Easterly Government Properties, Inc.
Form 10-Q
November 05, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2018

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from To

Commission file number 001-36834

EASTERLY GOVERNMENT PROPERTIES, INC.

(Exact Name of Registrant as Specified in Its Charter)

Maryland (State of Incorporation)	47-2047728 (IRS Employer Identification No.)
2101 L Street NW, Suite 650, Washington, D.C. (Address of Principal Executive Offices)	20037 (Zip Code)

(202) 595-9500

(Registrant’s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company” and “emerging growth company” in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer	Accelerated Filer
Non-Accelerated Filer	Smaller Reporting Company
Emerging growth company	

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes No

As of October 31, 2018, the registrant had 60,818,841 shares of common stock, par value $0.01 per share, outstanding.

INDEX TO FINANCIAL STATEMENTS

Easterly Government Properties, Inc.

Consolidated Balance Sheets (unaudited)

(Amounts in thousands, except share amounts)

	September 30, 2018	December 31, 2017
Assets		
Real estate properties, net	$ 1,546,600	$ 1,230,162
Cash and cash equivalents	6,922	12,682
Restricted cash	4,388	3,519
Deposits on acquisitions	7,225	750
Rents receivable	17,394	12,751
Accounts receivable	9,186	9,347
Deferred financing, net	2,636	945
Intangible assets, net	167,044	143,063
Interest rate swaps	6,958	4,031
Prepaid expenses and other assets	10,158	8,088
Total assets	$ 1,778,511	$ 1,425,338
Liabilities		
Revolving credit facility	33,000	99,750
Term loan facilities, net	248,413	99,202
Notes payable, net	173,752	173,692
Mortgage notes payable, net	210,388	203,250
Intangible liabilities, net	33,038	38,569
Accounts payable and accrued liabilities	38,618	19,786
Total liabilities	737,209	634,249
Equity		
Common stock, par value $0.01, 200,000,000 shares authorized, 60,818,841 and 44,787,040 shares issued and outstanding at September 30, 2018 and December 31, 2017, respectively	608	448
Additional paid-in capital	1,015,603	740,546
Retained earnings	12,241	7,127
Cumulative dividends	(123,282)	(83,718)
Accumulated other comprehensive income	6,089	3,403
Total stockholders' equity	911,259	667,806
Non-controlling interest in Operating Partnership	130,043	123,283
Total equity	1,041,302	791,089
Total liabilities and equity	$ 1,778,511	$ 1,425,338

The accompanying notes are an integral part of these consolidated financial statements.

Easterly Government Properties, Inc.

Consolidated Statements of Operations (unaudited)

(Amounts in thousands, except share and per share amounts)

	For the three months ended September 30,		For the nine months ended September 30,	
	2018	2017	2018	2017
Revenues				
Rental income	$35,219	$30,079	$99,967	$83,600
Tenant reimbursements	4,086	3,554	11,658	10,156
Other income	132	225	758	592
Total revenues	39,437	33,858	112,383	94,348
Operating expenses				
Property operating	7,780	6,718	21,563	18,904
Real estate taxes	4,228	3,452	11,773	9,166
Depreciation and amortization	16,109	13,950	45,331	40,091
Acquisition costs	300	206	1,023	1,194
Corporate general and administrative	3,614	2,920	10,696	9,506
Total expenses	32,031	27,246	90,386	78,861
Operating income	7,406	6,612	21,997	15,487
Other expenses				
Interest expense, net	(4,924)	(5,495)	(15,981)	(11,626)
Net income	2,482	1,117	6,016	3,861
Non-controlling interest in Operating Partnership	(327)	(175)	(902)	(700)
Net income available to Easterly Government Properties, Inc.	$2,155	$942	$5,114	$3,161
Net income available to Easterly Government Properties, Inc. per share:				
Basic	$0.03	$0.02	$0.08	$0.08
Diluted	$0.03	$0.02	$0.08	$0.08
Weighted-average common shares outstanding				
Basic	60,446,199	39,962,471	51,051,388	38,098,805
Diluted	61,978,998	41,903,977	52,600,858	40,012,282
Dividends declared per common share	$0.26	$0.25	$0.78	$0.74

The accompanying notes are an integral part of these consolidated financial statements.

Easterly Government Properties, Inc.

