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Easterly Government Properties

First Quarter 2022 Earnings Conference Call

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CORPORATE PARTICIPANTS

Lindsay Winterhalter, *Vice President, Investor Relations*

Darrell Crate, *Chairman*

William (Bill) Trimble, *Chief Executive Officer, President, and Director*

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

CONFERENCE CALL PARTICIPANTS

Michael Griffin, *Citi*

Michael Carroll, *RBC Capital Markets*

PRESENTATION

Operator

Greetings. Welcome to Easterly Government Properties' First Quarter 2022 Earnings Conference Call.

Please note, this conference is being recorded.

I will now turn the conference over to Lindsay Winterhalter, Vice President, 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 Act Reform of 1995 and is making the 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 in its Annual Report on Form 10-K for the year ended December 31, 2021, which was filed with the SEC on February 28, 2022, and its Quarterly Report on Form 10-Q for the quarter ended March 31, 2022 to be filed with the SEC on May 3, 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 it's potential adverse impacts 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 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 and thank you for joining the call.

As I look at the call attendance list, I see the recent decline in stock price has attracted some equity generalists, in addition to our regular REIT cohort. Welcome.

Given the audience, let me step back for a moment and speak to how we are viewing this period of rate reorientation in the bond market. Obviously, the market is very concerned and uncertain about how the yield curve will change shape over the coming months and how assets will reprice.

What we see today and for the last year is a separation in how our assets are valued by the public market versus the private market. As debt capital becomes more expensive, we believe this disparity will diminish. Our competitors for acquisitions will have less access to cheap leverage, and development competitors who anticipate cap rate compression will no longer participate in the market. We can imagine that this reduction in purchasing power will push up cap rates, and that's a very healthy dynamic we have not seen in years.

We're very pleased with our existing portfolio. While some investors are focused on the flat nature of our leases, which is not an optimal headline in a rising rate environment, I observe the quality of our buildings as strong and enduring. The value of these assets is supported by their replacement cost, as the alternative for the government upon releasing is to build or redevelop an alternative site. As we've all observed, construction costs are accelerating, which translates into elevated NAV for our buildings.

The cash flow from that value growth will be realized upon release. In addition, there's a second dynamic that can improve our releasing results. Replacement cost will further increase as developers who have been pricing new constructions aggressively based upon the assumption that cap rate compression will continue and using cheap debt, those folks will be leaving the market. Both of these dynamics improve the environment for same-store NOI growth over time for our portfolio.

Turning to the balance sheet, while we have been envious of companies with substantial floating rate debt for the last decade, we're pleased that we had locked in our debt costs and the duration of our liabilities is in line with the duration of our leases. These debt obligations provide value for our shareholders. While the transition to a new steady state in the debt markets will be bumpy, we are optimistic that the environment will present a more fertile environment for our defined edge in the government lease space to create value for our shareholders, with substantial cash flow backed by the full faith in credit of the United States Government.

Further, given our audience today, I'll share a brief summary of the progress we have made during the last seven years as a public company. We have scaled our platform, either wholly owned or through joint venture from 29 to 89 properties; maintained the trajectory of external growth through accretive acquisitions in nonspeculative development; strengthened our portfolio through our strict adherence to the bullseye acquisition strategy, while adding significant scale to that platform; fortified our investment grade balance sheet with a highly fixed rate structure with long-dated debt maturities, a recipe viewed favorably by the rating agencies.

We have captured enhanced NOI through our CPI matched lease structure, while in an inflationary environment. We've diversified our tenant base from 12 to 40 U.S. Government agencies, each with enduring missions. We've increased our stable, recurring cash flows in aggregate contractual rent due from the U.S. Government from $360 million to $2.7 billion. All of this has been achieved through the consistent and dependable execution of our core investment thesis. We are real estate without the drama that thrives in many macro conditions.

When faced with inflation, the in-place portfolio is even more attractive at the time of renewal when the alternative is a new build to suit construction. When faced with recession, there is no better tenant to have than the United States Federal Government. When faced with rising rate environments, we're pleased that 96% of our fixed rate structure with long-dated maturities exist. Finally, when faced with global pandemic, as we saw, we're confident in the mission criticality of our buildings and the need for our federal workforce to work from our facilities, versus at home.

