretive to shareholders.

At present, Easterly expects to receive net proceeds of approximately $102.7 million from the sale of an aggregate 4.7 million shares of the Company's common stock that has not yet been settled, including the remaining 2.3 million shares pursuant to the Company's third quarter underwritten public offering and 2.4 million shares from sales under the Company's $300 million ATM program, assuming these forward sales transactions are physically settled in full using a net weighted average combined initial forward sales price of $21.87.

Finally, in the fourth quarter, Easterly announced the formation of a joint venture in connection with the agreement to purchase 10 assets that we refer to as the VA Portfolio. As mentioned on the last call, Easterly's JV partner will retain a 47% stake in the JV and Easterly will retain a 53% stake in the JV. Easterly will also receive asset management fees from the JV partner and will be responsible for the day-to-day management of the property. This relationship with our new JV partner, we believe demonstrates a global interest in the outsized current deals of GSA assets, like those in the Easterly portfolio, deals which are backed by the strength and stability of the U.S. government cash flows that underpin Easterly's credit quality. We are excited by the partnership and look forward to a strong, mutually beneficial relationship for many years to come.

Turning to renewals, I would like to highlight some of our re-leasing successes as of year end.

As previously mentioned, due to the unique nature of our leases, final renewal rents cannot be ascertained until the exact amount of tenant improvement, or TI, dollars required by the government at renewal is known and the TI work is complete. As such, there can be a lag in providing re-leasing data relative to the point at which we have signed a renewal lease.

As of December 31, 2021, we had executed 12 renewals for which the renewal TI work was complete and accepted by the government. This 12 includes PTO Arlington and IRS Fresno. When we exclude PTO Arlington and IRS Fresno, the average rent spread achieved on the remaining 10 renewals was 10%, including approximately $22 per foot of TI utilized by the government. The average total renewal term for these 10 renewal leases was 15 years.

I can also share that we currently expect our single-tenant bullseye properties that have renewed, but for which the new lease has not yet commenced or for which it has commenced but the TI has not yet been accepted by the government, to realize an average renewal rent spread of 10% to 15%. This group of assets totals roughly 346,500 square feet across seven properties, and each have renewed for total lease terms of 15 of 20 years, with an average of 16.7 years.

In addition to these bullseye renewals, we executed either renewal options or long-term extensions across 713,250 square feet of our portfolio. We look forward to working with the GSA upon the expiration of these assets between the years of 2023 and 2026.

Finally, with approximately 341,900 square feet and six leases expiring through the end of 2022, we are pleased to report we are making meaningful progress with the GSA and are in active discussions regarding all properties at this time. We feel good about the long-term mission and tenancy of these upcoming bullseye expirations.

Turning to our earnings guidance, as you recall, during the last quarter call there were questions surrounding acquisitions within the JV and outside of the JV. To provide further clarity, the Company is maintaining its FFO guidance per share on a fully diluted basis in a range of $1.34 to $1.36, but expanding its disclosure surrounding the assumptions underlying this guidance. This guidance is predicated upon $200 million to $250 million of wholly-owned acquisitions, the closing of properties in the VA portfolio totaling approximately $145 million at the Company's pro rata share, and up to $10 million in growth development related investment during 2022. At its midpoint, Easterly remains on track to continue our record of steady FFO growth year-over-year.

With that, thank you for your commitment to our thesis, and we appreciate your partnership.

I will now turn the call back to Sheri.

Operator:

Thank you. Our first question is from John Kim with BMO Capital Markets. Please proceed.

John Kim

Thank you. Good afternoon—or good morning. Meghan, your guidance for FFO was unchanged, but you did increase the acquisition guidance to $370 million, including the JV assets. Were there other components of guidance that changed to offset that acquisition target?

Meghan Baivier

John, what that's indicative of is deals that we had expectations could have closed last year, but will now be closing in 2022. So, it's not fully deals forward, it's actually deals that moved from '21 to 22.

John Kim

Okay. You talked about the leasing spreads being 10% through 2021, and 10% to 15% on leases that have not yet closed, but I'm wondering how that compares to market rents. If you signed to a non-GSA tenant, would you have gotten a higher leasing spread?