Consolidated Statements of Comprehensive Income (unaudited)

(Amounts in thousands)

	For the three months ended September 30,		For the nine months ended September 30,	
	2018	2017	2018	2017
Net income	$2,482	$1,117	$6,016	$3,861
Other comprehensive income:				
Unrealized gain (loss) on interest rate swaps, net	406	(111)	2,927	(697)
Other comprehensive income (loss)	406	(111)	2,927	(697)
Comprehensive income	2,888	1,006	8,943	3,164
Non-controlling interest in Operating Partnership	(327)	(175)	(902)	(700)
Other comprehensive income attributable to non-controlling interest	(9)	77	(241)	286
Comprehensive income attributable to Easterly Government Properties, Inc.	$2,552	$908	$7,800	$2,750

The accompanying notes are an integral part of these consolidated financial statements.

Easterly Government Properties, Inc.

Consolidated Statements of Cash Flows (unaudited)

(Amounts in thousands)

	For the nine months ended September 30,	
	2018	2017
Cash flows from operating activities		
Net income	$6,016	$3,861
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	45,331	40,091
Straight line rent	(4,253)	(1,376)
Amortization of above- / below-market leases	(6,737)	(6,283)
Amortization of unearned revenue	(127)	(82)
Amortization of loan premium / discount	(62)	(64)
Amortization of deferred financing costs	938	848
Non-cash compensation	2,307	2,215
Net change in:		
Rents receivable	(404)	265
Accounts receivable	161	(1,709)
Prepaid expenses and other assets	(1,890)	(1,632)
Accounts payable and accrued liabilities	7,815	6,690
Net cash provided by operating activities	49,095	42,824
Cash flows from investing activities		
Real estate acquisitions and deposits	(327,653)	(342,566)
Additions to operating properties	(4,064)	(2,221)
Additions to development properties	(38,891)	(5,560)
Net cash used in investing activities	(370,608)	(350,347)
Cash flows from financing activities		
Payment of deferred financing costs	(3,208)	(3,398)
Issuance of common shares	297,805	107,190
Credit facility draws	57,500	108,000
Credit facility repayments	(124,250)	(260,917)
Term loan draws	150,000	100,000
Issuance of notes payable	—	175,000
Issuance of mortgage notes payable	—	127,500
Repayments of mortgage notes payable	(2,363)	(2,221)
Dividends and distributions paid	(47,541)	(35,483)
Payment of offering costs	(11,321)	(4,222)
Net cash provided by financing activities	316,622	311,449
Net increase in Cash and cash equivalents and Restricted cash	(4,891)	3,926
Cash and cash equivalents and Restricted cash, beginning of period	16,201	6,491
Cash and cash equivalents and Restricted cash, end of period	$11,310	$10,417

The accompanying notes are an integral part of these consolidated financial statements.

4

Easterly Government Properties, Inc.

Consolidated Statements of Cash Flows (unaudited)

(Amounts in thousands)

Supplemental disclosure of cash flow information is as follows:

	For the nine months ended September 30, 2018	2017
Cash paid for interest, net of capitalized interest	$13,017	$8,236
Supplemental disclosure of non-cash information		
Additions to operating properties accrued, not paid	$584	$819
Additions to development properties accrued, not paid	14,061	719
Financing costs accrued, not paid	1	—
Offering costs accrued, not paid	8	27
Deferred asset acquisition costs accrued, not paid	86	—
Unrealized gain (loss) on interest rate swaps, net	2,927	(697)
Debt assumed on acquisition of operating property	9,414	—
Exchange of Common Units for Shares of Common Stock		
Non-controlling interest in Operating Partnership	$(9,846)	$(20,401)
Common stock	6	14
Additional paid-in capital	9,840	20,387
Total	$—	$—

The accompanying notes are an integral part of these consolidated financial statements.

Easterly Government Properties, Inc.

Notes to the Consolidated Financial Statements (unaudited)

1. Organization and Basis of Presentation

The information contained in the following notes to the consolidated financial statements is condensed from that which would appear in the annual consolidated financial statements; accordingly, the consolidated financial statements included herein should be reviewed in conjunction with the consolidated financial statements for the fiscal year ended December 31, 2017, and related notes thereto, included in the Annual Report on Form 10-K of Easterly Government Properties, Inc. (the "Company") for the year ended December 31, 2017 filed with the U.S. Securities and Exchange Commission (the "SEC") on March 1, 2018.

