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Easterly Government Properties

Third Quarter 2017 Earnings Conference Call

November 7, 2017

CORPORATE PARTICIPANTS

Lindsay 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 Baivier, *Executive Vice President, Chief Financial Officer and Chief Operating Officer*

CONFERENCE CALL PARTICIPANTS

Emmanuel Korchman, *Citigroup*

Brian Hawthorne, *RBC Capital Markets, LLC*

Michael Lewis, *SunTrust Robinson Humphrey, Inc.*

Jon Petersen, *Jefferies*

PRESENTATION

Operator:

Greetings and welcome to the Easterly Government Properties' Third Quarter 2017 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, Vice President, Investor Relations. Thank you, Ms. Winterhalter. 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 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-end December 31, 2016, filed with the SEC on March 2, 2017, 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 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 joined by Bill Trimble, our Chief Executive Officer, and Meghan Baivier, our Chief Financial Officer and Chief Operating Officer.

Through the third quarter of 2017, Easterly continues to deliver strong and consistent financial results. Management continues to execute on two strategic goals: the first, to achieve consistent, long-term FFO growth of 5% to 7% through the re-leasing, acquisition, and development of Class A mission-critical properties leased to United States Federal Government; the second, to scale the business with high quality accretive assets in order to materially increase float and thereby reduce the cost of entry and exit for our Investors in our common stock. The Team continues to hone its definable edge in identifying, underwriting, and servicing portfolio buildings leased to and backed by the full faith and credit of the United States Government. Easterly is a brand in the Federal-leasing community. Reputation matters, but particularly in the area of public-private commerce. We strive to be the Government's partner of choice when acquiring, developing, or managing a Government-leased building.

2017 has been marked by the purchase of larger flagship assets, like FBI - Salt Lake City and VA - Loma Linda, and I'm proud to note that we materially scaled the Company, growing enterprise value by 40% and simultaneously deepening our relationship and stature with two important mission-critical agencies.

Since September 30, 2016 we generated a total return for Shareholders of 13.7%, well in excess of the 2.6% returned by the broader REIT market. We also achieved our goal of delivering FFO growth while materially reducing our future earnings volatility related to possible interest rate increases. With over 97% of our revenue backed by the full faith and credit of the United States Government, we are grateful to have the highest tenant credit quality of any REIT.

This has been a great year for Easterly. We'd like to thank our Team for their hard work and thank our Shareholders for their partnership as we work to complete 2017 and start generating value in 2018. With that, I will turn the call over to Bill to provide color on the initiatives at Easterly that drive Shareholder return.

William C. Trimble:

Thanks, Darrell, and good morning. I would like to begin by highlighting the Company's achievements in the third quarter of 2017. This quarter we announced and closed on a 169,000-square foot FBI field office located in Salt Lake City, Utah. The Class A LEED Gold certified four-story single-tenant facility is located on a 7.5-acre campus and oversees Federal operations in all of Utah, Idaho, and Montana. FBI - Salt Lake City is one of 56 FBI field offices strategically located throughout the United States and serves as a regional headquarters, directing 18 satellite offices, also known as resident agencies, located throughout Utah and the two surrounding states.

The build-to-suit construction was completed in 2012 and is 100% occupied by the FBI through October 2032, for initial non-cancelable lease term of 20 years. Upon closing of this important Government-occupied facility, Easterly Government Properties now owns 7 of the 56 FBI field offices, thus making Easterly the single largest private owner of FBI field offices in the country.

As we mentioned on prior calls, Easterly is also under contract to acquire a VA outpatient facility that is located just outside of South Bend, Indiana. The outpatient facility is now complete and is seeing local veterans on a daily basis. We expect to close on this property in the coming quarter and look forward to welcoming this highly important mission critical facility into our growing portfolio. As a reminder, the VA - South Bend Outpatient Clinic is very similar to VA - Loma Linda, but on a smaller scale of 86,000 square feet. The outpatient facility is leased to the VA for an initial 15-year non-cancelable term.

Once the VA - South Bend acquisition is complete, Easterly will own two new state-of-the-art Class A VA outpatient facilities totaling a combined 414,000 square feet of lease space, all backed by the full faith and credit of the U.S. Government.