In closing, the fundamentals of our business are strong. Our prospects for value creation are excellent. The credit quality of our underlying tenant, with leases backed by the full faith in credit of the U.S. Government remains at the best of any public REIT, with a current dividend yield of roughly 5.5%. We thank you for your continued partnership and engagement as we work to grow this premiere portfolio of real estate assets leased to the United States Federal Government.

With that, I'll turn the call over to Bill to give you insights into the first quarter results.

William Trimble

Thanks, Darrell, and good morning. Thank you for joining us for our first quarter earnings call.

Just after the first quarter, we were pleased to add VA Birmingham through our joint venture, the fifth brand new VA facility of our previously announced 10 building portfolio. This mission critical clinic is approximately 77,000 square feet and provides state of the art care to our veterans through a multitude of important medical functions. Including VA Birmingham, we expect to close on approximately $145 million of this portfolio throughout 2022. In addition, we have seen a strong pipeline of opportunities outside of this joint venture and look forward to announcing additional acquisitions as they take place.

I think it's important to look at the current state of the government lease market, as we have seen the 10-year treasury increase by over 100 basis points since we signed the PSA for the VA portfolio last summer. Until recently, our market has been the beneficiary of increased institutional interest for several important reasons. First, private equity understands the unique inflation hedge GSA lease structure that protects us as landlord from inflation induced operating cost increases and have got more access in the space.

Second, while regular office has been challenged with occupancy and long-term post pandemic space requirements, the U.S. Government is back to work and continues to require build to suit space to conduct their missions in our bullseye corner of the vast 550 million square foot U.S. leased market. The government continued to utilize our facilities throughout the crisis. Work from home really was not an option for the FBI, DEA, CBP, FDA, and others, and the laboratories supporting these critical agencies. President Biden announced the return to office for the rest of the U.S. Government employees at the State of the Union Address several months ago.

On the current market, reflecting recent sales, assets that resemble our portfolio's attributes with eight years or more of lease term remaining, a comparable mission profile, and/or recent renovations or build to suits are generally commanding a 5.25 cap rate. FBI field offices, laboratories, and new outpatient facilities within 15- to 20-year remaining lease terms are inside of that, commanding closer to a 5 cap. We are very pleased that our seasoned global JV partner understood that dynamic almost a year ago and moved forward with us on a portfolio that, based on current market conditions, appears to have already seen a great increase in implied value. We believe that we will see a turn in cap rates at some point, sooner rather than later as the Fed continues to increase rates. We continue to see potential CAD accretive NAV enhancing transactions and will continue to focus on only the best opportunities within our universe.

Turning to leasing updates, our asset management team continues to secure renewals that lengthen the duration of our government backed cash flows and enhance the portfolio NAV. In the first quarter, we renewed two important leases, EPA Kansas City as well as the lease at FBI Birmingham, both for 20 year noncancellable terms. These two renewals with combined 2.7% of our annualized lease income launched what we hope will be another successful renewal year for our seasoned asset management team.

The remaining renewals for 2022 includes a DEA laboratory in Dallas, the FBI field office in Little Rock, and the ICE facility in Louisville, Kentucky. At the quarter end, negotiations on these three leases are underway and we look forward to providing updates in future quarters. Our FDA and land laboratory project is now in the final stages of design drawings, which should lead to a restart in the near term. We estimate this facility will be delivered in the second quarter of 2024.

In closing, we are off to a strong start in the new year with the acquisition of VA Birmingham facility and a strong pipeline of actionable opportunities. As always, you can expect the Easterly team will continue to execute on its disciplined strategy of acquiring the most important assets leased to the Federal Government. We will continue to work with the GSA and underlying tenant agencies on upcoming renewals and look to nonspeculative development opportunities that can provide attractive returns.

We've enjoyed seeing our investors in person once again and look forward to upcoming conferences and investor meetings in the not-so-distant future.

With that, I thank you for your time this morning and I will turn the call over to Meghan to discuss the quarterly financial results and capital markets executions.

