

Transcript of
JLL Income Property Trust
2Q22 JLL Income Property Trust Public Earnings Call
August 17, 2022

Participants

Allan Swaringen - President and Chief Executive Officer, JLL Income Property Trust
Gregg Falk - Chief Financial Officer, JLL Income Property Trust
Sean Nolan - Senior Portfolio Accountant, LaSalle

Presentation

Operator

On behalf of JLL Income Property Trust, I'd like to welcome you to the Second Quarter 2022 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 Sean Nolan [ph] from JLL Income Property Trust. Sean, please go ahead.

Sean Nolan

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, 2021, 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, 2022.

Links to a transcript and audio replay of this call will be posted and available on our website, JLLIPT.com until September 17, 2022. For further information on the Company's performance, we invite you to review our Quarterly Report on Form 10-Q filed on August 11, 2022 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, 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, Sean. Hello, everyone, and thank you for joining us for our second quarter earnings call.

As of June 30th, our portfolio aggregated to \$6.7 billion-dollars comprised of 128 core properties spanning the residential, industrial, healthcare, office, and grocery-anchored retail sectors. We realized an approximate 0.9% income return, 0.7% appreciation return and an overall 1.7% total return for the second quarter on our M-I share class. Quarterly dividends have now been paid for 42 consecutive quarters, with an average annual increase of 3.8% over that more than 10-year period. Durable income and modest appreciation across market cycles, from core stabilized assets, remain the cornerstones of JLL Income Property Trust's investment thesis.

Before delving into further detail on our second quarter accomplishments, I will provide our usual overview of the broad economic environment in which we operated.

Signals coming out of the US economy and real estate markets in the second quarter leave little doubt that the pace of economic growth has slowed. To some degree, this loss of momentum is by design, as the Fed hikes interest rates in an effort to stamp out high inflation. Headline GDP growth was negative for a second consecutive quarter in Q2, yet labor market indicators remain strong – putting the economy in limbo between its recovery from COVID disruption and a possible recession. Inflation remained elevated in the second quarter, but the first signals from the third quarter indicate the peak of inflation rates could be behind us.

Property market fundamentals have not been immune from the heightened macro uncertainty. Yet fundamentals started from a position of strength, and property sectors beginning to see some vacancy increases are starting from record low levels.

Apartment vacancy has begun to tick higher from its all-time lows. National apartment vacancy rose from 2.4% in March to 3.6% in June. Sub-3% apartment vacancy was unsustainable and, while rent growth is cooling, owners continue to have pricing power and rents are keeping pace with inflation. Q2 apartment rents grew 13% year-over-year. Similar dynamics exist in single family rentals with a 2.2% vacancy rate following a 10 basis point increase from last quarter, based on publicly traded REIT data. Single family rental blended lease-trade-out was steady and strong at 11%.

For industrial, open-air retail, and medical office, vacancy declined in Q2. Industrial demand kept pace with supply deliveries as 3PLs and other users picked up some of the slack left by Amazon, sending national vacancy rates down 10 basis points to 2.8%, another all-time low. Industrial rent growth remains torrid, rising in Q2 at an annualized pace above 20%. Open-air retail vacancy continued its recovery, declining 20 basis points to 6.3%. Rent growth has been positive, albeit below inflation, at 2.6% year over year.

Medical office vacancy improved by 20 basis points to 8.6%. By contrast, conventional office continues to be a negative outlier and is showing more signs of stress from slowing economic growth as several major tech-industry office tenants, like Amazon and Meta, tempered their plans for near-term office expansion. Overall, national office vacancy rates increased another 10 basis points to 16.9% last quarter. Office rents are stagnant and remain below pre-pandemic levels.

Fed rate hikes and rising interest rates broadly have been felt in the real estate capital markets, resulting in smaller bidding pools and moderately higher cap rates. Higher leverage buyers are less competitive or out of the market for some property types due to debt costs that exceed income yields. Transaction data through June began to show tapering growth in volume – June 2022 was flat relative to June 2021 - but this tends to be a lagging indicator. Feedback from LaSalle's acquisitions team based on deals in the market points towards a slowing market relative to last year, but still one where transactions are getting done. In the broader institutional markets, the NCREIF Property Index, or NPI, returns are also cooling. The quarterly NPI return slowed to 3.2% in Q2, down from 5.3% in Q1. This slow-down in property appreciation was expected and is forecast to continue even as property income remains stable.

