Easterly Government Properties, Inc.
Form 10-Q
May 08, 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 March 31, 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	47-2047728
(State of Incorporation)	(IRS Employer Identification No.)
2101 L Street NW, Suite 650, Washington, D.C.	20037
(Address of Principal Executive Offices)	(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 and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted 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 and post 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	(Do not check if smaller reporting company)	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 April 30, 2018, the registrant had 45,695,511 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)

	March 31, 2018	December 31, 2017
Assets		
Real estate properties, net	$ 1,232,211	$ 1,230,162
Cash and cash equivalents	9,591	12,682
Restricted cash	4,389	3,519
Deposits on acquisitions	1,050	750
Rents receivable	13,565	12,751
Accounts receivable	9,911	9,347
Deferred financing, net	733	945
Intangible assets, net	136,651	143,063
Interest rate swaps	5,890	4,031
Prepaid expenses and other assets	10,710	8,088
Total assets	$ 1,424,701	$ 1,425,338
Liabilities		
Revolving credit facility	98,750	99,750
Term loan facility, net	99,236	99,202
Notes payable, net	173,702	173,692
Mortgage notes payable, net	202,495	203,250
Intangible liabilities, net	36,093	38,569
Accounts payable and accrued liabilities	19,733	19,786
Total liabilities	630,009	634,249
Equity		
Common stock, par value $0.01, 200,000,000 shares authorized, 45,458,706 and 44,787,040 shares issued and outstanding at March 31, 2018 and December 31, 2017, respectively	455	448
Additional paid-in capital	741,089	740,546
Retained earnings	8,646	7,127
Cumulative dividends	(95,447)	(83,718)
Accumulated other comprehensive income	4,889	3,403
Total stockholders' equity	659,632	667,806
Non-controlling interest in Operating Partnership	135,060	123,283
Total equity	794,692	791,089
Total liabilities and equity	$ 1,424,701	$ 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 March 31,	
	2018	2017
Revenues		
Rental income	$32,289	$26,020
Tenant reimbursements	3,483	3,628
Other income	202	239
Total revenues	35,974	29,887
Operating expenses		
Property operating	6,560	6,349
Real estate taxes	3,700	2,735
Depreciation and amortization	14,634	12,869
Acquisition costs	224	532
Corporate general and administrative	3,459	3,444
Total expenses	28,577	25,929
Operating income	7,397	3,958
Other expenses		
Interest expense, net	(5,582)	(2,417)
Net income	1,815	1,541
Non-controlling interest in Operating Partnership	(296)	(304)
Net income available to Easterly Government Properties, Inc.	$1,519	$1,237
Net income available to Easterly Government Properties, Inc. per share:		
Basic	$0.03	$0.03
Diluted	$0.03	$0.03
Weighted-average common shares outstanding		
Basic	45,008,062	36,891,595
Diluted	46,018,040	39,143,887
Dividends declared per common share	$0.26	$0.24

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

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Easterly Government Properties, Inc.

Consolidated Statements of Comprehensive Income (unaudited)

(Amounts in thousands, except share amounts)

	For the three months ended March 31,	
	2018	2017
Net income	$1,815	$1,541
Other comprehensive income:		
Unrealized gain on interest rate swaps, net	1,859	108
Other comprehensive income	1,859	108
Comprehensive income	3,674	1,649
Non-controlling interest in Operating Partnership	(296)	(304)
Other comprehensive income attributable to non-controlling interest	(373)	(12)
Comprehensive income attributable to Easterly Government Properties, Inc.	$3,005	$1,333

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 three months ended March 31, 2018	2017
Cash flows from operating activities		
Net income	$ 1,815	$ 1,541
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	14,634	12,869
Straight line rent	(1,807)	(143)
Amortization of above- / below-market leases	(2,279)	(2,112)
Amortization of unearned revenue	(26)	(27)
Amortization of loan premium / discount	(21)	(21)
Amortization of deferred financing costs	285	251
Non-cash compensation	864	727
Net change in:		
Rents receivable	991	775
Accounts receivable	(564)	83
Prepaid expenses and other assets	(2,613)	(1,905)
Accounts payable and accrued liabilities	834	(1,313)
Net cash provided by operating activities	12,113	10,725
Cash flows from investing activities		
Real estate acquisitions and deposits	(326)	(43,968)
Additions to operating properties	(890)	(124)
Additions to development properties	(10,410)	(79)