Meghan Baivier

Thank you, Bill. Good morning, everyone. It gives me great pleasure to post another strong quarter and commence another strong year here at Easterly.

As of March 31, we own 89 operating properties, comprising 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. Through the acquisition of newer facilities, the weighted average age of our portfolio remains young, at 13.9 years. Successful long-term renewals at existing properties have also allowed us to grow our weighted average remaining lease term to an historic high of 9.8 years. This represents a year-over-year lengthening of our weighted average remaining lease term of 1.2 years.

Maintaining a young portfolio age and a long-weighted average remaining lease term is reflective of our strategy of owning relatively new, build to suit assets with enduring missions. This strategy provides us with distinctive future cash flow visibility, which in turn allows us to prudently manage the Company's balance sheet and support our highly accretive acquisition and development project pipeline.

Turning to our first quarter results, 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 $0.31. Our cash available for distribution was $28.8 million.

Turning to the balance sheet, at quarter end the Company had total indebtedness of approximately $1.2 billion with approximately $415 million available on our line of credit for future acquisitions and development related expenses. As of March 31, Easterly's net debt to total enterprise value is 35.9%, and its adjusted net debt to annualized quarterly EBITDA ratio was 6.7 times. With a weighted average debt maturity of 6.5 years, a weighted average interest rate of 3.5%, and 96% of all outstanding debt fixed at attractive levels, I am particularly pleased with our Company's positioning as we enter a rising rate environment.

During the first quarter, Easterly issued approximately 435,000 shares of the Company's common stock, sold on a forward basis at an average net price to the Company of $21.63 per share. With the settlement of these shares in the first quarter, Easterly received approximately $9.4 million in net proceeds.

At present, Easterly expects to receive net proceeds of approximately $92.5 million from the sale of an aggregate of approximately 4.3 million shares of the Company's common stock that have not yet been settled, including the remaining 2.3 million shares pursuant to the Company's third quarter 2021 underwritten public offering and 1.95 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 $21.72 per share.

As Darrell and Bill mentioned, an inflationary environment serves as a real strategic benefit for Easterly, compared to other REITs. Due to the build to suit nature of our assets, the cost of constructing another facility upon lease expiration is increasingly less desirable for the government and our existing asset is further distinguished as a natural, cost-effective renewal option for the GSA and the underlying tenant agency.

Further, the unique nature of our leases allows for operating expense protection; while shell rent (phon) in most of our leases is flat, GSA leases generally contain an operating expense space which grows untapped with increases in our urban CPI. Thus, protecting us against NOI degradation in an inflationary environment. To be clear, the relevant urban CPI index, as of March 31, 2022, was 9.4% higher than one year ago.

Turning to our earnings guidance, the Company is maintaining its FFO guidance per share on a fully diluted basis in the range of $1.34 to $1.36. 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.

Finally, subsequent to quarter end, our Board approved an inaugural stock repurchase plan of up to 5% of the Company's outstanding shares, or approximately 4.5 million shares in total. This new tool in our capital markets toolkit will ensure we remain aligned with our consistent commitment to allocating capital in a way that drives the greatest value for shareholders.

With that, we thank you for your commitment to our thesis and appreciate your partnership. I will now turn the call back to Sherry.

Operator

Thank you.

Our first question is from Manny Korchman with Citi. Please proceed.

Michael Griffin

Hi, this is Michael Griffin on for Manny.

I'm curious. I know you mentioned the share buyback program. Kind of how are you balancing capital for acquisitions versus the buyback program sort of going forward in the near term?

Meghan Baivier

Sure. I think it's a fantastic tool, as we sit here looking at the stock today, to be responsive to what the remainder of 2022 brings, be it an opportunity to recycle capital, or to continue to address the strength of our balance sheet. It's going to allow us the flexibility we need in the coming year.

Michael Griffin

Great. On those future acquisitions that you mentioned, do you see them as more attractive in a wholly owned, versus in any future joint ventures?

William Trimble

Well, I think that it certainly depends on the particular asset. We've mentioned before that there's a bit of a tale of two cities. While all of the assets have certainly increased in value rather remarkably over the last 12 to 18 months, we're seeing a real premium put on those longer-term assets, those 15- to 20-year. Think brand new outpatient clinic. Think FBI where I think we're seeing a lot of international interest.

