Transcript of
JLL Income Property Trust
2Q18 Public Earnings Call
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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 would like to welcome you to their Second Quarter 2018 Earnings Conference Call. This call is being recorded, and our audience lines are currently in listen-only mode. A brief question and answer session will follow the formal presentation. [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 – Senior Portfolio Accountant
Thanks. 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 June 30, 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 August 10, 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 and Chief Executive Officer
Thanks, Sam. Hello, everyone, and thank you for joining us for our Second Quarter Earnings Call. During the second quarter JLL Income Property Trust continued to focus on actively managing and improving our $2.6 billion portfolio of 69 core properties that span the apartment, industrial, office, and retail property sectors.

Our strong operating performance through 2018 so far has positively impacted the investment performance of our portfolio. In the second quarter we achieved total net of fees returns of 1.5% and 1.6% on our Class A and M shares, respectively. Quarterly dividends have now been paid for 26 consecutive quarters, with an average annual increase of 5.1% over that six-plus-year period. Our NAV grew to approximately $1.6 billion at the end of the quarter. Our Q2 accomplishments will be covered in more detail, but first let me review the economic environment in which we operated during the first half of the year.

Given a push by corporate and individual tax cuts, high levels of consumer confidence and federal spending growth, economic conditions remain strong in the second quarter despite the introduction of new tariffs on steel, aluminum, and Chinese imports. US GDP increased at a seasonally and inflation-adjusted annual rate of 4.1%. This marks the strongest growth since 2014. While this rate of growth is not likely sustainable, Oxford Economics forecasts full-year 2018 growth to be near 3% and only slow slightly in 2019.

US payrolls grew by 211,000 jobs per month on average during the second quarter, up from their pace a year ago. Tenants continue to expand their footprints at a similar pace to deliveries of new construction, resulting in stable or slightly lower vacancy for all property types. Industrial vacancies declined 10 basis points to 7.2% in the second quarter, and is down 30 basis points over the last year. US seaports are reporting year-over-year increases in loaded inbound container volumes, which aligns well with our strategy to invest in properties near hubs of transportation.

CBD office vacancies declined to 10.5%, 20 basis points lower than a year ago. National suburban office vacancy was flat relative to a year ago, at 14.5%. In line with the typical seasonal pattern, apartment vacancy declined 30 basis points in the quarter to 4.9%, 10 basis points lower than a year ago. Apartment demand remains strong, in line with the strength of the employment market. The US is on track to achieve multi-family rent growth of 3% or more in 2018 according to a multi-family research report by Marcus & Milichap

In the retail sector, despite continued headline grabbing store closures, preliminary data shows open-air retail vacancy was flat in the second quarter, at 6.8% nationally. Focusing on the retail sector, there continue to be headlines regarding the weakness impacting retail, or what is often referred to as Retail Armageddon. However, we believe this story is too generalized and oversold. While it is true that online sales are growing, internet sales represent only 8.4% of total retail sales for 2018. For the quarter ending June 30th, nationwide retail and food services sales grew 5.9% from the same period a year ago.

Additionally, vacancies for grocery and drugstore-anchored retail centers has been in a consistent flat or downward trend for seven consecutive years. Our strategy of investing in high-quality, grocery-anchored retail centers has been equally as resilient. At the end of the second quarter, our retail portfolio occupancy increased to 95% and base rents grew 3.2% from the same period a year ago.

As the e-commerce industry grows and the full cost to build out distribution networks is better understood, it is becoming apparent that the relative cost advantages for internet sales are dwindling. New legislation recently was passed that allows states to tax internet companies regardless of a physical presence in that state, which will allow for more competitive pricing for brick-and-mortar stores. We believe our focus on investing in centers with strong demographics and a tenant mix of largely necessity-based retailers will be minimally impacted by the growth of e-commerce sales and continue to yield strong performance for our portfolio.

After slowing down in 2017, investment transaction volumes have stabilized, and through June were 2% above last year's pace. Private real estate returns were in line with the previous quarter, with the NCREIF Property Index showing a total return of 1.81% in the second quarter, with a 1.14% income return.

