Transcript of JLL Income Property Trust
1Q18 Public Earnings Call
May 18, 2018

Participants

Allan Swaringen – President & Chief Executive Officer
Gregg Falk – Chief Financial Officer
Sam Podwika – Sr. Portfolio Accountant

Presentation

Operator
On behalf of JLL Income Property Trust, I'd like to welcome you to their first quarter 2018 earnings conference call. This call is being recorded and our audience lines are currently in a listen-only mode. [Other operator instructions.] At this time, I would like to turn the conference over to Sam Podwika, from JLL Income Property Trust. Sam, please go ahead.

Sam Podwika – Sr. Portfolio Accountant
Thanks, and welcome, everyone, to today's call.

Any statements made about future results and performance or about plans, expectations or objectives are forward-looking statements. Actual results and performance may differ from those included in the forward looking statements as a result of factors discussed in the Company's Annual Report on Form 10-K for the year ended December 31, 2017, and in our other reports filed with the SEC. The Company disclaims any undertaking to update or revise any forward-looking statements.

In addition, all non-GAAP financial measures discussed during this call are reconciled to their most directly comparable GAAP financial measures in accordance with the SEC rules in our Form 10-Q for the quarter ended March 31, 2018.

Links to a transcript and audio replay of this call will be posted and available on our website, JLLIPT.com. For further information on the Company's performance, we invite you to review our Quarterly Report on Form 10-Q filed on May 11, 2018 and other filings which are available on the Company's website, as well as the SEC's website, sec.gov.

Now I would like to turn the call over to Allan Swaringen, President and Chief Executive Officer and Gregg Falk, Chief Financial Officer. At the conclusion of their comments, we will open the call for your questions.

Allan, if you'd like to begin?

Allan Swaringen – President & Chief Executive Officer
Thanks, Sam. Hello, everyone, and thank you for joining us for our first quarter earnings call. During the first quarter, JLL Income Property Trust focused on actively managing and improving our $2.5 billion portfolio of 68 core properties that span the apartment, industrial, office, and retail sectors. Our strong operating performance throughout last year and intensive asset management so far into Q1 2018 have positively impacted the investment performance of our portfolio. In the first quarter we achieved total net of fees returns of 1.3% and

1.6% on our Class A and Class M shares, respectively. Our first quarter dividend payment was increased 4%, and represents the fifth time JLL Income Property Trust has raised its dividend since 2012. Quarterly dividends have now been paid for 25 consecutive quarters, with an average annual increase of 5.4% over that 6 plus year period. Our NAV was approximately $1.6 billion at the end of the quarter which demonstrates our steady growth and ability to execute on our strategic plan to position JLL Income Property Trust as the market's leading perpetually-offered NAV REIT.

U.S. economic growth continued in the first quarter. The 2.3% annual rate of GDP growth in the first quarter was below the full-year forecast, but considered in line with expectations for the quarter, as the first quarter numbers have historically been below trend. 2.8% full year GDP growth is forecast by Oxford Economics, followed by 2.4% growth for 2019. This forecast is driven by good economic fundamentals and a boost to business investment and consumer spending coming from the Tax Cuts and Jobs Act put into effect at the end of 2017.

These economic gains are helping the positive jobs outlook to continue, with monthly average job growth in the first quarter of 2018 at 212,000 and April job growth at 164,000. In April, the unemployment rate declined to 3.9% from the steady 4.1% in the first quarter. This is the first time unemployment has been below 4% since the end of 2000. Job growth is forecast to slow slightly in the coming years as the low unemployment rate indicates fewer workers available to hire. Low unemployment is also supportive of higher wages, and trailing year wage growth has been at 2.6% in recent months, a level higher than earlier in the recovery, but consistent with 2017. This has contributed to inflation moving a bit higher. Trailing year CPI for all items, less food and energy, moved up to 2.1% in the first quarter, which is slightly above the Federal Reserve target of 2%.

