Stockholder Call -
JLL Income Property Trust Q2 2015 Earnings Call

OPERATOR
On behalf of JLL Income Property Trust, I'd like to welcome you to their second quarter 2015 earnings conference call. This call is being recorded and our audience lines are currently in a listen-only mode. At this time, I would like to turn the conference over to Jodi Akers, Head of Stockholder Services. Jodi, please go ahead.

JODI AKERS
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, 2014, 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 June 30, 2015.

Links to a transcript and audio replay of this call will be posted and available on our website, www.JLLIPT.com. For further information on the Company's performance, we invite you to review our Quarterly Report on Form 10-Q filed on August 7, 2015 and other filings which are available on the Company's website, as well as the SEC's website, www.sec.gov.

Now I would like to turn over the call 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

Thank you, Jodi. Hello, everyone, and thank you for joining us for our second quarter earnings call. JLL Income Property Trust had a very productive second quarter investing capital and made exceptional progress in attracting new capital, raising $76 million during the quarter. We continued to add value to our portfolio through active asset management, property acquisitions, strategic dispositions and securing accretive financings. Our success has allowed us to declare our fifteenth consecutive quarterly dividend. Today, I will first cover recent economic events that directly influence our business and commercial real estate markets. Gregg will then review our financial results and I will conclude with noteworthy accomplishments that occurred in Q2 and our progress toward achieving our longer-range objectives. We will then take your questions.

The outlook for US real estate in 2015 remains strong against a backdrop of an increasingly healthy labor market, moderate economic growth, and the expectation of rising interest rates. The preliminary estimate of second quarter GDP growth came in slightly below expectations at 2.3%, which is still an acceleration from first quarter growth. Both consumer spending and net exports picked up in Q2 confirming expectations that the economy has shrugged off some of the factors that slowed growth in Q1. Furthermore, first quarter growth was revised upward from negative (0.2%) to positive 0.6%, a positive for full-year growth prospects. Oxford Economics forecasts GDP growth will be a moderate 2.3% for the year.

Job growth has continued at a solid rate throughout the second quarter. Year-to-date job growth has averaged 211,000 jobs a month through July, sufficient to drive continued declines in the unemployment rate, which fell 20 basis points in the second quarter and ended July at 5.3%, a post-recession low. Initial jobless claims remain well-below their long-term average and job openings continue to rise. Moody's Analytics predicts hiring will remain strong for the remainder of 2015, resulting in full year growth of roughly 2.8 million jobs, just below last year's strong numbers. A robust labor market increases the likelihood that the Fed will begin normalizing interest rates.

Other economic indicators are mixed, however. The ISM Purchasing Managers' Index rebounded in the second quarter, indicating that the US manufacturing industry is back in expansion mode. Furthermore, there are signs of a pickup in the housing market, with home sales up and homebuilder optimism hitting a 10-year high. However, retail sales growth remains subdued, despite the positive impact from lower oil prices, as wage growth has yet to pickup. Nonetheless, the tightening labor market is increasingly likely to drive wage growth in coming quarters, which should spur retail sales in turn.

The ongoing economic recovery and related labor market strength drove improvement in the fundamentals of each of the four main property types during the second quarter. Office and warehouse markets continue to see the largest year-over-year vacancy declines, with vacancy rates in both sectors falling 100 basis points. National Office vacancy rate now stands at 13.5% as employers absorbed 8.2 million square feet of additional office space in the second quarter, according to REIS Inc. The National Warehouse vacancy has fallen to 9.9%, a vacancy rate now below the lowest level of the previous cycle. Apartment and retail vacancy rates also fell, to 3.7% and 6.1%, respectively. For retail, this was another 10 basis points of vacancy decline in what has been a slow, but steady recovery for this sector. The 3.7% apartment vacancy rate is the lowest ever recorded for the apartment sector spurring attractive rent growth in this property type. Looking ahead, accelerating construction of new apartments will make it more challenging for vacancy in this sector to continue to decline.

Rent growth remains strong, with rent increases on both an annual and quarterly basis in all four property sectors. Nationally, warehouse rents made the most progress, growing 4.7% over the past year. Office and apartment rent growth were also both strong, at 3.9% and 3.8%, respectively, on a year-over-year basis. Retail rent growth continues to lag as compared to the other property types; however, at 2.6% annual rent growth still outpaces annualized inflation.