Meghan Baivier

Yes, as you know, John, renewals within the GSA market, and particularly within our assets, are decoupled from "office market rents" in the markets where we operate. It's really an exercise in replacement costs for that asset, and, obviously, we have the wind at our backs, particularly today, with the new inflationary environment we seem to find ourselves in. So, it's really apples and oranges. We think about our renewals in that context.

John Kim

How does inflation, the current inflationary environment impact those kind of discussions on leases expiring this year?

Meghan Baivier

Yes, I mean, it's a great backdrop. I think everybody "in the room" of a renewal process understands the current dynamic, and when you truly are faced, in most instances, with the alternative being a new build, time is on our side.

Darrell Crate

Just to put a point on that, inflation is one of the dynamics that the government does understand. So often, our conversations, we have—we're very focused on sort of the commercial net present value IRR numbers related to our assets, they're very focused on mission. Inflation is something where they understand that that has impact on value, and I can't emphasize enough how many challenges the government is having across the board with construction costs and needing to relook at projects. So, I think that it's one of these few times where there's news in the market that is seen the same way by both parties.

John Kim

So, Darrell, do you think the GSA is open to having leases have a higher leasing spread, so implying more than 1% growth per annum?

Darrell Crate

Well, I think that we can't know what's in the mind of the GSA, but we certainly know that when we're signing a lease today, that we both understand that inflation is maybe ahead of us and we're—it's a constructive conversation. We'll see how it turns out.

John Kim

Great, thank you.

Operator

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

Michael Carroll

Yes, thanks. I wanted to talk a little bit about the Company's sustainability goals., and you kind of mentioned this in your prepared remarks, that you recently hired a new Director of Sustainability. How does DEA look at kind of advertising its ESG initiatives? I know that there's been a report kind of online highlighting what you're currently doing, but do you plan on having more of a formal report, that you're going to publish every year, like a lot of the other REITs do?

Meghan Baivier

Hey, Michael, good morning. So, yes, we're very excited to have hired a Director of Sustainability. For a company of our size, to be at that place, is a really exciting moment. We have consistently been focused on sort of the Energy Star framework. That's the framework the government pays closest attention to. We obviously have our portfolio in the Energy Star Tracker and we report within that, that framework. But, our new Director of Sustainability is very much focused today on rate baselining within the Company as we begin to set goals, and, yes, it would absolutely be our expectation to have a formal sustainability report as early as next year.

Michael Carroll

Okay, great. Then, can you talk a little bit about sort of type of goals that you want to set? I'm assuming that if you're just starting the baselining now, then setting those goals are still multiple years away. I mean, how are you thinking about that?

Meghan Baivier

No, it's not years away, I would say it's a 2022 priority, and we'll definitely inform how we come out in our report for 2023.

Michael Carroll

Okay. Then, how much information do you get from the government? Do you get all the necessary information on the environment from their type of buildings, like energy usage, and things like that? I mean, are there any difficulties getting that data, given the leases that you have?

Meghan Baivier

No, we don't face the same difficulties that a triple-net REIT would face, no.

Michael Carroll

Okay.

Meghan Baivier

We do have this data.

Michael Carroll

Great, and then just last one for me. Can you talk a little bit about the FDA Atlanta building, what's the progress on that, and is there any idea of when that could officially break ground?

Meghan Baivier

Darrell's point earlier really comes to play here with FDA Atlanta. They're all, on the construction side, facing the realities of inflation and finalizing their tenant improvement budgets, and that's been the story for FDA Atlanta, as well. We are at a good inflection point, we believe, with the government and have moved that commencement date to the middle of 2024, breaking ground—I wouldn't say breaking ground, but continuing to really put dollars to work closer to the end of this year and into next year. You can see our budget for this year is up to $10 million of spend.

Michael Carroll

Okay, great. Thank you.

Meghan Baivier

Mm-hmm.

Operator

Our next question is from Emmanuel Korchman with Citigroup. Please proceed.

Emmanuel Korchman

Hey, good morning. Just thinking about the comments you've made thus far on increasing costs, sort of maybe more tactful negotiations, etc., has that changed the competitive landscape out there? Are other developers either finding it easier or harder to sort of make their deals pencil up?