The Federal Reserve raised its target interest rates range from 1.5% to 1.75% at its March meeting. A narrow majority of members predicted three rate increases in 2018, with the rest predicting four rate increases. They acknowledge inflation has moved higher and plan to continue to take action to control it, but not to dramatically change plans based on the slight increase in inflation. Longer term interest rates also moved higher. The 10 Year Treasury Note ended the first quarter at 2.74%, up from 2.4% at the start of the quarter. There were further increases in April, reaching 3% on April 24th before falling back from that threshold slightly, though this week the 10-year is back above 3%. Higher interest rates are impacting real estate borrowing costs, but some of the increase is being mitigated by narrowing spreads. Overall, real estate prices, especially for core real estate, have so far not been impacted by the higher interest rates.

Real estate values inched higher in the first quarter according to the RCA CPPI index of repeat-sales which was up 1.8%. The NCREIF market value index also moved up, recording a 0.9% increase in the first quarter. Commercial real estate transaction volumes were up 5% in the first quarter from year-ago levels, with specialty sectors, industrial and apartments seeing the most increase, while retail transaction volume was down.

U.S. real estate fundamentals are benefiting from the positive growth environment, but the impact varies by property type and market. Industrial is seeing the strongest demand due to the combination of economic growth and the growth of e-commerce. Apartments are also seeing good demand as job growth fuels household formation. Both sectors are seeing new construction though which should lead to stable or slightly higher vacancy rates. Office demand has been muted, as tenants are focusing on being more efficient and job growth has not yet translated into stronger demand for office space. Retail malls, big box, and department store anchors are experiencing headwinds from e-commerce, and the closures by some leading retailers is expected to lead to increasing retail vacancy rates. However, the impact varies by type of retail center, with many grocery anchored centers continuing to see strong tenant demand, while also maintaining higher occupancies.

Going forward we expect the positive underlying property fundamentals to sustain real estate income growth. Interest rates at their current level are not expected to negatively impact real estate values. Investors continue to seek out real estate for diversification and income, which should contribute to stable transaction volumes and returns in line with our longer-term expectations for our core strategy.

The economy's performance over the past couple of years has benefitted our portfolio in terms of leasing, occupancy and our outlook for modest future rent growth. For the remainder of the year, we expect increasing occupancies, declining vacancy rates and rental growth to be in-line with inflationary expectations. Gregg will now discuss the portfolio's financial performance, before I continue with Q1 results. Gregg?

Gregg Falk – Chief Financial Officer

Thanks, Allan. Our operating performance continues to be strong, as evidenced by our performance metrics. As I highlight our financial results, I will discuss the key underlying drivers of our performance.

We reported total revenues of $42 million this quarter, an increase of approximately $2 million or 6% over the prior year. The Company recorded net income of $33 million for the quarter, compared to a loss of $1 million in the prior year, primarily related to a $30 million gain on the sale of Station Nine Apartments in February 2018.

Funds from Operations, or FFO, is a supplemental measure of operating performance used by the real estate industry which most closely resembles GAAP net income. For the quarter ended March 31st, we reported FFO of $18.5 million, an increase of approximately $1.5 million or 9% from the prior year, primarily due to the contributions from our new acquisitions and the income generated from our unconsolidated properties and fund investments. Our per share FFO for Q1 was $0.14 compared to $0.13 for the prior year.

We also closely monitor AFFO as a supplemental measure of operating performance. AFFO is calculated as FFO adjusted for non-operating expenses and non-cash items. AFFO increased slightly to $15.5 million this quarter. Our per share AFFO for Q1 was $0.12 compared to $0.11 for the prior year.

We feel positive about the portfolio occupancy remaining stable at 94% at the end of the quarter. Our occupancies by segment were 96% for Apartment, 93% for Industrial, 92% for Office and 95% for Retail for the quarter. We saw an increase of 2% in the apartment segment occupancy since last quarter, driven by increased occupancies across most of our apartment properties.