Market returns for 2018 are trending towards a range of 6% to 8%, consistent with our long-term expectations. The spread between NCREIF income yields and the US 10-year Treasury rate is 179 basis points as of quarter end, below its 15-year average, but similar to a quarter ago. During the last cycle in 2007 this spread reached an all-time low of 98 basis points.

The economy's performance over the past couple of years has benefitted our portfolio in terms of leasing, occupancy, and our outlook for future rent growth. The near-term economic outlook is somewhat unclear since the US property market has entered the later stages of the bull cycle, but the passage of the Tax Cuts and Jobs Act is increasing spending. We believe we are positioned well for a slowing in growth in the economy, with a strong presence in both grocery-anchored retails and industrial markets that should continue to be in high demand. For the remainder of the year we expect increasing occupancies and rental growth to be in line with inflationary expectations.

Gregg will now discuss the portfolio's financial performance, before I continue with Q2 results. Gregg?

Gregg Falk – Chief Financial Officer

Thanks, Allan. Our operating performance continues to be strong through the second quarter of 2018. As I highlight our financial results, I will discuss the key underlying drivers of our performance.

We reported total revenues of $84 million for the first six months of the year, an increase of 5% and 40% over the same period in 2017 and 2016, respectively. The Company reported operating income of $50 million through June 30th, which represents a 2% increase over the same period in 2017 and a 16% increase over that period in 2016.

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 six months ended June 30th we reported FFO of $35.9 million, an increase of approximately $1 million, or 2% from the prior year, primarily due to the contributions from our new acquisition. Our year-to-date per share FFO through June 30th was $0.27 compared to $0.26 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 $500,000 from Q1 to reach $16 million in Q2, and $31.5 million year-to-date. Our per share AFFO for the six months ended June 30th was $0.24, compared to $0.23 for the prior year. We feel positive about the portfolio occupancy, which was 92% at the end of the quarter. Our occupancies by segment were 94% for Apartment, 91% for Industrial, 93% for Office, and 95% for Retail.

Leasing activity remains robust, with 65,000 square feet of new and renewal leases completed during the quarter and 137,000 square feet leased over the past six months. Our weighted average lease duration at June 30th was six 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 third quarter of 2018 at $0.13 per share to stockholders of record as of September 28th, payable on or around November 1st. These gross dividends will be paid out to stockholders, but will be reduced for share class specific fees, if any.

In Q1 we announced that we reduced the dealer/manager fees on Class A shares from 1.05% to 0.85% of net asset value annually, and eliminated the fee on Class MI shares. As dealer/manager fees are deducted from dividends paid to stockholders, these reductions of 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 to Class MI 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 6.4% 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.

Our NAV per share increased by 0.6% in Class A and 0.5% on Class M shares when compared to Q1 as a result of a net increase in the value of our portfolio. Most notably, during Q2 the portfolio experienced robust appreciation within the Office sector, with values increasing by 5.7% on an annualized basis.

Valuation gains were generally attributable to favorable market conditions driving increases in both the rent rate and investor demand. 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 strategy.

Allan Swaringen – President and Chief Executive Officer
Thanks, Gregg. To highlight Q2 accomplishments, we focused on our strategic acquisition initiatives. We acquired Villas at Legacy, an amenity-rich 328-unit apartment community located in Plano Texas in June. The acquisition of this property supports our investment strategy, given its desirable location, with an affluent renter base, highly-rated schools, and strong market fundamentals and demographics. Just after quarter end we also closed on two additional apartment communities in suburban Boston. We will continue to seek out new investment opportunities that align with our objectives.

Also in Q2 we closed on a $45 million loan on 180 North Jefferson, our 274-unit apartment community in downtown Chicago, at a fixed interest rate of 3.89%. This financing is aligned with our goal to de-risk our portfolio from rising interest rates. Across our portfolio, 93% of total debt is at a fixed rate, which gives us confidence in this rising interest rate environment.

Our overall company leverage ratio remained consistent at 38% at the end of Q2, 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 team of nearly 6.6 years and our weighted average interest rate on outstanding borrowings is 3.8%.

Turning to our stock transactions, in Q2 we repurchased approximately $15 million in shares pursuant to our share repurchase plan, which had a second quarter limit of $78 million. For the third quarter 2018 share repurchases will have a limit of approximately $80 million, which is 5% of the NAV of the company as of June 30th. 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 12-month holding period.
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 half of the year we invested

approximately $9.8 million of capital improvements in our existing portfolio, all geared towards maintaining our higher occupancies. At the end of Q2, our portfolio diversification by property type was 26% for apartments, 23% industrial, 19% office, 31% retail, and 1% 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 modest appreciation over time. As evidenced by our increasing NAV, our asset management team continues to strengthen our portfolio through carefully planned investments and leasing opportunities. 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 second 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 during the remainder of the 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
At this time, I will open the lines for your questions. [Operator instructions]. Our first question comes from Matt Blackburn [ph]. Please go ahead.

Q: Thank you. You'd mentioned suburban apartment acquisitions, I'm just curious, what are your views on urban versus suburban properties?

Allan Swaringen – President and Chief Executive Officer
Thanks, Matt. In the second quarter we added our tenth apartment community, and then right after the second quarter we acquired our eleventh and twelfth. So, overall, if you look at our strategy over the last couple of years, the biggest shift has been adding high-quality apartment communities. Today we own, as I said, 12 communities, it's about $730 million gross assets of our $2.6 billion, so it's 28% of our overall portfolio. The big shift I talked about is if you looked at our portfolio a number of years ago we were significantly underweight to apartments, and now we continue to add them.

Across the 12 communities we own, four would be considered urban and city urban areas, such as downtown Chicago, or in St. Paul, and [indiscernible] San Diego; and eight of them would be probably more characterized as suburban. Though, if you look at the value of the properties we own it's really about 40% urban and only 60% suburban, so looking at the number of properties can sometimes lead you to a different conclusion.

The reality is we very much like both markets and believe they contribute nicely to our portfolio for different reasons. The characteristics of the urban apartments we're focused on owning and acquiring is very much geared toward the local amenities and the close in proximity features.

To measure that, we actually are big believers in a website and characteristics for apartments developed by walkscore.com. If you look at walkscore.com in a certain area, they calculate the distance to neighborhood restaurants, and coffee shops, and grocery stores, and parks, and other amenities, also public transportation and commuter lines. So, we're very much focused in the urban markets on properties that we think are in areas our research and strategy team calls millennial magnet areas. We're very focused on high quality starting jobs, so we're attracting a younger base of renters who really want to live in a vibrant, energetic community. So, that typifies our downtown strategies.

Our suburban market properties, different than that, are very focused on school districts and being sure that the communities we own are in areas with highly rated elementary, middle, and high school education opportunities. We believe as renters move out of the urban environment and are starting their families, they're going to be very focused on being sure that their kids have the opportunity to go to very good schools. So, our focus in the suburban markets are in these school areas.

We also tend to focus in apartments in areas where the single family housing pricing is substantially higher than what it would be to rent. In that way we think we attract and retain renters because it's not necessarily easy to move that rental cost stream to homeownership if the average price of a home is 5 times more than maybe what we would own the apartment units for.

So, that is a little more color on why we like both categories, both urban and suburban. We're going to continue to add those to our portfolio over time if we find the right deals.

Operator
Thank you. Our next question comes from Jack Smith. Please go ahead.

Q: Thank you for taking my question. Year-over-year revenue and funds appropriation growth has been up. What is the main driver for your growth?

Gregg Falk – Chief Financial Officer
Revenue increased about $4 million year-to-date, which was about a 5% increase over last year, and FFO increased about $1 million, which was about a 2% increase over last year, really driven by three different areas. First, we've had some positive operating results from our office segment. We've seen some nice increasing rents out at our San Francisco office building, 111 Sutter Street.

The second, we implemented a lease décor strategy for the apartment segment, and in that we had acquired Dylan Point Loma a couple years ago when it was about 30% leased. Now, we have successfully leased that up into the mid-90s and consider that completely leased up to a core standard at this point, and that's generated some nice revenue and FFO for us.

But, by and far, the largest generator of these increases really came from the revenue and FFO generated from our new acquisitions. The properties that we acquired using new capital that we raised and recycling some capital through some sales that we had made late last year and earlier this year have really contributed greater revenue and FFO growth to the portfolio.

So, a positive direction that we're heading in and we're really pleased with the results that we've had so far. Thanks, Jack.

Operator
Our next question comes from Joe Werner. Please go ahead.

Q: Thank you for the update, Allan. You spoke about paying down your line of credit this quarter. What's your strategy around leverage given the low interest rate environment?

Allan Swaringen – President and Chief Executive Officer

Joe, it's interesting, we do get a lot of questions about our approach to leverage, and while it's still a relatively low interest rate environment we certainly expect interest rates to continue to rise. The Fed fund rate has moved up substantially in the last couple years, moving the short end of the curve up, and they're also saying that they expect to have two more rate increases. So, we're very cognizant that rates are more likely to trend up than trend down accordingly.

As you mentioned and Gregg covered in his notes, we did pay down our line of credit by $45 million at the end of the quarter, and left us with a relatively small balance of $55 million and with a line of over $200 million, and that gives us a lot of dry powder, actually $145 million of undrawn capacity on the revolver component of that overall facility. But we continue to focus on locking in long-term interest rates, and during my comments I mentioned that we put long-term financing on one of our apartment communities here in Chicago, locked that rate, I think, at a 3.89% interest rate.

So, we're very focused on being sure that we don't have floating interest rate exposure. Ninety-three percent of our borrowing across the portfolio is fixed rate, and that leaves very little floating rate exposure, and we're going to continue to do that.

We also, of the solutions in the market today, we continue to be the one that's operating at the lowest leverage, with at the end of the quarter only a 38% loan-to-value, so that's relatively low leverage in the current market environment. We're pretty cognizant that we're in the later cycle of whatever cycle we're in, it's hard to think that we're anything other than the last few innings. So, we're going to continue to be sure we have very little floating rate exposure. We want long duration borrowings and fixed rate, and we're going to keep our overall loan-to-value pretty low and let others take that interest rate expense and higher LTV risk.

So, that summarizes our overall approach to the current interest rate environment, Joe.

Operator
[Operator instructions]. Our next question comes from Joan Lanius-Nichol with US Trust. Please go ahead.

Q: Hi. I lost the call for a few minutes, so I apologize if any of this question has already been addressed, so just bear with me. I'd like you to help understand a little bit more for me on the retail side. You made the comment about—I'd like to understand the concept of what open air retail means. And, secondly, when you made the earlier comment about this essential kind of element of a crossover period as state tax internet sales, the idea that that potentially creates more of a block or a wall relative to the brick-and-mortar concept. Can you elaborate a little bit more on how you analyze those crossover points and give a little more description about what you're looking at?

And the other thing is, I'd also like to understand when you allocate your sectors, apartment, industrial, office, etc., are you involved in data centers, and does data center come within the industrial segment? And, if you do have any distribution centers, are distribution centers considered retail or industrial?

And then the last piece is, what do you think, or have you thought about when you look at the apartment sector where the concept of these elegant, what I'll call assisted living types of facilities, fit within your perspective of value or non-value.

Allan Swaringen – President and Chief Executive Officer
Joan, great. Wow, I think I got all that down. If not, I'm going to ask my team to help me cover all that, but I appreciate you dialing in and your questions. So, let me tackle the retail question you asked first.

To put a finer point on our strategy, throughout our portfolio we've been narrowly focused in a single format of retail, and that format is, for the most part, suburban grocery-anchored shopping centers. We don't own malls. We don't own power centers. We don't own department stores. We don't own discount off-price centers. We own neighborhood and community grocery-anchored shopping centers, that we've looked at in the underwriting of buying those properties and we're quite confident that the local demographics, the people that live within a three to five-mile radius have the incomes to support that grocery-anchored shopping center and that we think over time they will support that.