Net cash (used in) investing activities		(11,626	)		(44,171	)
Cash flows from financing activities						
Payment of deferred financing costs		—			(18	)
Issuance of common shares		13,669			—	
Credit facility draws		4,000			65,750	
Credit facility repayments		(5,000	)		(119,750	)
Term loan draws		—			100,000	
Repayments of mortgage notes payable		(763	)		(732	)
Dividends and distributions paid		(14,424	)		(11,049	)
Payment of offering costs		(190	)		—	
Net cash provided by (used in) financing activities		(2,708	)		34,201	
Net increase (decrease) in Cash and cash equivalents and Restricted cash		(2,221	)		755	
Cash and cash equivalents and Restricted cash, beginning of period		16,201			6,491	
Cash and cash equivalents and Restricted cash, end of period	$	13,980		$	7,246	

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)

Supplemental disclosure of cash flow information is as follows:

	For the three months ended March 31, 2018	2017
Cash paid for interest, net of capitalized interest	$3,497	$2,190
Supplemental disclosure of non-cash information		
Additions to operating properties accrued, not paid	$183	$102
Additions to development properties accrued, not paid	2,532	92
Offering costs accrued, not paid	17	—
Deferred asset acquisition costs accrued, not paid	8	—
Unrealized loss on interest rate swaps, net	1,859	108
Exchange of Common Units for Shares of Common Stock		
Non-controlling interest in Operating Partnership	$—	$(1,727)
Common stock	—	1
Additional paid-in capital	—	1,726
Total	$—	$—

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

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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. (which may be referred to in these financial statements as the "Company," "we," "us," or "our") 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.

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 March 31, 2018, we wholly owned 46 operating properties in the United States, including 44 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 3.7 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 our business. The Company is the sole general partner of the Operating Partnership. The Company owned approximately 83.0% of the aggregate limited partnership interests in the Operating Partnership ("common units") at March 31, 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 March 31, 2018, and the consolidated results of operations for the three months ended March 31, 2018 and 2017 and the consolidated cash flows for the three months ended March 31, 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 March 31, 2017	As Previously Reported	Adjustment	As Revised
Total revenues	$ 29,887	$ —	$ 29,887
Depreciation and amortization	13,060	(191)	12,869
Total expenses	26,120	(191)	25,929
Net income	1,350	191	1,541
Net income available to Easterly Government Properties, Inc.	1,084	153	1,237
Net income available to Easterly Government Properties, Inc. per share (basic and diluted)	0.03	—	0.03
Comprehensive income	1,458	191	1,649

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 guidance should be applied retrospectively, however 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 guidance should be applied prospectively to an award modified on or after the adoption date, however, 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 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 March 31, 2018, the Company had a sublease for office space in Washington D.C. 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 $1.7 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.

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.

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. 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 three months ended March 31, 2018, we incurred $0.2 million of acquisition-related expenses including $0.2 million of internal costs associated with property acquisitions.

Consolidated Real Estate and Intangibles

Real estate and intangibles consisted of the following as of March 31, 2018 (dollars in thousands):

	Total
Real estate properties, net	
Land	$134,163
Building	1,099,949
Acquired tenant improvements	47,503
Construction in progress	27,395
Accumulated amortization	(76,799)
Total Real estate properties, net	$1,232,211
Intangible assets, net	
In-place leases	$160,119
Acquired leasing commissions	38,464
Above market leases	9,455
Accumulated amortization	(71,387)
Total Intangible assets, net	$136,651
Intangible liabilities, net	
Below market leases	$(62,856)
Accumulated amortization	26,763
Total Intangible liabilities, net	$(36,093)

4. Debt

At March 31, 2018, our consolidated borrowings consisted of the following (dollars in thousands):

Loan	Principal Outstanding March 31, 2018	Interest Rate [(1)]	Current Maturity
Revolving credit facility:			
Senior unsecured revolving credit facility [(2)]	$ 98,750	L + 150bps	February 2019 [(3)]
Total revolving credit facility	98,750		
Term loan facility:			
Senior unsecured term loan facility	100,000	3.17% [(4)]	September 2023
Total term loan facility	100,000		
Less: Total unamortized deferred financing fees	(764)		
Total term loan facility, net	99,236		
Notes payable:			
Senior unsecured notes payable, series A	95,000	4.05%	May 2027
Senior unsecured notes payable, series B	50,000	4.15%	May 2029
Senior unsecured notes payable, series C	30,000	4.30%	May 2032
Total notes payable	175,000		
Less: Total unamortized deferred financing fees			