While on the topic of the VA, the nearly 328,000 square foot Loma Linda Outpatient Care Center has had its first full quarter of operations under Easterly's ownership and we are pleased to report everything is going well in this state-of-the-art Class A facility. In fact, our Asset Management Team recently received a number of requests from the VA to make tenant-funded enhancements, valued at over $1.5 million to this almost brand-new facility. Our Asset Management Team is doing a wonderful job of addressing the needs of our tenants, and at quarter-end we're managing 16 active value-enhancing tenant-funded projects across the portfolio.

Turning to development, Mike Ibe and his Team have made meaningful strides in building the pipeline of development opportunities that we expect will serve us well for the next several years. Development opportunities are not only accretive, as we add real value to both the Government and our Shareholders but they also give us longer, valuable leases, many being 20 years in duration, which can provide earnings stability and additional opportunities to be opportunistic in managing our liabilities.

As you may recall, we have two active development projects underway, both to be occupied by the FDA. The first is a 70,000 square foot laboratory located in Alameda, California. We are pleased to report that we've completed the initial demolition of the current site and now have all show permits and the first stage TI permits in hand. We are working hand-in-hand with the GSA and FDA to incorporate some design changes to make sure the facility functions to the highest and best use of tenant agency. The estimated completion date of this project is the first quarter of 2019.

The second laboratory, located in the Lenexa, Kansas, just outside of Kansas City, is roughly 53,000 square feet and we are currently finalizing the design intention drawings. We anticipate an early third quarter 2019 completion for this laboratory.

Upon completion of these two facilities, two brand-new non-cancelable 20-year leases will commence.

Our Acquisition Team is constantly sourcing new high-quality opportunities that mirror our average portfolio of building size and drive FFO growth. We have a robust pipeline of bullseye opportunities that fall within the $20 million to $40 million acquisition range and remain in constant contact with developers looking to sell properties so that they can move onto their next development project. To reiterate, our target market includes buildings leased to a single tenant of the U.S. Federal Government. They're often the result of a design build award and are usually over 40,000 square feet in size. If a building of this nature is occupied for the right tenant, fulfilling the right mission, and meets the traditional real estate underwriting requirements, then we will evaluate a potential acquisition. These bullseye elements are very important from a re-leasing perspective as we look to achieve renewal rates at an increase in the high teens to low 20s.

Finally, to summarize our acquisition and development activities since the third quarter of 2016, we have acquired five new assets, soon to be six, adding 700,000 square feet to the portfolio. We welcomed two new tenant agencies to the portfolio—the VA and OSHA—and we've grown our relationship with existing tenant agencies, like the U.S. Courts and the FBI. We were awarded the development rights for brand-new state-of-the-art FDA laboratory in Lenexa, Kansas, marking two active development projects for the Company. Through this growth we have reduced the age of our portfolio and extended the average remaining lease term despite the progression of time working against us.

As the Company's CEO, I'm quite proud of all we have accomplished in the past year. With that, I'll now turn the call over to Meghan for a discussion of the quarterly results and earnings guidance.

Meghan Baivier:

Thank you, Bill. Today I will touch upon our current portfolio, discuss our third quarter results, provide an update on our balance sheet, and review our 2017 and 2018 guidance. Additional details regarding our third quarter results can be found in the Company's third quarter earnings release and supplemental information package.

As of September 30, we own 46 operating properties comprising approximately 3.7 million square feet of commercial real estate. The weighted average remaining lease term for our portfolio was 6.9 years, the average age of our portfolio was 12 years, and our portfolio occupancy remained at 100%. In addition, over 97% of our annualized lease income was backed by the full faith and credit of the United States Government.

For the third quarter, net income per share on a fully diluted basis was $0.02, FFO per share on a fully diluted basis was $0.32, and FFO as adjusted per share on a fully duty basis was $0.28. GAAP measures and reconciliations to GAAP measures have been provided in our supplemental information package.

