Transcript of
JLL Income Property Trust
2Q19 Public Earnings Call – Q&A
August 15, 2019

Participants

Allan Swaringen – President & CEO
Gregg Falk – CFO
Sam Selzer

Presentation

Operator
On behalf of JLL Income Property Trust, I'd like to welcome you to their second quarter 2019 earnings conference call. This call is being recorded and our audience lines are currently in a listen-only mode. [Operator instructions.] At this time, I would like to turn the conference over to Sam Selzer, from JLL Income Property Trust. Sam, please go ahead.

Sam Selzer
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, 2018, 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, 2019.

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 9, 2019 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
Thanks, Sam. Hello, everyone, and thank you for joining us for our second quarter earnings call. JLL Income Property Trust continues to focus on managing and growing our $2.8 billion-dollar portfolio of 73 core properties spanning the apartment, industrial, office, and grocery-anchored retail property sectors. In the second quarter, we achieved total net of fees returns of 1.3% and 1.5% on both Class A and M shares, respectively. Quarterly dividends have now been paid for 31 consecutive quarters, with an average annual increase of 5% over that 7-plus year period. I would like to begin today's discussion by giving an overview of the economic environment in which we operated, before highlighting some of our specific accomplishments from this quarter.

The US Economy continued steady economic growth in the second quarter, with the US Bureau of Economic Analysis reporting 2.1% GDP growth. The labor market – a key driver of tenant demand for space – also remains strong, according to data from the US Bureau of Labor Statistics. The national unemployment rate of 3.7% is lower than it has been 99% of the time since 1990. Hiring remained strong in July, with 164,000 new jobs that month, just below the trailing twelve-month average of 187,000. Overall in the second quarter, job growth averaged 157,000 new jobs per month. However, there are signs growth is beginning to moderate. GDP Growth was down from the previous quarter, PMI surveys are signaling the potential for slower growth ahead, and the yield curve has become inverted again. In response to these signals of slowing, in July the Federal Reserve decided to lower its benchmark interest rate for the first time since 2008 in what they described as a "mid-cycle adjustment".

Since the end of the second quarter, there has been a re-ignition of vitriolic trade rhetoric between the US and China, leading to increasing volatility in equity and interest rate markets. The negative impact of economic sentiment has not yet weighed on real estate markets, and the fall in interest rates has at least temporarily boosted returns for leveraged borrowers.

Vacancies declined for all major property types except open-air retail last quarter, according to data from CBRE. Office vacancy improved the most over the last year, tightening by 60 basis points to 12.2%, followed by apartments with a 50 basis point drop to 4.1%. Apartment vacancy is now at a cycle low. Industrial vacancy, already near record lows, moved 10 basis points lower to 4.3%. Open-air retail vacancy rose 10 basis points in the second quarter and has been flat over the last year.

Industrial rents rose fastest over the last year, rising by 6.3%. Office rent growth picked up 5.1% year-over-year, though this was in part helped by the addition of new construction buildings with higher rent levels to the sample set. Apartment rent growth maintained recent momentum with 3.1% rent growth. Retail rent growth remained positive at 2.5% year-over-year.

Looking ahead to construction deliveries in 2019, LaSalle is forecasting that office may overtake apartments in terms of new supply. Office construction deliveries are likely to equal 1.8% of existing stock in 2019, a cycle high. Warehouse construction is slightly higher, at approximately 2.2%. While office deliveries are up significantly from 2018, expected apartment and industrial deliveries this year are very similar to their 2018 totals.

As measured by the NCREIF Property Index, interest rate declines in the first half of 2019 increased real estate income spreads to both ten-year Treasuries and corporate bonds, widening by 65 and 80 basis points, respectively. This helped boost listed REIT pricing to a slight NAV premium relative to private values after more than two years of trading at a discount. Real estate transaction volume across the four major property types totaled $114 billion, up from both the seasonally slow first quarter and the comparable period a year ago.