While financial conditions have tightened, there continues to be market liquidity, particularly for property types other than office. For low-leverage core investors, the combination of these capital market shifts with still strong market fundamentals is likely to contribute to rising income returns in the year ahead, and it is resulting in higher go-forward expected returns for asset acquisitions today than at the peak of the market in late 2021 and early 2022.

Having covered the industry-wide performance and market update, Gregg will now share a closer look at our portfolio's financial performance during Q2 before I continue. Gregg?

Gregg Falk

Thanks, Allan. 2022 has been a strong year, with \$157 million in year-to-date revenues, as compared to \$109 million dollars in the prior year, which represents a 44% increase. The increase is primarily related to new acquisitions made in 2021 and 2022 and an increase in rental rates and occupancy. Net income was \$14 million dollars for the first half of the year compared to net income of \$26 million dollars in the prior year. The decrease in net income was primarily driven by performance fees accrued during 2022 as a result of our strong year to date investment performance and non-cash interest expense related to our DST Program.

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 first six months, we reported FFO of \$22 million dollars, a decrease of 46% from the prior year, primarily related to the accrual of performance fees during 2022 and non-cash interest expense related to the DST Program of \$19 million. Year to date FFO was \$0.10 cents per share.

We also track adjusted funds from operations, or AFFO, as a supplemental measure of operating performance. AFFO is calculated as FFO adjusted for non-operating expenses and non-cash items. AFFO through June 30th was approximately \$51 million dollars, an increase of \$18 million dollars from the prior year, primarily related to the acquisitions made 2021 and 2022. Year to date AFFO was \$0.23 cents per share.

Stabilized occupancy remained strong through the second quarter of 2022 with the portfolio leased at 96% at June 30th. Our occupancies by segment were 99% for Industrial, 95% for Residential, 93% for grocery-anchored Retail, 81% for Traditional Office, and 97% for our Healthcare portfolio. Maintaining higher occupancies through active tenant retention strategies continues to

be a priority of our asset management team. The team has been focused on working with current and potential tenants to sign new and renewal leases. Trading lease term extension and early renewals in exchange for future lease execution risk is a strategy of our asset management team, which has provided great benefit for us today and we expect will continue to do so into the future. Through the second quarter, we signed new and renewal leases for over 800-thousand square feet, with a weighted average rent increase of 7.0% over the previous rental rate or underwritten rental rates. These efforts have driven an approximate 10% increase in same store operating income from the first six months of this year compared to the same period last year. Active asset management has been a key to our strategy since we launched in 2012. One of the primary ways that we generate predictable, attractive income for distribution to our stockholders is through long-term lease agreements with higher credit tenants. We also continue to strive to lengthen the weighted-average lease term of our overall commercial portfolio, which was 6 years at the end of Q2.

Offering a reliable and attractive level of current income to our stockholders that steadily grows over time is a primary focus of JLL Income Property Trust. On August 9th, 2022, our Board of Directors approved a gross dividend for the third quarter of 2022 of \$0.14 cents per share to stockholders of record as of September 22, 2022. The dividend is payable on or around September 29, 2022. All stockholders will receive \$0.14 cents per share, less share class specific fees, and the annualized yields will differ based on share class.

Since we launched our initial public offering in October of 2012, we have provided net of fees annualized income returns of 4.4% and an appreciation return of 4.2% for a total return of 8.8% over that nine plus year period for our no fee share class.

Our NAV grew to approximately \$3.4 billion at the end of the second quarter. Our daily NAV methodology has provided stable market valuations, as evidenced by our 3% standard deviation of share price.

Throughout the second quarter, we reinvested approximately \$10.3 million dollars of capital improvements into our existing portfolio, all geared toward maintaining our higher occupancies.

Now, I'll hand the call back over to Allan to discuss our key second quarter activities.

Allan Swaringen

Thanks, Gregg.