Turning to the balance sheet, at quarter-end the Company had total indebtedness of $539.9 million, which is comprised of $59.3 million outstanding on our unsecured revolving line of credit, $100 million outstanding on our unsecured term loan facility, $175 million on senior unsecured notes, and $205.7 million of secured mortgage debt. Availability on our line of credit stood at $340.8 million. As of September 30, 2017, Easterly's net debt to total enterprise value was 33.3% and its net debt to annualized quarterly EBITDA ratio was 6.1 times pro forma for a full quarter of operations from FBI Salt Lake City which the Company acquired on September 28, 2017.

On September 11, 2017, the Company physically settled the forward equity sales agreements entered into on March 27, 2017 by issuing 4.945 million shares of the Company's common stock in exchange for approximately $92.7 million in gross proceeds. The forward equity sales agreements were entered into in conjunction with the closing of an underwritten offering on a forward basis and the announcement of the VA - Loma Linda and VA - South Bend acquisitions.

As noted on the second quarter earnings call, the Company recently completed a $175 million private placement of senior unsecured notes and a $127.5 million mortgage financing on the VA - Loma Linda

Outpatient Care facility. These two capital markets activities meaningfully extended the average maturity of the Company's liabilities and shifted its ratio of fixed versus floating rate debt. The Company believes the strength of the execution on both its private placement senior notes and the VA - Loma Linda mortgage speaks to the superiority of the Company's portfolio and the high credit quality of its underlying tenant, the U.S. Government.

Turning to the Company's guidance, for the 12 months ending December 31, 2017, the Company is narrowing its guidance for FFO of $1.26 to $1.29 per share on a fully diluted basis. This guidance assumes acquisitions of $385 million in 2017, including the OSHA - Sandy acquisition completed in the first quarter, the VA - Loma Linda acquisition completed in the second quarter, the FBI - Salt Lake City acquisition completed in the third quarter, as well as the announced VA - South Bend acquisition with an anticipated closing date in the fourth quarter of 2017.

The Company is also introducing its 2018 guidance of FFO per share on a fully diluted basis in a range of $1.31 to $1.35. This 2018 guidance assumes $250 million of acquisitions and between $75 million and $100 million of development-related investments during 2018. The Company's 2017 and 2018 FFO guidance is forward-looking and reflects Management's view of current and future market conditions.

As previously announced last week, our Board of Directors declared a dividend related to our third quarter of operations of $0.26 per share. This dividend will be paid on December 21, 2017 to Shareholders of record on December 6, 2017. This increase in the dividend is consistent with our pattern of growing the dividend by a penny every other quarter since IPO and we expect to continue targeting future dividend growth commensurate with earnings growth.

Finally, before turn the call over to the Operator for questions, allow me to step back and look at how far we have come since this time last year. Since the third quarter of 2016 we have grown our FFO by 7% while extending the duration of our liabilities and maintaining a conservative balance sheet. Our average debt maturity has been extended by over 80% to 8.5 years, beyond our average remaining lease term of 6.9 years. Additionally, one year ago our debt structure was 77% floating and today it's 86% fixed rate. Using the strength of our growing portfolio, we've been active in the capital markets to term out our debt, both through the unsecured private placement market and with the secured mortgage on VA - Loma Linda. We raised equity accretively in connection with the announcement of VA - Loma Linda and VA - South Bend, thus increasing the liquidity of our stock, and we commenced an active ATM offering program.

It's been a great year for the Company and we would like to thank our capital providers for their ongoing partnership. I will now turn the call back to the Operator for questions.

Operator:

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

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

Emmanuel Korchman:

Hey. Good morning, everyone. Bill, maybe this one's for you. Can you talk about what you've seen in terms of yield trends over the last months or quarters? Has there been any tightening or loosening of yields versus where you sort of first came out a couple of years ago?

William C. Trimble:

Good morning, Manny. We have not really seen much in the way of change. We'd expect at some point that that would happen, but it has definitely lagged and we're basically purchasing those sort of bullseye properties at the same rates we've been purchasing for the last several years.

Emmanuel Korchman:

Meghan, I've got a couple for you. One, just your thoughts on longer-term leverage targets, you're over 6 times now; is that something you're comfortable with? For next year's guidance, the $75 million to $100 million of development spending, is that just related to the two projects that you mentioned earlier or is there a new project or two assumed in that?