We're seeing a lot of private equity interest, and this pricing, our pricing in a 25, 50 basis points instead of the other side, which would be a wonderful opportunity for our JV to have a very long-term perspective on the value of these assets. On the other side of the equation, and we see interest there as well, but those will probably be bought individually by us. They don't really conflict with each other, which is certainly very healthy.

Michael Griffin

Got you. That's great. I appreciate the color. Thanks for the time.

Operator

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

Michael Carroll

Yes, thanks. I wonder if you can provide some color on overall private market valuations. I know, I think Darrell said in his prepared remarks that you expect cap rates to trend higher, but then you also said that your private market valuations or NAV for your portfolio has increased fairly meaningfully over the past 12 to 18 months. I mean, how do we coordinate between those two? Are cap rates going higher, or are they going lower, or how should we think about that?

William Trimble

Let me start, and maybe Darrell can follow. I think, you know, you're in a transition moment, so several things are happening at once. There is a huge demand, certainly for all of our assets in the bullseye category. They are the occupied office asset. They're understood.

I think we've done a great job explaining it to the world over the last seven years of being public, and they continue to draw a lot of attention. But at the same time, we've seen the industrial world and other areas you're very familiar with, Mike, are beginning to make the turn as they reflect the change and try to fight the Fed, which in the long term I think is never a successful endeavor.

We're seeing both things happening at the same time, but you can be assured from our standpoint that we are going to be careful. We're very focused on being NAV accretive here at Easterly and in making sure we have the finest assets. We're looking at all sorts of different options in this particular market, and not going to go out there and get crazy, but continue to try to do the best for our shareholders.

Darrell Crate

We don't have a crystal ball, but one of the things that we know is true is so much capital has just flooded into real estate broadly. High quality assets and lesser sort of uniform, you know, lower scale assets or assets that are a little different… the cap rate compression among all of those just got tighter and tighter and tighter. As we look forward, I think there's a couple things that we see. There will be dispersion of GSA leases among agency, among size, and I think that's more opportunity for us to find value.

Michael Carroll

I think you probably quantify, where are the cap rates today for the types of assets in the bullseye that you're looking at and have they started to move higher yet? I mean, have you seen that when you're bidding on deals?

William Trimble

No, I think we're 5.25 and I think our entire portfolio would probably trade under that right now, just to give you an idea. It's an interesting time.

Michael Carroll

Okay, great. Then with the stock repurchase program, how aggressive, I mean, can you be pursuing that? Are you willing to increase leverage to pursue some of your buybacks? I guess, how should we think about that?

Meghan Baivier

Sure, so I think the tool, like I said, is meant to be responsive to multiple potential paths that we could take, be it returning the balance sheet in line post some recycling capital, or in turn as we recycle capital.

But you're right, Mike. At 6.7 times the turn of leverage I don't think would—we've never believed we disrupt the ability of this cash flow to perform, and obviously a turn is….

Darrell Crate

As you know, we think the rating agencies and others would view that as a solid investment grade balance sheet. So, I think we have a lot of flexibility.

Michael Carroll

Then would you pursue some asset sales? I know you kind of talked a little bit about capital recycling. Is that the plan is kind of being more aggressive, pursuing asset sales and then using those proceeds to buy back stock? Is that how we should think about it?

William Trimble

I think that's a great question and I think that's another tool in our toolkit. Obviously, I think we see a lot of folks that understand the value of all of our assets, and we're constantly looking at all of them. We do love our children, but there's different buildings we have in the portfolio. We're always trying to drive to our particular bullseye, and we have stayed very constant on that. We have a number of buildings we purchased a bunch of years ago that have been an incredible return to our investors to this point and we have got a geographic footprint all over the country, and maybe there's some spots that are more difficult for us to service than others. Everything is on the table, and you can expect us to do whatever we do very prudently and best thing for shareholders.

Michael Carroll

Okay, great. Thank you.

William Trimble

Thank you.

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 First Quarter 2022 Conference Call. We appreciate your time and we'll continue to work hard to deliver strong, risk adjusted returns for our shareholders for the 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.