The Company is a Maryland corporation that has elected to be taxed as a real estate investment trust ("REIT") under the Internal Revenue Code, as amended (the "Code") commencing with its taxable year ended December 31, 2015. The operations of the Company are carried on primarily through Easterly Government Properties LP (the "Operating Partnership") and the wholly owned subsidiaries of the Operating Partnership. As used herein, the "Company," "we," "us," or "our" refer to Easterly Government Properties, Inc. and its consolidated subsidiaries and partnerships, including the Operating Partnership, except where context otherwise requires.

We are an internally managed REIT, focused primarily on the acquisition, development, and management of Class A commercial properties that are leased to U.S. Government agencies that serve essential functions. We generate substantially all of our revenue by leasing our properties to such agencies, either directly or through the U.S. General Services Administration ("GSA"). Our objective is to generate attractive risk-adjusted returns for our stockholders over the long term through dividends and capital appreciation.

As of September 30, 2018, we wholly owned 56 operating properties in the United States, including 54 operating properties that were leased primarily to U.S. Government tenant agencies and two operating properties that were entirely leased to private tenants, encompassing approximately 4.8 million square feet in the aggregate. In addition, we wholly owned three properties under development that we expect will encompass approximately 0.3 million square feet upon completion. We focus on acquiring, developing, and managing U.S. Government leased properties that are essential to supporting the mission of the tenant agency and strive to be a partner of choice for the U.S. Government, working with the tenant agency to meet its needs and objectives.

The Operating Partnership holds substantially all of our assets and conducts substantially all of our business. The Company is the sole general partner of the Operating Partnership. The Company owned approximately 87.5% of the aggregate limited partnership interests in the Operating Partnership ("common units") at September 30, 2018. We believe that we have operated and have been organized in conformity with the requirements for qualification and taxation as a REIT for U.S federal income tax purposes commencing with our taxable year ended December 31, 2015.

Principles of Consolidation

The accompanying consolidated financial statements are presented on the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America ("GAAP") and include the accounts of the Company, Easterly Government Properties TRS, LLC, Easterly Government Services, LLC, the Operating Partnership and its other subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

Basis of Presentation

The condensed consolidated financial statements included herein are unaudited; however, they include all adjustments (consisting only of normal recurring adjustments) which, in the opinion of management, are necessary to state fairly the consolidated financial position of the Company at September 30, 2018, and the consolidated results of operations for the three and nine months ended September 30, 2018 and 2017 and the consolidated cash flows for the nine months ended September 30, 2018 and 2017. Certain prior year amounts have been reclassified to conform to the current year presentation. The year-end condensed consolidated balance sheet data was derived from audited financial statements but does not include all disclosures required by GAAP. The results of operations for the interim periods presented are not necessarily indicative of the results to be expected for the full year.

The preparation of the consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the balance sheet and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

2. Summary of Significant Accounting Policies

The significant accounting policies used in the preparation of the Company's condensed consolidated financial statements are disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

Revision of Previously Reported Consolidated Financial Statements

In connection with the preparation of the Company's consolidated financial statements for the year ended December 31, 2017, the Company identified an error in the estimated useful life utilized to amortize certain assets associated with three properties contributed at the time of the Company's initial public offering in the first quarter of 2015. As a result of the error, Depreciation and amortization expense had been overstated and thereby Real estate properties, net, Intangible assets, net and Equity were understated. The Company concluded that the amounts are not material to any of its previously issued consolidated financial statements. However, to maintain proper comparability between our financial statements we have elected to revise prior periods. Accordingly, the Company revised these balances in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2017. The effects of this revision to the consolidated financial statements are as follows (in thousands, except for per share data).

Effect of Revision For the Three Months Ended September 30, 2017	As Previously Reported	Adjustment	As Revised
Total revenues	$ 33,858	$ —	$ 33,858
Depreciation and amortization	14,141	(191)	13,950
Total expenses	27,437	(191)	27,246
Net income	926	191	1,117
Net income available to Easterly Government Properties, Inc.	782	160	942
Net income available to Easterly Government Properties, Inc. per share (basic and diluted)	0.02	—	0.02
Comprehensive income	815	191	1,006

Effect of Revision For the Nine Months Ended September 30, 2017	As Previously Reported	Adjustment	As Revised
Depreciation and amortization	$ 40,663	$ (572)	$ 40,091
Total expenses	79,433	(572)	78,861
Net income	3,289	572	3,861
Net income available to Easterly Government Properties, Inc.	2,693	468	3,161
Net income available to Easterly Government Properties, Inc. per share (basic and diluted)	0.07	0.01	0.08
Comprehensive income	2,592	572	3,164

Recently Adopted Accounting Pronouncements

On January 1, 2018, the Company adopted ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606). Please refer to Note 10 for more information pertaining to our adoption of this guidance.