While still showing green, private real estate returns slowed in the second quarter, primarily driven by a dip in returns from mall properties, which recorded negative appreciation in the quarter. Industrial properties in the NCREIF Property Index had a trailing return of 13.9% through Q2 2019. Regional malls and power centers were the worst performing retail subtypes while neighborhood and community centers still had positive appreciation in Q2. Garden apartment returns continued to outperform the NPI average, office returns were very close to the all property index average, and high-rise apartment returns were slightly below the NPI average.

The economy's overall sustained growth, while muted, continues to benefit our portfolio in terms of leasing, occupancy and rent growth. We continue to focus on investing in higher quality, stabilized real estate that is diversified across property type and geographic market to generate durable income and positive returns for our investors.

Gregg will now provide a recap of our portfolio's financial performance results for Q2 before I continue. Gregg?

Gregg Falk

Thanks, Allan. Our strong operating performance continued through Q2, with total quarterly revenues of $41 million dollars, compared to $42 million dollars in the prior year. The decrease of $1 million dollars was related to the sale of 111 Sutter Street, but was partially offset by the revenues from our new acquisitions. Second quarter net loss was $3 million dollars compared to net income of $3 million in the prior year. The decrease in net income was primarily attributable to non-cash fair-value adjustments to our interest rate swaps.

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 $28.5 million, which equates to $0.20 cents per share, a decrease of $0.07 cents per share from 2018 as a result of the non-cash fair-value adjustments to our interest rate swaps.

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 for the first half of the year was $32.5 million, an increase of 3% over the prior year. Per share AFFO was $0.23 cents per share.

Portfolio occupancy increased to 96% at the end of the second quarter. Our occupancies by segment were 93% for apartment, 99% for industrial, 92% for office and 94% for grocery anchored retail. Maintaining higher occupancies continues to be an area of focus for our asset management team. In the first half of 2019, we experienced robust leasing activity, with over 700,000 square feet of new and renewal leases signed. Most notably, there was a 400,000 square foot vacancy filled at Kendall Distribution Center, an industrial property located near Atlanta, Georgia. The lease is for seven years to a high-quality logistics company. Industrial rental growth continues its upward trend, and competition for quality space is expected to grow rents throughout the rest of 2019 and into 2020.

We strive to offer a reliable and attractive level of current income to our stockholders that steadily grows over time. On August 8, 2019, our Board of Directors approved a gross dividend for the third quarter of 2019 of $0.175 cents per share, which includes a one-time, special dividend of $0.04 cents per share and a regular dividend of $0.135 cents per share. The $0.04 cents per share special dividend allows the company to reduce certain state income taxes due from the capital gains on the sale of 111 Sutter Street. The 111 Sutter Street sale generated a $120 million taxable gain that was fully sheltered from federal taxation at the company level and should result in the dividends paid throughout 2019 to be primarily characterized as long-term capital gains, a reduced tax rate as compared to ordinary income tax rates for most stockholders. Certain states also assess REIT income taxes.

Through the special dividend, totaling approximately $6 million dollars, along with other tax mitigation efforts, the company saved over $2 million from our initial state tax estimates. In these situations, which are fairly unique, we would rather pay cash to our stockholders in the form of special dividends than have the company incur taxes. The dividend is payable on or around November 1, 2019 to stockholders of record as of September 27, 2019. On an annualized basis, the regular portion of the gross dividend is equivalent to $0.54 cents per share and represents a yield of approximately 4.4 % on a NAV per share of $12.21 as of August 7, 2019. All stockholders should receive $0.175 cents per share less applicable share class specific fees and the annualized yield will differ based on the share class. Dividends per share have increased 4% year over year. JLL Income Property Trust has declared thirty-one consecutive quarterly dividends to its stockholders beginning with the first quarter of 2012.

Since we launched our initial public offering in October of 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 investment opportunities that will further diversify our portfolio, enable moderate NAV growth, and generate favorable risk-adjusted returns.