We believe that, in fact, Amazon's purchase of Whole Foods, paying $7 billion or $8 billion for Whole Foods to buy 600-plus brick-and-mortar grocery stores, is really an affirmation of our strategy. If Amazon could have gotten into the grocery business by delivering them through trucks they would have done that, but they said the grocery business is going to be driven by brick-and-mortar.

So, we actually believe that's an affirmation of our strategy, and we own two Whole Foods in the portfolio, one in west suburban Houston and one in the island of Maui. Since Amazon bought those Whole Foods we've seen increased traffic at those stores, and actually the stores, the other shop spaces that are adjacent to our grocery stores are also seeing increased foot traffic, and sales traffic, and everything. So, we actually are excited about Amazon's movement into the grocery store space.

But we're very focused in that kind of retail. My comments earlier was it's hard to pick up any popular press, whether it's the *Wall Street Journal*, or *Barrons*, or any investment article, that's not talking about the decline of brick-and-mortar retail, and I do think there is some risk of that, but in these other formats. We really don't see the penetration of online sales and e-commerce in the grocery store space, and that's what we've been focused on for the last five or six years, that's what we own in our portfolio. I think Gregg mentioned that our overall retail portfolio is 95% leased and occupied, I'm pretty sure that was the number you gave. We maintain a very high occupancy across our retail, so 95%, Gregg's confirmed that. So, that's how we think about the grocery-anchored retail space.

You asked about our exposure to warehouse properties, and distribution centers, and also data centers. We are not in the data center business and we do not own any data centers. All of our warehouses, we have 28 warehouse properties across the portfolio, it's 22% of our portfolio, all 28 of those warehouses, industrial spaces are having some sort of tenants that are logistics, moving goods and services.

We actually have Amazon as a tenant in one of our warehouses, and I visited that building up in Northern California a few weeks ago, and they have drivers coming in in herds loading up the drivers and then taking stuff back out. So, stuff's brought in on big trucks and then it's broken down into small segments and then it's shipped back out to other folks.

Most of our warehouse, industrial buildings, are really moving goods across the chain of distribution. We do have a few warehouses where, I'd say, there might be some light manufacturing in the back of the warehouse, but then some sort of distribution out of the front.

So, we're not in the data center business. It has been a very good business. We've kept our eye on the data center business, but we think that's very technology driven and the folks that are really making good investments in the data center space really need to understand the technology things that are driving that and where companies need to be located, and where the intersection of the fiber lines are, and all sorts of things that are not our area of expertise. That's very specialized real estate. We focus more on the four primary food group, which is office, apartments, retail, and industrial.

Then the last question you asked about our apartments is assisted living, and that's not a space that we're investing in now. We've looked at senior living, senior lifestyle living, and we may make investments in that down the road. But all of our apartment communities now, the 12 we own, 8 in suburban markets, 4 in downtown urban markets, they're traditional 12-month apartments with regular renters. We do have two properties that have a low income housing component, where 10% of the units are set aside for affordable, but most of the whole portfolio is market rate apartments with typical 12-month leases.

The assisted living area and the senior lifestyle living area, it is often those apartment communities, because these tenants are looking for additional services, sometimes enhanced healthcare, sometimes food service, sometimes rehabilitation type services, they get into a little bit more of a business component. And while we've looked at that, if we chose to get into that space we'd be doing that with probably a partner who's really an expert at providing those additional services, because it's real estate that comes with something else and you have to be able to provide that food service, that additional healthcare, often transportation services, and special skills that are not within our bailiwick right now. So, we've chosen to stay away from that. We have looked at it, but it's not in our portfolio today.

Joan, hopefully, I hit all three questions there, but if I didn't let me know.

Q: You did. Very helpful. Thank you.

Operator
There are no other questions. This concludes today's call. I will hand the call back over to Allan for closing remarks.

Allan Swaringen – President and Chief Executive Officer
Great. Thank you, everyone. We look forward to updating you all next quarter after the end of the third quarter and our performance for the first three quarters of the year. Thank you.