On January 1, 2018, the Company adopted ASU No. 2016-15, Statement of Cash Flows (Topic 230), which provides classification guidance for certain cash receipts and cash payments including payment of debt extinguishment costs, settlement of zero-coupon debt instruments, insurance claim payments and distributions from equity method investees. The Company adopted this ASU using the retrospective method and the implementation of this update did not have a material impact on our consolidated financial statements.

On January 1, 2018, the Company adopted and retrospectively applied ASU No. 2016-18, Statement of Cash Flows (Topic 230), which requires that the statement of cash flows explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. The Company now reconciles both cash and cash equivalents and restricted cash in the accompanying Statements of Cash Flows for all periods, whereas under the prior guidance the Company explained the changes during the period for cash and cash equivalents only.

On January 1, 2018, the Company adopted ASU No. 2017-05, Other Income-Gains and Losses from the Derecognition of Nonfinancial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets. This ASU clarifies the scope and accounting of a financial asset that meets the definition of an "in-substance nonfinancial asset" and defines the term "in-substance nonfinancial asset." This ASU also adds guidance for partial sales of nonfinancial assets. The Company adopted this ASU using the modified retrospective method and the implementation of this update did not have a material impact on our consolidated financial statements.

On January 1, 2018, the Company adopted ASU 2017-09, Stock Compensation (Topic 718): Scope of Modification Accounting, which provides updated guidance about which changes to the terms or conditions of a share-based payment award would require an entity to apply modification accounting under the topic. The Company adopted this ASU using the prospective method to an award modified on or after the adoption date, however, the implementation of this update did not have a material impact on our consolidated financial statements.

Recent Accounting Pronouncements Not Yet Adopted

In February 2016, the Financial Accounting Standards Board (the "FASB") issued ASU No. 2016-02, Leases, which sets out the principles for the recognition, measurement, presentation and disclosure of leases for both parties to a contract (i.e., lessees and lessors). The new standard requires lessees to apply a dual approach, classifying leases as either finance or operating leases based on the principle of whether or not the lease is effectively a financed purchase of the leased asset by the lessee. This classification will determine whether the lease expense is recognized based on an effective interest method or on a straight-line basis over the term of the lease. A lessee is also required to record a right-of-use asset and a lease liability for all leases with a term of greater than 12 months regardless of their classification. Leases with a term of 12 months or less will be accounted for in the same manner as operating leases today. As of September 30, 2018, the Company had a sublease for office space in Washington, DC expiring in June 2021 and a lease for office space in San Diego, CA expiring in April 2022. The remaining contractual payments under the Company's lease and sublease for office space aggregate $1.5 million.

The new standard requires lessors to account for leases using an approach that is substantially equivalent to existing guidance for sales-type leases, direct financing leases and operating leases. In connection with the new revenue guidance, we believe that the new revenue standard may apply to executory costs and other components of revenue deemed to be non-lease components, even when the revenue for such activities is not separately stipulated in the lease. In that case, we would need to separate the lease components of revenue due under leases from the non-lease components. Under the new guidance, we would continue to recognize the lease components of lease revenue on a straight-line basis over our respective lease terms as we do under prior guidance. However, we would recognize the non-lease components under the new revenue guidance as the related services are delivered. As a result, while the total revenue recognized over time would not differ under the new guidance, the recognition pattern could be different. The Company is currently in the process of evaluating the significance of the difference in the recognition pattern that would result from this change.

In July 2018, the FASB issued ASU 2018-11, Targeted Improvements to Topic 842 Leases. The improvements in ASU 2018-11 provide for (a) an optional new transition method for adoption that results in initial recognition of a cumulative effect adjustment to retained earnings in the year of adoption and (b) a practical expedient for lessors, under certain circumstances, to combine the lease and non-lease components of revenues for presentation purposes.

Additionally, ASU 2016-02 will require that lessees and lessors capitalize, as initial direct costs, only those costs that are incurred due to the execution of a lease. Under ASU 2016-02, allocated payroll costs and other costs that are incurred regardless of whether the lease is obtained will no longer be capitalized as initial direct costs and instead will be expensed as incurred.

In July 2018, the FASB issued ASU 2018-10, Codification Improvements to Topic 842, Leases, which clarifies, corrects, or consolidates authoritative guidance issued in ASU 2016-02 and is effective upon adoption of ASU 2016-02.