Our NAV grew to over $1.8 billion at the end of the second quarter. Valuation gains were generally attributable to favorable market conditions. New and renewal leasing activity also had an impact on valuation gains, such as the new lease signed at Kendall Distribution Center, which led to an attractive appraisal lift in Q2. Our daily NAV methodology has provided stable market valuations, as evidenced by our sub 2% standard deviation of share price, and we have realized moderate appreciation in share price since we began the 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 highlight some Q2 accomplishments.

Allan Swaringen
Thanks, Gregg.

To highlight Q2 strategic initiatives, we acquired two new properties in May. First, we acquired Stonemeadow Farms, a 280-unit premier apartment community in the desirable Seattle suburb of Bothell, Washington for $81.8 million dollars. At approximately $292,000 per unit, this garden-style community is well aligned with our investment strategy. The property's higher quality and strategic location within a highly rated school district fits well within our suburban apartment strategy. Second, we acquired an industrial distribution center that is one of two buildings that comprise Grand Prairie Distribution Center. The warehouse is located in Grand Prairie, TX serving the growing Great Southwest industrial market and was acquired for $16 million dollars. We have closed on approximately $330 million dollars of gross acquisitions so far this year on pace with our 2019 business plan.

Our overall company leverage ratio decreased to 34% at the end of Q2. 100% of our total debt is currently fixed rate. With limited near-term debt maturities, we have a portfolio-wide weighted average remaining loan term of approximately seven years and our weighted average interest rate on outstanding borrowings is 3.7%. As of June 30th, our portfolio diversification by property type was 32% Apartments, 26% Industrial, 11% Office, 29% Grocery-Anchored Retail and 2% Other, which currently consists of two parking garages.

Looking at our stock transactions this quarter, we repurchased approximately $18 million dollars in shares pursuant to our share repurchase plan, which had a second quarter limit of $86 million. For the third quarter 2019, share repurchases will have a limit of approximately $91 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 the stockholders who desire to rebalance their asset allocations subject to the quarterly limits and a twelve-month holding period.

We remain focused on investing capital in the industrial, apartment, and grocery-anchored retail sectors, as well as complementary low beta strategies such as medical office, which fulfill key portfolio investment goals of reliable income and moderate NAV growth over time. During Q2, we reinvested approximately $5.5 million dollars of capital improvements in our existing portfolio, all geared towards maintaining our higher occupancies.

We remain committed to actively managing our real-estate portfolio to deliver competitive risk adjusted returns, preserve investor capital, and realize moderate appreciation over time. Our NAV has continued to steadily grow as our asset management team strengthens our portfolio through carefully planned investments and leasing opportunities. Financial Advisors and Portfolio Managers are looking for both diversifying investments and alternative sources of income and core real estate is well positioned to provide both.

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 confident that we will continue to add value to our current portfolio and look forward to growing and further diversifying our investments throughout the balance 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 we'll be conducting a question-answer session. [Operator instructions]. Our first question is from Mike Laudizio. Please proceed with your question.

Q: You had mentioned portfolio occupancy has been increasing and is primarily driven by your leasing activity. Could you expand on your leasing efforts? Thanks.

Gregg Falk
Thanks, Mike, I'll go ahead and take that. Yes, we utilize a very active asset management structure here to get in front of lease maturities and get out in front of new tenants to try to drive occupancy in our portfolio. During the second quarter we increased our occupancy across the portfolio from 94% to 96%. With that, we've done 250,000 square feet of renewal leases in 2019, which represent about $2.7 million of rent. The weighted average rent renewal rate was up 10.4% on those 250,000 square feet.

We've also, as I mentioned, the Kendall [ph] lease, we signed other new leases totaling about 430,000 square feet in 2019, representing about $2 million of annual rental income. And those rents were up about 3.6% over the last rent that was in place for the previous tenant. Feel good that we are able to drive rents in vacancies as well.

And then finally, we're already working on our 2020 lease expirations, and have signed over 200,000 square feet of lease renewal, representing about $3.8 million of rent. So very active with our leasing program and having some really good success there. Really appreciate that question, thanks, Mike.