As a testament to the quality of our overall portfolio, leasing activity remained robust, with 70,000 square feet of new and renewal leases completed during the quarter and almost 700,000 square feet leased over the past 12 months. Our weighted average lease duration at March 31st was 6.1 years, in-line with the prior quarter.

It is one of our primary investment objectives to offer an attractive level of current income to our stockholders. Our Board of Directors approved a gross distribution for the second quarter of 2018 at $0.13 per share to stockholders of record as of June 28th, payable on or around August 1st. These gross dividends will be paid out to stockholders, but will be reduced for share-class specific fees, if any. We are pleased to report that effective as of April 1st, dealer manager fees on Class A shares were reduced by 19 percent - from 1.05% to 0.85% of Net Asset Value annually. Additionally, dealer manager fees were completely eliminated on Class M-I shares. As dealer manager fees are deducted from dividends paid to stockholders, these reductions in share class specific expenses effectively result in a comparable 5.9% increase in any future dividends paid to Class A stockholders and a 1.1% increase for Class M-I stockholders.

Since we launched our initial public offering in October 2012 we have provided net of fees annualized total returns for our Class A and M shares of 6.5% and 7.1%, respectively. We continue to search for strategic investment opportunities that will further diversify our portfolio, as well as strategic dispositions that will generate profits for our portfolio and provide steady returns for investors.

There was an increase in our NAV per share for the first quarter for our Class A and M shares of 0.4% and 0.5%, respectively, as a result of a net increase in the value of our portfolio. Our daily NAV methodology has provided stable market valuations and we have realized moderate appreciation in share price since we began this offering in 2012. As a perpetual life, daily NAV REIT, JLL Income Property Trust is not subject to the same market fluctuations that affect the pricing of listed stocks. Our share price is determined based on independent appraisals of the real estate investments we own and the income they generate.

Now, I'll hand the call back over to Allan to discuss accomplishments from the quarter and upcoming business strategies.

Allan Swaringen – President & Chief Executive Officer

Thanks, Gregg. To highlight Q1 accomplishments, we focused on our strategic acquisition and disposition initiatives. We identified two acquisitions that are currently in the pipeline for closing in Q2, and disposed of a property that no longer aligned with the fund's investment strategy. With a more seasonal leasing schedule, along with its age dictating a need for physical upgrades, Station Nine Apartments in Durham, North Carolina, no longer aligned with our strategic objectives. Given the strong demand that exists for core-plus style apartments, we anticipated and were rewarded with strong buyer interest for the property. The property sold for $75 million in February, resulting in a GAAP accounting gain of $29.7 million dollars in Q1. We will continue to monitor performance and optimize our portfolio holdings through selective dispositions of non-strategic properties that we don't view as long-term holds.

Turning to our asset management efforts, another notable Q1 accomplishment is the earning of LEED Silver certification by one of our office properties located in Portland, Oregon, Pioneer Tower. The 300,000 square foot property also recently earned the U.S. Environmental Protection Agency's ENERGY STAR certification, which signifies that the building performs in the top 25% of similar facilities nationwide for energy efficiency. We began working toward the LEED Silver certification status in early 2017, and through the efforts of pro-active asset management, the local property team, and in-house energy and sustainability experts, Pioneer Tower was able to meet the stringent criteria to achieve both of these highly sought after environmental distinctions. We believe that implementing strong environmental, social, and governance principles across our portfolio will have a positive impact on our long-term investment performance.

Turning to our stock transactions, in Q1 we repurchased approximately $23 million dollars in shares pursuant to our share repurchase plan, which had a first quarter limit of $78 million. For the second quarter 2018, share repurchases will have a limit of approximately $78 million, which is 5% of the NAV of the company as of March 31st. Stockholders should aspire to be long-term investors and should plan to hold our shares for five to seven years or longer as we are typically underwriting new property investments over a similar time horizon; however, our share repurchase plan is available to stockholders who desire to rebalance their asset allocations subject to the quarterly limits and a minimum twelve month holding period.