ASU No. 2016-02 is effective for reporting periods beginning January 1, 2019, with modified retrospective application for each reporting period presented at the time of adoption or utilizing the optional transition method under ASU 2018-11. Early adoption is also permitted for this guidance. The Company is in the process of evaluating the impact of this new guidance.

In August 2017, the FASB issued ASU 2017-12, Derivatives and Hedging: Targeted Improvements to Accounting for Hedging Activities. The purpose of this updated guidance is to better align a company's financial reporting for hedging activities with the economic objectives of those activities. The transition guidance provides companies with the option of either adopting the new standard early using a modified retrospective transition method in any interim period after issuance of the update, or alternatively adopting the new standard for fiscal years beginning after December 15, 2018. This adoption method may require the Company to recognize the cumulative effect of initially applying the ASU as an adjustment to accumulated other comprehensive income with a corresponding adjustment to the opening balance of retained earnings as of the beginning of the fiscal year that an entity adopts the update. While the Company continues to assess all potential impacts of the standard, we do not expect the adoption of this guidance to have a material impact on our consolidated financial statements.

3. Real Estate and Intangibles

During the nine months ended September 30, 2018, we acquired ten operating properties in asset acquisitions, consisting of VA – Golden, VA – San Jose, and the First Closing Properties (as defined below) for an aggregate purchase price of $321.0 million. We allocated the aggregate purchase price based on the estimated fair values of the acquired assets and assumed liabilities as follows (amounts in thousands):

	Total
Real estate	
Land	$ 18,835
Building	261,883
Acquired tenant improvements	7,798
Total real estate	288,516
Intangible assets	
In-place leases	38,263
Acquired leasing commissions	4,198
Above-market leases	1,307
Total intangible assets	43,768
Intangible liabilities	
Below-market leases	(1,827)
Total intangible liabilities	(1,827)
Purchase price	330,457
Less: Mortgage note assumed	(9,414)
Net assets acquired	$ 321,043

The intangible assets and liabilities of operating properties acquired during the nine months ended September 30, 2018 has a weighted average amortization period of 6.39 years as of September 30, 2018. During the nine months ended September 30, 2018, we included $3.0 million of revenues and $0.5 million of net income in our consolidated statement of operations related to VA – Golden, VA – San Jose, and the First Closing Properties (as defined below).

On June 15, 2018, we entered into a purchase and sale agreement to acquire a 1,479,762-square foot portfolio of 14 properties (the “Portfolio Properties”) for an aggregate purchase price of approximately $430.0 million. On September 13, 2018, we closed on the acquisition of eight of the Portfolio Properties (the “First Closing”). The eight properties acquired in the First Closing, consisting of an aggregate of 1,024,036 square feet, include the following (listed by primary tenant agency, if applicable, and location): Various GSA – Buffalo, NY, Various GSA – Chicago, IL, TREAS – Parkersburg, WV, SSA – Charleston, WV, FBI – Pittsburgh, PA, GSA – Clarksburg, WV, ICE – Pittsburgh, PA and SSA – Dallas, TX (collectively, the “First Closing Properties”). Please refer to Note 12 for information regarding the six remaining Portfolio Properties.

During the nine months ended September 30, 2018, we incurred $1.0 million of acquisition-related expenses including $0.8 million of internal costs associated with property acquisitions.

Consolidated Real Estate and Intangibles

Real estate and intangibles consisted of the following as of September 30, 2018 (amounts in thousands):

	Total
Real estate properties, net	
Land	$152,999
Building	1,364,862
Acquired tenant improvements	55,301
Construction in progress	67,950
Accumulated depreciation	(94,512)
Total Real estate properties, net	1,546,600
Intangible assets, net	
In-place leases	198,383
Acquired leasing commissions	42,664
Above market leases	10,762
Accumulated amortization	(84,765)
Total Intangible assets, net	167,044
Intangible liabilities, net	
Below market leases	(64,682)
Accumulated amortization	31,644
Total Intangible liabilities, net	$(33,038)

The following table summarizes the scheduled amortization of the Company’s acquired above- and below-market lease intangibles for each of the five succeeding years as of September 30, 2018 (amounts in thousands):

	Acquired Above-Market Lease Intangibles	Acquired Below-Market Lease Intangibles
2018	$ 342	$ 2,213
2019	1,318	7,379
2020		