Meghan Baivier

I think the—there's a small set of folks who even traffic in the development space within the U.S. government requirements, and I'd say it hasn't changed that landscape, Manny. It's a particular skill set, just like ours is, within the asset management side of the business. But, it's certainly has created a sharpening of the pencils, right, as folks are bidding these deals and responding to RFPs, but hasn't (inaudible).

Darrell Crate

But, you know, Manny, I think what's very helpful for folks who aren't as sort of immersed in our Company as you are, fundamentally, you step back, and the value—the government really has two alternatives, which is to renew our building or go build a new one, and when you look at a new building and—our sort of accumulated depreciation in our building is essential our edge, because it's there, it's working. We work very hard to keep the tenant happy, the agency happy back in Washington, and the GSA, who's in charge of doing all of this. So, as we look forward, it is very clear that construction costs are getting higher and that factors into our negotiation.

When we look at new builds out there, there is—clearly, there's less certainty about future construction costs, which would again—you can only imagine that contractors are not going to be in a position to build, you know, to give a guaranteed price today with very thin margins. The volatility in those construction costs is our friend, and construction costs, generally, is a friend of our portfolio.

Emmanuel Korchman

Great, Darrell, thank you. Then, maybe this one's for you, as well, but there's been a little bit more press on the government pushing to bring people back to offices. I think that's a little bit less relevant, maybe, for your direct agency relationships, but have you seen any change in either the usage of the buildings or renewed conversations that maybe went on hold while people just weren't using the office space?

William Trimble

Yes, Manny, good morning, it's Bill. I think it's obviously, overall, positive. However, as you know, our buildings are mission-critical and the folks in those buildings have really been working throughout the entire pandemic. Having said that, I think that we are seeing more interest in some facilities for potential expansion in the future. So, I would say all the winds are blowing in the right direction. Our buildings are busier than they've been, and will continue to do so. I think it's been a great place to be and I think the government has also realized that it is very, very difficult—and I'm talking about more of plain-vanilla missions, because, as you know, most of our missions are mission-critical, but on those other missions, it's hard to do it from home, it's very inefficient, and they, too, have realized, in order to conduct a mission, they're going to have to execute that from their offices.

Emmanuel Korchman

Great. Thanks all.

Darrell Crate

Thank you.

Operator

Our next question is a follow-up from John Kim with BMO Capital Markets. Please proceed.

John Kim

Thanks. Hey, Meghan, you mentioned the increased acquisition guidance in 2022 reflects some delays that you had from last year, but last year you did exceed your acquisition guidance of $350 million, so I'm just wondering if there were any other offsetting factors to that increased acquisition guidance this year that would impact your FFO guidance.

Meghan Baivier

Yes, I think we would have exceeded our growth number last year by a larger amount, John, so, no. outside—the expectations, outside of the joint venture, have not changed.

John Kim

So, where do you see cap rates on the target acquisitions this year?

William Trimble

Well, I think, John, it's been an interesting market. I can tell you that certainly, even though we're seeing the turn in interest rates going up, nobody's heard it in the GSA space. There's a lot of money coming in and I think they're continuing to be compressed. As you know, on the pristine building portfolio that we just purchased, it was at a 5.25 cap, I think we're trading more at a 6.25 cap, so there's a big gap right there. I think the private markets are valuing these buildings, and I think they're able to do that through the utilization of leverage, which, obviously, makes a lot of sense when you consider the counterparty is the United States Federal Government. So, I think we are seeing a continuing move down in cap rates in this area. However, we are always opportunistic and we do only accretive transactions, and we're very pleased to have our global JV partner assisting us with some of those transactions. So, we're being nimble, but it is a different game out there.

John Kim

Bill, for those type of assets, are you willing to do those on balance sheet or strictly through the JV?

William Trimble

Well, it depends. The bottom line is accretive, John, and so it just depends which bucket they fall into. I think if you see some of these super new buildings, they're even talking under 5 caps for them. We're aware of that and we have the capability of executing on those, but, obviously, we'll do it on balance sheet when the property fits that bucket. Clearly, two buckets out there.

John Kim

Great, thanks for the color.

Operator

We have reached the end of our question and answer session. I would like to turn the conference back over to Darrell for closing comments.

Darrell Crate

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

Operator

Thank you. This does conclude today's conference, you may disconnect your lines at this time, and thank you for your participation.