Our overall Company leverage ratio decreased from 39% at the end of Q4 to 38% at the end of Q1, which is in line with our strategy to maintain a lower leverage ratio. With limited near term debt maturities, we have a portfolio-wide weighted average remaining loan term of nearly 7 years and our weighted average interest rate on outstanding borrowings is 3.7%. Across our portfolio, 88% of total debt is at a fixed rate, which gives us confidence in the current rising interest rate environment.

For the remainder of the year, we are focused on investing capital in industrial, apartment, and grocery-anchored retail sectors, as well as complementary strategies such as medical office, which fulfill key portfolio investment goals of stable income and moderate NAV growth over time. During the first quarter we invested approximately $6.8 million of capital improvements in our existing portfolio, all geared towards maintaining our higher occupancies. At the end of Q1 our portfolio diversification by property type was 24% for Apartments, 24% Industrial, 19% Office, 31% Retail and 2% Other, which currently consists of two parking garages.

We remain committed to actively managing our real-estate assets to provide attractive risk-adjusted returns to our stockholders and realize appreciation over time. Financial Advisors and Portfolio Managers are looking for increased diversification and alternative sources of income for their client portfolios and core real estate is well positioned to provide both. Investment performance is the most important measure of success and our sustained focus on active asset management, portfolio diversification and leverage reduction has driven our positive first quarter results.

JLL Income Property Trust continues to deliver a competitive current yield and attractive annualized total returns all the while maintaining a high-quality portfolio of institutional-caliber investments. We believe both property type and geographic market selection will continue to be one of the greatest contributors to our strengthening investment performance. We are optimistic and believe we are well positioned to take advantage of opportunities as they arise this year.

Thank you for your time and attention today and I hope you found our remarks informative. Operator, we would now like to open the call for any questions.

Operator
Great, thank you. At this time, we'll be conducting a question and answer session. [Operator instructions.] One moment please while we poll for questions. Our first question here is from Jim Melnick. Please go ahead.

Q: Hi, gentlemen, good morning. Thank you for taking my question. Allan, you mentioned the dealer manager fee that recently occurred. I was just wondering if you could go into a little greater detail on it.

Allan Swaringen – President & Chief Executive Officer
Yes, thanks for that, Jim. I'm going to turn that first to Gregg, our CFO. Then, I'll add a little additional color after he reviews the mechanics there.

Gregg Falk – Chief Financial Officer
Sure, thanks, Jim. Effective April 1st, we reduced the dealer manager fees on our Class A and M-I shares. The Class A shares originally had a dealer manager fee of 105 basis points annually, and we reduced that to 85 basis points annually. The Class M-I shares had a 5 basis point fee which we completely eliminated.

The result of that is that each of the shareholders in the Class A and Class M-I share classes are going to get an increase in their dividends that they see going forward. For example, the next dividend we pay for stockholders as of record as of the end of June, which gets paid around August 1st, with be an increase for both to those share classes.

Allan Swaringen – President & Chief Executive Officer
Great, the only other color I would add to that which is accomplishment we're pretty proud of, the reduction in this fee prospectively is a net positive to stockholders. It ultimately will relate in a little bit higher net dividends because, as I said, dealer manager fee comes off each of our quarterly distributions. I think it's also worth noting that the reductions in this fee were first market driven, and second, really shared by either LaSalle or our home office distribution partners.

None of these fee reductions resulted in advisor cut to compensation. We were able to maintain the compensation advisors get for recommending and overseeing investments in income property trusts on behalf of their clients, our stockholders. Anyway, all in all a good positive outcome, we think.

Operator
The next question is from Joseph Warner. Please go ahead.

Q: Good morning, gentlemen. With interest rates raising and the 10-year treasury is now yielding over 3%, how are you protecting the portfolio against the rising interest rates?