Meghan Baivier:

Sure. On your first point, Manny, we remain consistent in our comfort level with 40% to 50% leverage triangulating to 6 to 7 times on an operating basis, not moving that target. Then with regard to the development guidance, that $75 million to $100 million, correct, that relates to FDA - Alameda and FDA - Lenexa.

Emmanuel Korchman:

All right. Thank you.

Meghan Baivier:

Thank you.

Operator:

The next question is from Brian Hawthorne with RBC Capital Markets. Please go ahead.

Brian Hawthorne:

Hi. Good morning. Can talk about the GSA build-to-suit market in general and if you're seeing any activity picking up there?

William C. Trimble:

I think that having been in this business for a while—and we saw the huge amount of construction during the 2005 to 2007 timeframe, which obviously slowed down massively—we are beginning to see some of it picking up at this point. I will say that we have won actually every single mandate since we have been public, for projects that would fit within our bullseye. Obviously can't guarantee that will go on forever, but we're beginning to see obviously some new laboratories in the FDA and a few other projects beginning to percolate up. Obviously, we're keenly interested in addressing those needs of the Federal Government.

Brian Hawthorne:

Okay. Then one more; the VA - South Bend acquisition, any reason that was pushed back into 4Q?

William C. Trimble:

Not really. I was out there for the opening, which was a spectacular day in South Bend, Indiana, about three, four weeks ago, I guess. Just going through some punch list items and as soon as those are cleaned up—it's an absolutely gorgeous facility—we will take ownership and look forward to serving the VA for 15 years to come.

Brian Hawthorne:

All right. Thank you for taking my questions.

Operator:

As a reminder, if you have a question, please press star and one on your telephone. Our next question comes from Michael Lewis with SunTrust Robinson Humphrey. Please go ahead.

Michael Lewis:

Thank you. On Alameda, I don't know why I was under the impression that that would be, like, more of a mid-'18 completion. Is that true that that—has that been moved back and has there been any change to the expected yield on that project?

Meghan Baivier:

Michael, good morning. Alameda is now targeted for early 2019, as we said earlier. Obviously, the GSA and the tenet and us are ongoing in just making this facility even more functional for the FDA and its yield is still consistent with that 50 to 75 basis point premium to where we're acquiring.

Michael Lewis:

I see. Thanks. Then in terms of the funding sources for '18, is it safe to assume a mix of equity and debt that's sort of consistent with where you've been running at?

Meghan Baivier:

Yes. I would tie you back to our leverage targets and that 6 to 7 times.

Michael Lewis:

Okay. Then just finally for me—I know I ask this every quarter—but are there any potential move-outs you see down the line? I assume that I could assume your renewal percentage in your 2018 guidance is 100%.

William C. Trimble:

I think that's correct and we continue to—obviously we're negotiating and dealing with the Government on three properties right now and renewed two, which we discussed before, very successfully. The DEA warehouse is 25% up, Social Security facility—but you are correct.

Michael Lewis:

All right. Great. Thank you.

Operator:

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

Jon Petersen:

Great. Yes, just one question. I'm curious with upcoming tax reform if you're seeing any changes in buyer and seller behavior in your market, or maybe and expectations of changes and any opportunities or challenges that might present for you guys?

William C. Trimble:

Yes. I think, actually, of more interest to us—and I've said this in prior calls, which doesn't necessarily seem to make as much sense—but we buy most of our properties off market, in fact, way more than half. As we see a modest increase in interest rates, we believe that we're going to see an even—that we have a very strong $350 million and $700 million over all in our active pipeline—so we're actually going to see an uptick in the opportunities going forward, as a lot of these owners feel that maybe they've reached the point that would make sense to depart with their property.

Meghan, anything you have to say on the tax?

Meghan Baivier:

I think their retention of the 1031 Exchange is also certainly helpful.

Jon Petersen:

Okay. That's all for me. Thank you.

Operator:

There are no further questions at this time. I would like to turn the floor back over to Darrell Crate for closing comments.

Darrell W. Crate:

Great. Thank you, everyone for joining the Easterly Government Properties' Third Quarter Conference Call. We appreciate your interest and your support and we look forward to continuing to build a very high-quality portfolio of leases backed by the full faith and credit of the United States Government in an effort to deliver strong compounding returns to Shareholders.

Operator:

Thank you. This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation.