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Easterly Government Properties, Inc.

Fourth Quarter 2016 Earnings Conference Call

March 2, 2017

CORPORATE PARTICIPANTS

Lindsay Winterhalter, *Vice President, Investor Relations and Operations*

Darrell Crate, *Chairman of the Board of Directors*

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

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

CONFERENCE CALL PARTICIPANTS

Manny Korchman, *CitiGroup*

Brian Hawthorne, *RBC Capital Markets*

Patrice Chen, *Jefferies*

PRESENTATION

Operator:

Greetings and welcome to Easterly Government Properties Fourth Quarter 2016 Earnings Conference 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. As a reminder, this conference is being recorded.

I would now like to turn the conference over to Ms Lindsay Winterhalter, Vice President, Investor Relations for Easterly. Thank you, Ms Winterhalter. You may now 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-ended December 31, 2016 and 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 operations 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 the Board of Easterly Government Properties.

Darrell W. Crate:

Thanks, Lindsay. Good morning, everyone. Welcome and thank you for joining us for our fourth quarter 2016 earnings call. Today, in addition to Lindsay, I am joined by Bill Trimble, our CEO and Meghan Baivier, our CFO and COO.

While we began building this portfolio in 2010, this call marks our second year anniversary as a public company. I would like to thank our investors, many of whom have been with us since the IPO, for their support and confidence. I would also like to thank our board of directors who have given us sound guidance and are always focused on building long term value for shareholders, and the people of Easterly Government Properties. Bill Trimble has built an organization with dedicated, skilled professionals in all the key areas required for our success: Acquisition, Government Relations, Asset Management, Finance and capital formation.

Easterly Government Properties remains the only internally managed public REIT focused on owning properties that are leased solely to the United States federal government. Our growing portfolio is sourced largely off-market and is comprised of young, Class A commercial properties. These properties are the result of a build-to-suit design process and are specifically tailored to meet the unique needs of the various tenant agencies in the U.S. Federal Government. Our non-cancelable leases are backed by the full faith and credit of the U.S. Government, are not subject to annual appropriations, and therefore provide an extremely stable platform for strong, recurring cash flow year over year.

We derive additional growth from accretive acquisitions and development. In the 4th quarter of 2016 we did just that. Bill will go into greater details on these strong additions to the portfolio later in the call, but to summarize, we closed on an FBI field office in Albany, New York and a Federal Bankruptcy Courthouse in South Bend, Indiana. Our pipeline continues to season as well as we've become known for our way of operating with intent and certainty with sellers. We are also pleased with the development arm of the business as progress continues on our FDA - Alameda laboratory project. Again, U.S. Government build-to-suit development projects are great opportunities for the Company to achieve premium risk adjusted returns while also being an outstanding partner to the US government.

As Easterly's Chairman, I am most proud of our people. The team continues to demonstrate its definable edge in the sourcing, underwriting and servicing of mission critical federal government buildings, as evidenced by our attractive and stable portfolio of young, fully leased Class A build-to-suit buildings located across the country. We expect to continue executing on our proven strategy by maintaining prudent balance sheet leverage, deploying capital accretively, and continuing to focus on delivering the benefits of scale in our G&A line item to shareholders. Easterly has targeted $150 million to $200 million of acquisitions as an acquisition goal for 2017 and you can fully expect to see this target achieved through the addition of properties that both add strength and stability to our portfolio. For shareholders, through dividends and accretive acquisitions, we believe we can responsibly target returns that rival the Russell 2000 for investors on a compounding basis. Our goal is to deliver a consistent and growing double-digit return to investors built upon a stable base of cash flows generated by the full faith and credit of the United Stated federal government.

We want to be the REIT security of choice for investors looking for stability, consistency and superior cash flow growth over the long term. With that, I'll turn the call over to Bill to provide additional information on developments within Easterly that drive Shareholder return.

William C. Trimble:

Thanks Darrell, and thanks everyone for joining us this morning. First, I would like to discuss the properties we acquired over the course of the fourth quarter. I am very pleased to report the acquisition of the fourth and final property we had previously announced as part of Easterly's first portfolio acquisition since the IPO. This property, an FBI Field Office in Albany, New York, serves an incredibly important mission for the U.S. Federal Government. This field office is one of 56 field offices throughout the entire country, and we are delighted Easterly now owns 6 of these facilities. These field offices serve as central hubs throughout the United States and help keep Americans safe from threats, both foreign and domestic. We also acquired a Federal Bankruptcy Courthouse located in South Bend, Indiana in the fourth quarter of 2016. This courthouse serves the Northern District of Indiana and is responsible for handling bankruptcy cases throughout 11 counties. Courts such as these act as specialists within the U.S. district courts and have subject matter jurisdiction over all bankruptcy cases throughout the United States. Both of these buildings meet Easterly's target criteria of owning Class A build-to-suit properties with enduring missions that are critical to the lawful operation of our country.

Turning to development, we are pleased with the strong progress being made at the previously announced FDA laboratory in Alameda, California. Easterly has been working hand-in-hand with the General Services Administration and the U.S. Food and Drug Administration through the design process and we continue to expect this approximately 66,000 square feet building to be completed and delivered by mid-2018.

I would like to reiterate that when we engage in federal development opportunities, there is already a signed lease in place that typically guarantees an initial lease term of at least 15 - 20 years. Easterly does not engage in speculative development. Further, we enter into design-build contracts with experienced general contractors so as to insulate ourselves from any risk of cost overruns. These risk-mitigating factors, coupled with the opportunity for premium returns, make the opportunities for federal government development quite appealing.

Development remains an attractive source of growth for Easterly. One major opportunity where we expect to see the strong potential for build-to-suit development and acquisition activity is with the Department of Veterans Affairs, or the VA. The VA is the 2nd largest department in terms of total appropriations and staffing, employing nearly 350,000 people, which in turn provides vital services to the approximately 22 million U.S. military veterans living today. In order to provide health coverage for these 22 million deserving veterans, the VA has over 1,700 health care sites, which include both hospitals and outpatient clinics. In recent years, the VA has begun to undertake a transformation in their health care facilities that serve these veterans. Rather than providing health care to veterans in hospital-centered, inpatient care facilities, the VA has taken on a roughly estimated $63 billion project to provide new, state-of-the-art outpatient care facilities located throughout the country. These facilities are typically located near major hospital centers and offer a wide range of outpatient services, ranging from primary care, specialized care, mental health care, and related medical and social support services for veterans in need. There is now greater reliance on the private sector to develop and own VA facilities on behalf of the U.S. Government. Leases on these new facilities are very attractive: they are typically 15 - 20 years in initial length, backed by the full faith and credit of the U.S. Government, and can even offer greater flexibility in the lease terms than we typically see in our GSA leases. Examples of this include greater cost reimbursements and periodic bumps in rent over the term of the lease. Easterly has been a strong partner with the GSA and we're looking forward to the opportunity to expand that relationship to the VA. Overall, VA outpatient facilities are a very exciting prospect for Easterly to expand our bullseye of strategic opportunities and you can fully expect the Easterly team to diligently pursue these types of accretive acquisition and development projects.

The acquisition team continues to seek real estate opportunities that will provide earnings growth to our shareholders, while also maintaining strict adherence to the set of values we hold ourselves to when sourcing and underwriting buildings. We pride ourselves on our high standards and we will only acquire buildings that we believe will maintain or elevate that standard. I am pleased to report that the acquisition pipeline remains robust as we review single-facilities, as well as multi-facility portfolios, as a means of future growth. To reiterate our stated building requirements, we will look for properties that are leased to a single tenant of the U.S. federal government, are build-to-suit and mission-critical for that current tenant, and are usually over 40,000 square feet in size. Because the missions being performed in our facilities are so inherently critical to the overall safety, well being and strength of our country, we believe there is an understanding across party lines that the missions are enduring. For example, the FBI, having doubled in size since 9/11, has expanded its mission to include cyber terrorism, counter terrorism, all in addition to its primary focus to investigate federal crimes. We do not see their scope of mission decreasing. As a reminder, these buildings renew on average 94% of the time, and we will continue to focus our acquisition and development efforts on these mission critical properties located in the center of our bullseye.

Our acquisition activities are an important component of our earnings growth strategy. Delivering properties that both elevate the portfolio while also providing immediate accretion to earnings is our mission. To give you some visibility to the depth and discipline of this effort, we are defined by the attractive deals we do, but we are also defined by the deals we don't do. In the fourth quarter we passed on $100 million of opportunities of seemingly reasonable candidates for acquisition, however, upon further review, those opportunities fell short of our stated acquisition criteria. As we have matured as a company in experience and resources, I am pleased with the opportunity the acquisition growth initiative will deliver to shareholders over time.

Turning to our existing portfolio, our Asset Management team currently has 15 active projects to improve the everyday performance and functionality of our properties for our government tenants. An example of such a project can be found at the FBI field office in Richmond, Virginia, which is currently working with our Asset Management team to build a brand new Emergency Operations Center, located within our building. This Center, once complete, will allow multiple law enforcement agencies to collaborate in a highly technical 24/7 facility, which will provide around the clock emergency preparedness in response to high profile incidents that require the partnership and support from various arms of the law enforcement community. A facility of this type is extremely important to the mission of the FBI and directly contributes to the overall safety and wellbeing of the American people. Not only does a project like this create tremendous value for our shareholders by ensuring continued tenant satisfaction, mission support and strong relationships for years and decades to come, but as a Company, we feel extremely gratified that we are in a position to help deliver a project that will ultimately contribute to the increased security and wellbeing of our country.

With that, I'll now turn it over to Meghan for discussion of the quarterly and annual results as well as our 2017 earnings guidance.

Meghan Baivier:

Thank you, Bill. Today, I will touch upon our current portfolio, discuss our fourth quarter and full-year 2016 results, provide an update on our balance sheet, and review our 2017 guidance. Additional details regarding our fourth quarter and full-year 2016 results can be found in the Company's fourth quarter earnings release and supplemental information package, which is on the Easterly website at ir.easterlyreit.com.

As of December 31st we owned 43 operating properties, comprising nearly 3.1 million square feet of commercial real estate. The weighted average lease term for the portfolio was 5.9 years, the average age of our portfolio was 12.7 years, and our portfolio occupancy remained at 100%. In addition, 97% of our annualized lease income was backed by the full faith and credit of the United States Government.

For the fourth quarter, FFO per share on a fully diluted basis was $0.31, up 19% year-over-year. FFO as adjusted per share on a fully diluted basis was $0.30 and our cash available for distribution was $11.7 million.

For the full year, FFO per share on a fully diluted basis was $1.21, up 16.5% year-over-year. FFO as adjusted per share on a fully diluted basis was $1.17 and our cash available for distribution was $43.7 million. Descriptions of these non-GAAP measures and reconciliations to GAAP measures have been provided in our supplemental information package.

Turning to the balance sheet, at year end, we had total debt of $292.5 million and leverage was 23.8% in terms of net debt to total enterprise value or 4.5x annualized fourth quarter EBITDA. Despite material acquisition growth in 2016, our leverage, as measured by net debt to total enterprise value, compared favorably to a year ago. We continue to be capitalized well to pursue our stated acquisition goals.

Recall, that at the end of the third quarter, the Company entered into a $100 million 7-year unsecured term loan facility with a 180-day delay-draw period. Early in the fourth quarter we subsequently entered into forward-starting interest rate swaps to effectively fix the interest rate on future draw downs under the term loan facility at a rate of 3.12% annually, based on the company's current leverage ratio. As of December 31, 2016, on a pro forma basis, fully drawing the term loan and using all of the proceeds to repay a portion of the borrowings on the Company's revolving credit facility, the Company's weighted average debt maturity would be 6 years, in line with its weighted average remaining lease term, and the Company's percentage of fixed rate debt would be 56%. Additionally, the Company would have $288 million of availability on its $400 million revolving line of credit. This is ample capacity for the Company to exceed its accretive acquisition program for 2017 and support the following guidance.

For the 12 months ending December 31, 2017, the Company is establishing guidance for FFO per share on a fully diluted basis of $1.24 to $1.28 per share. This guidance assumes our previously stated range of $150 million to $200 million of acquisitions in 2017, including the recently announced OSHA - Sandy acquisition, and does not contemplate any dispositions. And not to leave out the obvious, we remain confident in our team's ability to renew the portfolio of leases which roll in 2017. Our Asset management and government teams are continually focused on ensuring that we remain a partner of choice to the U.S. Government as we manage the properties we own and performing diligence on newly-acquired properties to ensure they're part of the enduring mission of the U.S. Federal Government.

Finally, as previously announced this week, our Board of Directors declared a dividend related to our fourth quarter of operations of $0.24 per share. This dividend will be paid on March 22nd to Shareholders of record on March 7th.

I'll now turn the call back to the Operator for questions.

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 is from Manny Korchman of Citi. Please go ahead.

Manny Korchman:

Hey, good morning everyone. Bill, going back to your comment on you being defined on what you didn't buy, can you just give us an idea of why you didn't buy the assets you mentioned? You said that they fell short, but could you be more specific as to what that sort of implies?

William Trimble:

Sure, Manny, and I want to be careful, but I think, you know, in one case, we did not see a second renewal for the building. We not only are looking towards the next renewal of the property, but as you know, our buildings are basically 12 years old, our competitors are sort of north of 24 to 25 years old—but we like to see two lease rolls, at least, going into the future before we're going to feel confident to buy that property.

Manny Korchman:

Got it. Then maybe sticking to a similar sort of question, have you seen any changes in seller trends, especially since the election? Are people trying to get out of properties faster? Are people trying to hold onto them longer? Do they see sort of better renewal prospects? Just how are sellers feeling in this market right now?

William Trimble:

That's a great question. As you know, we really do stay in touch with them, and that's a big part of my job day in and day out, and I would say that I think sellers, we're seeing—well, one of the reasons we sort of gave higher guidance for the size of our pipeline that we were going to act on this year is because we're seeing more opportunities from sellers. I don't think that necessarily has to do much with the recent election, as with the fact that I think that they feel that can realize some terrific value here, and interestingly, they're also seeing, with the uptick in interest rates, a lot of the prepayment on some of their long-term debt is more attractive at this point to pay down, so we're actually seeing an expansion in our pipeline.

Manny Korchman:

Great. That was it for me. Thank you.

Operator:

Thank you. The next question is from Michael Carroll with RBC Capital Markets. Please go ahead.

Brian Hawthorne:

Hi. This is Brian Hawthorne filling in for Michael. My first question is about the expirations. It looks like your expirations are ticking up over the next year or two. Can you talk—are you in discussions with them for renewals and can you kind of talk about the cash lease spreads we could expect?

William Trimble:

I'll start off with saying that we are obviously actively involved. While not a large portion of our portfolio, we feel extremely confident in the renewal of every single one of those leases in '17 and '18, and we're actively working on a number of them right now. Obviously, depending on the particular building and the mission criticality, the build-to-suit features and the length of the initial lease term, that will have an effect on the lease renewal spread, but I think we're feeling very confident across the board.

Brian Hawthorne:
Sure, okay. Then just kind of with the new administration, is that going to affect how you guys think about deploying capital at all?

William Trimble:

I think that—when we started this firm, in a private world back in 2009, we were very focused on buying buildings, whether there was a Republican or a Democrat in office, that these were mission-critical facilities that, I think we'd all agree, both parties, that they have a long-term mission within the federal government. So, I guess I'm very glad that we did that tact at that point and over 62% of our properties right now are leased to what we call gun-toting agencies and the federal courts. I think we're going to see an expansion probably of some of the projects in our immigration and customs enforcement, customs and border patrol, and US federal courts on the border. I could go on and on but I think from our standpoint we're beginning to see a nice tailwind in some of those opportunities.

Brian Hawthorne:

Yes, sure. Okay, that's it for me. Thank you.

Operator:

Thank you. The next question is from Patrice Chen of Jefferies. Please go ahead.

Patrice Chen:

Hi guys. Just a couple for me. I noticed that your 2017 guidance includes no dispositions. Would you say are there any properties that are in the current portfolio that you might identify as likely to sell?

Megan Baivier:

Patrice, as you know, our long-term goals are obviously to build a portfolio that is 100% focused on the US federal government, so the triple-net private lease tenant properties, while there's nothing to disclose, are always potential opportunities for ways to recycle capital.

Patrice Chen:

Got it, okay. Have you seen any change in demand for GSA-leased properties which might be driving cap rates up or down?

William Trimble:

I think that certainly since we've been in the market and defined an institutional asset class, there are more people aware of the properties today than there were certainly in 2009 and '10, but having said that, in the market that we're in, the middle market, we're not seeing a great increase in competition either from public or private players.

Patrice Chen:

Okay, great, thanks, that's helpful. That's it for me. Thanks.

Operator:

Thank you. The next question is from Manny Korchman of Citi. Please go ahead.

Manny Korchman:

Just a follow-up from me. In terms of the guidance, does the acquisition number also include developments, or is that a straight acquisition number?

Meghan Baivier:

That's a straight acquisition number, Manny.

Manny Korchman:

Are you not assuming any developments, or you're just not talking about them at the time?

Meghan Baivier:

No. So, we've announced FDA Alameda, and that project, as we said, is expected to deliver in 2018, so construction will be underway throughout the back half of this year and the beginning of next year, and that is taken into consideration.

Manny Korchman:

Got it.

Darrell Crate:

I would say, Manny, today, more than ever, we feel like the development opportunity is a robust opportunity for growth for our business, as these agencies continue to readjust missions. As we've spoken over the last eight to nine years, we have not seen significant development projects coming out of the US government. You can see renewed focus on the Veterans Administration and some of these other gun-toting agencies. There will be needs for additional housing to support mission and we think we're—we are always positioning ourselves to be the partner of choice to the United States government in helping them satisfy those missions.

Manny Korchman:

Okay. In terms of the VA discussion, both earlier and you just brought it up again, is there something that has changed from your perspective and now you're more open to doing those deals, or is it a strictly a matter of the government now being focused and providing more opportunity in that space?

William Trimble:

Well, I think one thing, Manny, that's interesting is that the GAO reported in 2015 that the federal new-construct VA projects—so these are the ones that they did themselves—were seeing cost overruns from 66% to 427% and delays of 18 to 86 months, and I think what you're seeing there is a realization, like they had in the GSA sector, that the private sector is the most cost-efficient, most effective and preferred way to house these particular missions. The VA, which is now I think under terrific leadership, has bipartisan support, has now really figured out—they understand what they need and how they're going to serve the veterans going forward, and it's really the focus on the outpatient side of things. So, I think the answer yes, it is a department that has I think gotten its act together, it understands what its mission is, and I would say that the same message would have been in the Obama administration as the Trump. In fact, they have the same person running the Veterans today. So, I think there is more opportunity going forward.

Darrell Crate:

Just to be clear, Manny, moving VA into our bull's-eye is what we're communicating, and we stand ready to be a good partner to the US government as they continue to improve the service to America's veterans.

Manny Korchman:

Great. Thanks everyone.

Operator:

Thank you. As a reminder, ladies and gentlemen, it is star, one if you would like to ask a question.

We have no further questions in queue at this time. I would like to turn the conference back over to Management for closing remarks.

Darrell Crate:

Great. Thank you everyone for joining Easterly Government Properties today on our 2016 earnings call. We look forward to 2017, and delivering strong results for the coming year and years to come.

Operator:

Thank you. Ladies and gentlemen, this does conclude today's teleconference. You may disconnect your lines at this time and thank you for your participation.