Allan Swaringen – President & Chief Executive Officer
Joe, timely question. The 10-year in both the long and the short end of the curve are bouncing around. I'm going to also ask Greg Falk, our CFO, to talk a little bit more about our interest rate strategies.

Gregg Falk – Chief Financial Officer
Sure, as you know we are a low-leverage strategy here. We're 38% LTD as of the end of the quarter. Of all the debt that we have outstanding, 88% of it is fixed. Either it's long-term mortgage debt that is fixed rate or it is five-year term loan debt that we have swapped from floating to fix, so we feel that rising interest rates aren't going to have a material impact on us. It's just the way we've designed our portfolio. We're attractive to lenders because we are a low-leverage borrower, and as we've seen rates rise a bit, we've also seen some of the spreads come in, so it hasn't been a direct one-for-one impact, but it was definitely something that we keep our eyes on and make sure that we are prepared for what could happen in the market.

Allan Swaringen – President & Chief Executive Officer
The only thing I would add is in the current environment we very much want income property trusts to be positioned as the higher quality, more institutionally-focused and lower leverage strategy in the marketplace. There's others that are running similar strategies at significantly higher leverage rates and we feel like now the current interest rate environment plays to our strength versus those that are more highly leveraged, but we'll all see how that plays out over time with ultimate investment performance.

Q: Fantastic, thank you for the information.

Operator
Our next question is from Jack Eastman. Please go ahead.

Q: Good morning. Should we consider the sale of the apartments in Durham, North Carolina to indicate that you are making a strategic shift in your portfolio's construction?

Allan Swaringen – President & Chief Executive Officer
Yes, thanks for that question, Jack. It is interesting to note that we did recently sell an apartment community when at the same time, apartments have been the largest investment of late that we've been adding to the portfolio. When I think about what we added to the portfolio in '16 and '17, it was more apartments than anything else and we continue to look at apartments for new acquisitions. So, the question about why we sell one of our apartment investments is timely and worth providing a little more color on. So, thanks for that.

The Station Nine Apartments in Durham, North Carolina has been a long-term hold for us. We've owned it since we launched Income Property Trust in 2012, and it's been a very good performer for us. I don't think it ever fell much below 97% or 98% occupancy since we've owned it, and we've been able to grow rents, and it's really been a good contributor to the portfolio.

That said, it's also a property that, given its construction, age, and vintage, it was getting a little bit older and apartments, while they have a very long useful life if they're well-maintained, every six, eight, ten years, they start to really require more capital just from a refurbishment standpoint. That certainly was the case for Station Nine.

The other unique component of Station Nine is, given its location, while it's not student housing, we did have a relatively high student-oriented population coming from Duke University in the Business School and the Medical

Office campus there. So, it had a little bit more of a seasonality to it than we wanted in our portfolio where it had a very high leasing window, and then it stayed leased, but if you didn't achieve that leasing, your outlook for the whole year was going to be a little bit depressed. We wanted to move into more traditional 12-month apartment leases that often have less seasonality. They're a more ratable roll throughout the year.

For that reason, and our optimism about that it would be aggressively bid because it's a very high quality apartment community, we took it to market. We're very pleased with the sale. It's added a little bit of lift to our NAV in 2017, a little bit more when it closed in 2018, and we were quite pleased with the results, but it in no way portends a strategic shift away from apartments.

We're going to continue to add more apartments to our portfolio. We think they're good investments, and we want to actually increase our allocation to them in this current economic environment. So, thanks for the question and the opportunity to provide a little more color on that.

Q: Thank you.

Operator
Thank you. This concludes the question and answer session. I'd like to turn the floor back over to Mr. Swaringen for any closing comments.

Allan Swaringen – President & Chief Executive Officer
Great. Thank you, everyone, for joining us today, and we appreciate your time. We look forward to updating you later in the year after the end of the second quarter and our mid-year accomplishments. Thanks, and have a good day.