Operator
Our next question is from Jack Eastman. Please proceed with your question.

Q: Good morning. It was a strong quarter for new acquisitions for IPT. Could you please provide more color on those new investments?

Allan Swaringen
Thanks, Jack. As I mentioned in our prepared remarks, it wasn't active. It has been an active kind of first half of the year in terms of acquisitions, closing nearly $330 million of new investments. I think what we're most pleased about our acquisition pipeline and what we've closed year to date is that it's really tracking very well with our business plan in terms of continuing to diversify our portfolio. We closed five individual acquisitions for seven different properties, but those properties are really spread across our three primary targets for expanding the allocation this year. So we've closed two properties in the industrial sector, one in Southern California in Fremont, and one in Dallas in the Great Southwest park [ph] area. We closed a really nice medical office building, that two-property complex in San Diego, and we've also closed two very high-quality apartment communities that are in keeping with our strategy to acquire apartments in suburban markets with highly rated school districts; one in suburban Seattle in Bothell, Washington, and another in Chandler, Arizona, a suburb of Phoenix.

So very diverse pipeline, but right in keeping with our business plan. I say we continue to have a strong pipeline of acquisitions for the balance of the year. Capital raising is up, and that's exciting for us, and we're still seeing good investing opportunities.

Operator
Our next question is from Max Stegner. Please proceed with your question.

Q: Thank you. How does the earn interest rate environment affect the portfolio? And what is your outlook given the Fed's recent [audio drops] and the ten-year treasury below 2%?

Allan Swaringen
Thanks for that question, Max. Gregg and I will tag team that a little bit. I'll kind of cover it more from the macro perspective, and I thought it's just worth remarking here, I thought it was interesting that we commented in our prepared remarks that everything from the trade war to—well, principally, I guess, but the trade war and the uncertainty of the economy is continuing to cause extraordinarily volatile equity markets, and also interest rate markets, and certainly yesterday was an example of that. We commented that the in-yield curve had been inverted, and then it even delivered that for us yesterday, too.

It's a tumultuous time out there in traditional asset classes, and we still feel like real estate is performing very well at kind of both the fundamental and risk adjusted levels. I'd say from an interest rate standpoint, the ten-year, really as low as it is is a surprise to us, but on the upside, we're taking advantage of that surprise, and we're locking down as much long-term fixed-rate loans on properties that we think are long-term holds. And while we're keeping our overall leverage ratio low, it's a great time to be a borrower. We're going to continue to take advantage of those low interest rates.

I'd say the downside of the very low interest rates is, as a low leverage core buyer targeting high single-digit returns, we continue to compete with capital for the same deals that are targeting mid-teens returns and they're leveraging investments that 75%, 80%. The low interest rates have really brought in more competition for investments that that competition had kind of been weeded out of the market when the ten-year was up over 2.5% and getting closer to 3%. It's been both a good news and a bad news thing.

Specifically how we're dealing with low interest rates with our portfolio, I'll ask Gregg to provide a little more color on that within IPT.

Gregg Falk
Sure, thanks, Allan. Our target leverage range is 30% to 50%, with us having the target of being 40% loan to value as the kind of fully invested threshold. Today we're a little bit under levered at 34% LTV. We're 100% fixed-rate debt. Weighted average interest rate is about 3.7% with seven years of remaining life weighted average on that same [ph] debt. What you're going to see us do is take out some of our larger assets that are currently unencumbered and lock in long-term fixed-rate mortgages, generally from life insurance companies. We see this as an opportunity to really reduce our overall cost of debt, and it's most efficient to use our bigger assets to go out and get this debt.

Even at these low interest rates debt is plentiful. We are seeing great competition from life insurance companies when we go out to bid on these mortgage loans and feel like we're in a great spot to really take advantage of it.

Thanks a lot for that question, Max.

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

Allan Swaringen
Great, thanks, Omar, appreciate your help today. I would like to thank everyone for joining today's call. We look forward to updating you again after we close out the third quarter of 2019. Thanks and have a good day.