Real estate capital markets remain very active, despite this year's greater interest rate volatility. Second quarter transaction volume came in below the first quarter’s record numbers, but was still quite strong with $87 billion of office, industrial, retail, and apartment properties traded. Valuations also continued to climb in the second quarter across a wide range of markets with cap rates near, or in some cases below, previous market lows. Liquidity has strengthened in secondary markets and for lower quality assets as investors search for yields amidst record low cap rates in gateway markets. Buyers with the lowest cost of capital continue to bid aggressively to win trophy properties in gateway or coastal markets.

Looking ahead, given the healthy labor market and a solid 2015 GDP forecast, real estate demand should remain strong for the balance of the year. While new construction is increasing in some markets, we expect occupancies to remain high and rents to continue growing. The potential for financial market volatility is a greater risk with the Fed still expected to begin raising interest rates. Nonetheless, our expectation is for rate hikes to be well-managed, resulting in a slow and steady increase to interest rates. This has the potential to stabilize valuations in the US commercial real estate markets, however we do not believe it will reverse recent gains or negatively impact transaction volumes.

Within JLL Income Property Trust, we continued to build on first quarter's momentum in the second quarter as we closed three new property investments. The robust property markets, along with the tireless work of our acquisitions and asset management teams, allowed us to execute on our strategic priorities and shortly after quarter end we completed another acquisition further diversifying our portfolio. I will discuss these and other Q2 activities in greater detail after Gregg gives you a recap of our financial performance. Gregg?

GREGG FALK

Thanks, Allan. I'm going to briefly walk through our financial results and certain operating statistics for the three and six months ended June 30th and describe some of the key underlying drivers of our performance.

In the second quarter, the Company had a net loss of $0.4 million or $0.01 per share compared to net income of $0.9 million or $0.02 per share for the second quarter of 2014. For the six months ended June 30th, we had net income of $23.2 million or $0.45 per share compared to net income of $2.2 million or $0.05 per share for the same period last year. The decrease in net income for the second quarter was primarily related to the disposition of our four student housing properties that occurred during Q1 2015, which were owned throughout 2014. The disposition resulted in an accounting gain on sale recognized during the six months ended June 30th, 2015.

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. FFO was $7.1 million, or $0.13 per share for the second quarter of 2015 compared to FFO of $7.4 million, or $0.16 per share for the second quarter of 2014. For the six months ended June 30th, FFO was $13.3 million or $0.26 per share compared to $14.8 million or $0.34 per share for the same period last year. The decrease in FFO for the second quarter and for the first half of the year between 2015 and 2014 was primarily related to the sale of our student housing properties during 2015.

We also use Adjusted FFO or AFFO as a supplemental measure of operating performance. AFFO is calculated as FFO adjusted for non-cash items and one-time non-operating expenses. AFFO was $6.8 million or $0.13 per share for the second quarter of 2015 compared to AFFO of $6.4 million or $0.14 per share for the second quarter of 2014. For the six months ended June 30th, AFFO was $13.8 million or $0.27 per share compared to AFFO of $13.0 million or $0.30 per share for the same period last year. The slight increase in AFFO for the second quarter and first half of the year was primarily related to the positive influence of our new acquisitions and our office properties. For the rolling four quarters ended with this second quarter, our FFO to dividends paid coverage was 120% and our AFFO to dividends paid coverage was 116%.

Enhancing the operational performance of our properties continues to be one of the key priorities of our asset management team. At quarter end, our total portfolio occupancy was stable at 98% and increased 1% from the prior year. Our weighted average lease duration at June 30, 2015 was 6.6 years, down from 7.4 years in the prior quarter. The decrease is primarily related to the acquisition of DFW Distribution Center as that property has a weighted average lease term of approximately 4 years. We are comfortable with adding a few shorter duration leases to our portfolio as this is a multi-tenant property with a good mix of lease durations ranging from six years at the long end to two years at the short end.

Looking at each operating segment which we define as our primary property types, our apartment occupancy remained stable at 96% this quarter, an increase of 3% from the prior year.

Our industrial occupancy remained unchanged at 100% this quarter. This will be the thirteenth consecutive quarter having our industrial segment fully occupied.

Our overall office occupancy decreased by 3% this quarter to 93% due to tenant vacancies at 111 Sutter Street dropping its occupancy to 85%. However, we have three LOIs executed and leases are currently being negotiated, which would bring the occupancy at 111 Sutter Street up to 93% by the end of Q3.

Our retail occupancy was stable at 96% this quarter and increased 3% compared to last year primarily due to the sale of a non-grocery anchored property in 2014.

In all cases, our segment occupancies compare well with national averages of 96% for apartments, 90% for industrial, 87% for office and 94% for retail. Overall, we feel positive about the occupancy of the portfolio, which is near or better than national averages across all property types.

On February 6th, May 1st, and August 7th, we paid gross dividends of $0.12 per share related to the fourth quarter of 2014 and the first and second quarters of 2015. These gross dividends were paid out to stockholders, but were reduced for share-class specific fees.

On August 6, 2015, our board of directors approved a gross distribution for the third quarter of 2015 of $0.12 per share to stockholders of record as of September 29, 2015, payable on or around November 6, 2015. Again, this dividend will be reduced by share-class specific fees for all stockholders.

In terms of share value, the NAV per share of our Common Stock as of June 30th was between $10.76 and $10.79 per share. The NAV of each share class increased this quarter as a result of increasing property valuations and a positive impact from property operations.

For the first six months of 2015, our various classes of common stock have provided stockholders a total return of between 3.8% to 4.4% and annualized returns ranging from 6.2% to 9.1% since we launched our initial public offering in October of 2012.

Now, I'll hand the call back over to Allan to discuss a few of our significant accomplishments for the quarter.

ALLAN SWARINGEN
Thanks, Gregg.

As I mentioned earlier, we had a very active second quarter as we acquired three properties in 2Q and closed on an additional new acquisition right after quarter-end. In April, we acquired DFW Distribution Center, a two building, 643,000 square foot multi-tenant industrial property located in Grapevine, Texas, for approximately $44.3 million. This acquisition, located proximate to the Dallas-Fort Worth International Airport, was financed with a ten-year, interest only, mortgage loan that bears interest at a fixed-rate of 3.23%. The property is 100% leased to six different tenants.

On May 15th, we acquired Skokie Commons, a newly constructed 93,000 square foot grocery-anchored retail property in an in-fill location in Skokie, Illinois, for approximately $43.8 million. This acquisition was financed at approximately 50% loan-to-value with a fixed interest rate loan at 3.31% for 10 years. The property is 97% leased, with Mariano's supermarket, a leading specialty grocer in the Chicago market, as the anchor tenant, and other strong national tenants such as Starbucks and Bank of Amercia, that will further enhance the stability of the property. This investment provides exposure to a major metropolitan city, just north of Chicago, and is anchored by a strong, New Age grocer in a demographic area ranking in the top 5% nationally in population density.

At the end of May, we acquired Townlake of Coppell, our third acquisition of Q2, a 398 unit garden style apartment property, for approximately $43.2 million. The acquisition was financed with a five-year mortgage loan that bears interest at a fixed-rate of 3.25%. Townlake of Coppell is strategically located in an infill location in northwest suburban Dallas, Texas. The property has historically been well-occupied and should maintain strong occupancy due to the highly desirable school district and community amenities, such as two-resort style pools, an expansive playground, basketball court, and a 24-hour fitness center. This investment expands our apartment portfolio in a mature, bedroom community that has benefitted from its close proximity to DFW airport, local high-end retail shopping and downtown Dallas.

Acquiring new properties with low leverage has allowed us to maintain our Company leverage ratio between our target range of 30% to 50%. At June 30th, our Company leverage ratio was 40%. For the quarter, our weighted average interest rate on outstanding borrowings decreased from 4.6% at March 31st to 4.4% as of June 30, 2015.

During the quarter we also extended and expanded our revolving line of credit with Bank of America. The new facility has a two year term with a one-year extension option and includes an accordion feature which allows us to expand the available balance up to $75 million. This expanded credit facility provides us with greater flexibility and capacity to pursue our strategic objectives in this highly competitive capital markets environment. The new facility will be used to accelerate acquisitions and provide us with available working capital as needed.

On July 30th, just after quarter-end, we acquired AQ Rittenhouse, a newly constructed, 110 unit, 12-story apartment building located in downtown Philadelphia for approximately $51 million using available cash on hand. We intend to obtain a mortgage loan at an approximate 50% loan to value on this investment. The property is located in the trendy Rittenhouse Square neighborhood that has become a Millennial magnet in recent years. This newly constructed property features studio, one and two bedroom units with condo-quality finishes and numerous tenant amenities including a rooftop lounge and outdoor patio with unobstructed views of the Philadelphia skyline. This investment is our second recent apartment acquisition and also increases our exposure to the Eastern region of the United States.

With the acquisition of the AQ Rittenhouse, we now own 29 different properties in our portfolio, comprised of 11 industrial warehouses, 5 grocery anchored retail centers, 6 office buildings, 5 apartment complexes and 2 parking garages. In total, we now own almost 7 million rentable square feet.

The cornerstone of our investment strategy will continue to focus on acquiring and actively managing higher-quality income-producing commercial real estate properties across the four primary property sectors. We believe this strategy will enable us to provide investors with a portfolio that is well-diversified across all property types, geographic regions and underlying tenant industries, both in the United States and, over time, internationally. At the end of Q2 our portfolio diversification by property type was 17% for Apartments, 26% Industrial, 29% Office, 24% Retail and 4% Other, with Other being our two parking garage investments.

We are extremely pleased with our recent accomplishments. Since 2012, we have raised nearly $500 million of new capital. We have also disposed of 21 non-strategic properties generating approximately $310 million in sale proceeds. With this capital we have acquired 17 new properties (all of these consistent with our go-forward strategy) investing approximately $470 million. We also repaid or refinanced over $280 million in higher interest rate and higher loan-to-value loans and have repurchased more than $130 million of our shares, returning capital to stockholders that desired liquidity or chose to reduce their allocations to core real estate.

As I mentioned earlier, we declared our fifteenth consecutive quarterly dividend to our stockholders beginning with the first quarter 2012. We continue to offer our investors stable dividend payments fully covered by our cash flow from operations and at one of the highest dividend coverage ratios in the non-listed REIT industry. Offering an attractive level of current income for distribution to our stockholders is one of our primary investment objectives.

Lastly, we remain the preferred daily NAV core real estate offering in the marketplace attracting more capital than nearly all of our competitors combined. We have also significantly expanded our distribution partnerships, which now span ten different wealth management platforms representing wirehouses, private trust banks, RIA's and major national independent broker dealers.

We continue to see strong inflows of new capital as economic and real estate market conditions are favorable. 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. As we grow our portfolio of diversified core properties, we remain committed to actively managing our real-estate assets to provide attractive income returns to our stockholders.

Our target acquisitions remain well located, well leased industrial properties and grocery-anchored community oriented retail properties. We also intend to further rebuild our multifamily allocation through acquiring conventional apartments that may provide growth to our portfolio as our economy continues to expand. We will also dispose of properties when we see better risk-adjusted returns in other property types and markets. We are very pleased with our accomplishments in the first half of the year and are confident we can continue to add value to our portfolio and generate moderate appreciation over time for our stockholders.

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

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 comes from Stan Barrett. Please proceed with your question.

<Q>: Yes. Hi. You mentioned your focus is on purchasing and managing high quality income-producing core properties, what are your thoughts on core versus opportunistic, and at what time do you think it's better to invest in each, given your prior comments about where we're at in the market cycle?

ALLAN SWARINGEN

Great. Thanks for the question, Stan. A couple points on that. I think it's as we kind of talked about, especially in the first part of the call related to property fundamentals. The fundamentals today are very, very strong. We're seeing strong and improving occupancies, we're seeing rent growth across all of our four primary property types, we're seeing strong job numbers, and so the underlying fundamentals are very strong and those continue to kind of—we think support the current valuations of core properties and hopefully provide a growing stream of income from the ownership of those sort of properties.

There's all sorts of conversation out there in the popular press talking about calling tops of the markets or bubbles and all sorts of things like that, but I think in that case you've really got to look at what are investors' objectives and investors that are looking for something in their portfolio to make an allocation to diversification; to investments that diversify their portfolio; to investments that provide income; to investments that have lower correlations to other asset class returns.

We feel like core is still well-positioned to meet those objectives and in just making a comment about the opportunistic side, those folks that are trying to execute opportunistic strategies in the United States, I think they're pretty much focused on new developments and I think new developments as opposed to what we're doing, where we're principally a long-term fixed rate borrower, developers are typically short-term floating rate borrowers and I think they're going to be much more susceptible to the concerns about rising interest rates than what core real estate is. So we like core in the current market cycle. It's what we're doing and then we're going to stick to our knitting.

OPERATOR

Our next question is from Bert Olsen. Please proceed with your question.

<Q>: Yes. Thanks. Allan, you touched on this low interest rate environment. Can you talk a little bit how real estate stacks up as an alternative source of income for investors like myself?

ALLAN SWARINGEN

Yes, Bert. Thanks for the question. I was looking at the 10 Year Treasury right before we came in and with everything going on in China and the devaluation of the yuan, the Treasury has strengthened a lot—I think it's about at 2.2%, and it was down about 2.15 yesterday. So that's your risk-free rate, 2.0% if you want to own 10 Year Treasuries and lock money up for 10 years.

As far as different sources of income, the liquid alternative of listed REITs provide a little bit better return than the 10 Year Treasury, but have a lot more volatility. Private real estate, and our strategy is providing greater current return than that, and any sort of bond investment these days at the current low interest rate environment—we all know how the math works in a rising interest rate environment.

Bonds, by definition have to lose value so you're going to have a decline in the principal value and core commercial real estate does not necessarily perform that way. It may, but we also have the ability to grow our income stream and in a rising interest rate environment, hopefully we continue to have this improving economy and improving jobs, and as a landlord of nearly 7 million square feet, our asset management teams believe over time that they can continue to grow our rent and we might have the ability to kind of offset movement and cap rates which should follow the risk-free rate.

So we're very focused on long rates, not so much on short rates and the Fed is going to move the short rates so nobody knows exactly how the long rates are going to move over time. So for us, we spend a lot of time thinking about interest rates, but mostly from the standpoint of trying to be sure we are limiting our interest rate exposure. We do that by principally borrowing long-term fixed rate 10-year mortgages, 7-year mortgages, 15-year mortgages and locking interest rates at the time of a purchase of a property, so we have very little floating rate interest rate exposure, and we're going to keep it that way.

As far as how core real estate stacks up, again we feel like the risk-adjusted returns are still very strong. They're not at peak spread but they're about 25, 30 year average spread to the risk-free rate so we still feel like core real estate is fairly priced, at least as compared to the risk-free rate.

OPERATOR

Our next question comes from Chris DeMario. Please proceed with your question.

<Q>: Thanks, operator. Allan and Gregg, it seems as if property market fundamentals are improving across the board. I was wondering if you could touch on how these improving fundamentals are impacting, not just the current portfolio but also your acquisition strategy.

ALLAN SWARINGEN

Thanks, Chris. It seems like you kind of have a two part question there, so let me break it up in two parts. The first is the strong fundamentals and how it impacts our current portfolio. We're very optimistic about the performance of what we own today. We're 98% leased and occupied across the portfolio to almost a standard that seems nearly impossible that we could continue to maintain, but we've kept it up there now for a number of quarters.

We are seeing rent growth. Some of it's embedded in our lease structure, some of it is just as we renew tenants in a stronger and healthier environment we're able to capture rent growth with leases roll, and so we see embedded in the current portfolio the ability to grow our income modestly over time, not huge numbers but modestly. And we're also seeing healthy valuation gains in our share price. I mean, if you look at how our share prices performed, Gregg highlighted that—we've had very strong share price movements over the last few quarters and it's given the health of the portfolio we own today and the strength of those assets in their marketplace.

So we feel like that somewhat substantiates that we're thoughtful buyers and active asset managers, so that's what I'd take away in the current portfolio. As it relates to our acquisition strategy, certainly the weight of capital and the strength of capital that's trying to get into core real estate and various different markets, it does make acquiring the quality of assets that we're trying to acquire competitive, so in some ways we've got to be smarter than others, I'd say, and I think we have the potential to do that.

We're still very focused on trying to acquire new assets that kind of improve and enhance the existing portfolio to meet our investment objectives which are stable value, and durability of income and moderate appreciation over time, and we're more about protecting through asset management and enhancing value versus taking significant risks. So we're still seeing good opportunities to deploy capital with acquisitions. To get a little bit more granular on that, we're still sticking to the strategy that we've had for a couple years now; that we want to continue to expand our grocery-anchored retail presence and we acquired one of those in 2Q.

We continue to want to expand our presence in the big bulk distribution warehouse, industrial markets and we bought one of those in 2Q, and I would say what we've added to our strategy over the last 12 months is an attempt to expand our exposure to the apartment sector which we believe, over time will give us the opportunity to grow rent given their shorter lease nature than some of the longer-term leases we've got in our grocery-anchored retail and our warehouse properties.

So we are looking to invest a little more actively at the shorter end of the curve through our parking garages and through continuing to expand our exposure to apartments, which we think will give us growth if the economy takes off here and interest rates chug along. So that's how the strong property fundamentals are impacting our acquisition strategy.

OPERATOR

There are no other questions and this concludes today's call. I will hand the call back to Allan Swaringen for closing remarks. Allan?

ALLAN SWARINGEN

Great. Thank you, Rob. I'd like to thank everyone for joining us on today's call and we look forward to updating you again next quarter about our continued progress.