Our second quarter has been exceptionally busy with transaction activity, as we expanded our portfolio with eight new acquisitions, totaling approximately \$242 million dollars. This includes two industrial, three retail, and three medical office properties. The first property we acquired was Northeast Atlanta Distribution Center, a 458,000-square-foot, Class A industrial property located in the Northeast Atlanta industrial submarket. The recently constructed, long-term leased, single-tenant warehouse was acquired for approximately \$54 million. The second industrial property that we acquired were two additional buildings within the Southeast Phoenix Distribution Center portfolio, totaling 245,000-square-feet. The property is located in Chandler, Arizona and was acquired for approximately \$62 million.

Turning to the retail properties, we acquired Patterson Place, a 25,000-square-foot open-air shopping center in Durham, North Carolina. This property is anchored by Duke Medical Plaza, a long-term leased medical office building which was also recently acquired as an addition to our growing healthcare allocation. Patterson Place was acquired for approximately \$14.5 million. In Q2 we also acquired Silverado Square, a 48,000-square-foot grocery-anchored shopping center located in Las Vegas, Nevada, which is anchored by Sprouts. This property was acquired for approximately \$24 million. The final grocery-anchored retail property was acquired at the end of the quarter. Woodlawn Point Shopping Center is a 98,000-square-foot property, anchored by Publix who has an in-place 11-year lease, located in the Northwest Atlanta suburb of Marietta, Georgia and was acquired for approximately \$35 million.

The final three acquisitions are related to our healthcare portfolio. The first property acquired was Cedar Medical Center at Flagstaff, a newly constructed, state-of-the-art medical office building in Flagstaff, Arizona. The single-story, 26,400-square-foot property was acquired for \$17.2 million. We also acquired North Boston Medical Center, a 30,000-square-foot medical office property located in Haverhill, Massachusetts and North Charlotte Medical Center, a 25,000-square-foot medical center located in Stanley, North Carolina. The total price for both properties was approximately \$35 million. The weighted average lease term across these three portfolio additions was 10 years. These smaller medical office building additions add substantial lease term to our overall portfolio.

Our portfolio diversification by property type at the end of Q2 was 43% Residential, 31% Industrial, 13% Grocery-anchored Retail, 8% Healthcare, 4% Traditional Office, and 1% Other, which currently consists of two parking garages.

Our overall company leverage ratio decreased to 36% at the end of Q2. 75% of our borrowings are at a fixed interest rate and we have minimal debt maturities over the next three years. Our portfolio-wide weighted average remaining loan term is five years and our weighted average interest rate on outstanding borrowings is 3.1%. While our portfolio is substantially immunized from rising interest rates, we intend to closely monitor rate movements and will employ leverage judiciously as and when it is accretive to target risk-adjusted returns. During the second quarter, we closed a new \$1 billion credit facility with a syndicate of nine market-leading real estate lenders. The credit facility contains a \$600 million revolving component and a \$400 million term loan component and includes an accordion feature that can increase the facility up to a total of \$1.3 billion.

As for our stock transactions, we repurchased approximately \$26 million dollars in shares pursuant to our share repurchase plan during the second quarter, which had a quarterly limit of \$162 million dollars. Third quarter 2022 share repurchases will have a limit of approximately \$172 million dollars, which is 5% of our NAV as of June 30th. Stockholders should aspire to be long-term investors and hold our shares for seven to ten years or longer. Our share repurchase plan is available to stockholders subject to the quarterly limits and a twelve-month holding period.

Over the last ten years, we have built what we believe to be a strong, stable real estate portfolio with a conservative strategy and resilient balance sheet, and we will remain true to our disciplined core investment philosophy. The fundamental reason for including real estate in a portfolio is long-

term performance. Since inception from October 2012, JLL Income Property Trust has delivered attractive net of fees total returns of 8.8%, while consistently focusing on core, stabilized lower-risk investments.

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 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

Certainly, at this time, I will open the lines for your questions. [Operator Instructions] Your first question is coming from Anthony [indiscernible]. Please pose your question. Your line is live.

Q: Thanks, Allan. So you mentioned you decreased your leverage ratio to 36%. Can you talk a little bit more about your thinking behind that reduction?

Gregg Falk

Hey, Allan, I'll take that one. So yes, we were at 42% LTV at the end of last year, as you mentioned that June 30, we're down to 36%. Originally coming into 2022, our plan was to increase our leverage closer to 45% given the historically low interest rate environment we've been living in for so many years. With all the economic uncertainties out there, we changed our plan to start using less mortgage debt. We really just felt that was not a good time to take on added risks. Yes, negative leverage that is out there right now. And by negative leverage, I mean, its situation where the mortgage debt, the interest that you're paying on it is more than the property is generating in the cash yield. So it becomes negative leverage from our standpoint.

But luckily, we did complete our new \$1 billion credit facility early in Q2 before much of the capital market disruptions were occurring. Facility allows us to borrow at around 3.6%, 3.7% today which is accretive to our returns, what you're going to see is that we are likely going to continue to use the credit facility along with capital that we're raising through the sale of our common stock and our DSP program to acquire attractive investments through the remainder of the year. Thanks for that question, Anthony.

Operator

Your next question is coming from Matt Blackburn. Please pose your question. Your line is live.

Q: Thank you. Regarding your portfolio rent growth, and the real estate industry's latest rent growth, do you have a view as to sustainability of that level rent growth? Thanks.

Allan Swaringen

Yes, Matt. Certainly, the kind of unprecedented rent growth we're seeing especially across our two largest property sectors, which are residential and industrial, which again make up about three-fourths of our portfolio today, it truly is somewhat amazing to have seen this double-digit rent growth, gosh for coming up on almost 12 months now. It's certainly a part of on the residential side, it's part of the inflationary story.

But I think from both a single family rental and apartment rent growth story, I think the Fed at least is going to somewhat fight a losing battle with their interest rate increases, because the mortgage rates for single family homes are significantly up, back off a little bit over the last few weeks, but just a month or two ago were at near 10 year highs and that really makes housing less affordable, single family housing for ownership which causes folks to rent longer and to stay in apartments and not typically move out of apartments into the typical migration into single family homes.

So, hopefully, the Fed interest rates will continue to do their interest rate increases, will continue to do their jobs on energy costs and rising energy and rising food costs and other components of the economy. And they seem to be making a little headway there. But our expectation is that, we may continue to see, I wouldn't expect double-digit rent growth going forward. But when we typically forecast and underwrite properties, we historically have underwritten much more modest rent growth, it's not inflationary, historic inflationary rent growth in 2% to 4%.

What we're seeing now in actuality is significantly higher than that. And at some point in time, that will create a supply response. Developers develop and as they see abnormally high rent growth, they will buy land and they will get zoning and they will build new buildings. It's a continuous kind of virtuous cycle of commercial real estate in the United States and we expect to see that in industrial and the residential sectors, but one of the unique aspects of our asset class real estate is that there's a fair amount of lead time to develop.

And the supply response is not like Apple, dialing up China and say, hey, we need an extra million dollar -- extra million units of iPhones next month, crank up the factories, that's not the way real estate works. It was often a one to two to three year lead time to manufacture our product, our inventory. And so we're anticipating above normal rent growth for the next 12 to 24 months, not teens, not double-digits, but above trend line, historic rent growth and low single digits. We expect it will be up 7%, 8%, 9% percent rent growth going forward until we see that supply response. It will come though. And we're being very careful and thoughtful about markets we invest.

We like properties in markets where we feel like there's significant barriers to new construction. So we think that supply response hopefully will be in markets not head on against us. So still optimistic about continued above historical trend line rent growth, but not mid-teens rent growth, like you've been seeing over the last few quarters in the apartment, in the industrial sector.

Q: Appreciate it.

Operator

[Operator Instructions] Your next question is coming from Joe [indiscernible]. Please pose your question. Your line is live.

Q: Hi, Allan, you've posted strong investment performance in the first half of the year between 11% and 12% year-to-date. What's your outlook for the second half of the year?

Allan Swaringen

Well, Joe, thanks for that question. And first off, we don't really give guidance in terms of point for returns or targets. But I'm happy to I think kind of debug a little bit what's happened in the first half of the year. And give you our thoughts in terms of where we see the opportunities and what our outlook is for the second half of 2022. I think in looking at our kind of very strong returns through June 30, you've got to really break it down into what happened in Q1 and what happened in Q2. And Q1 as you know, I believe we have one of the more independent arm's length valuation processes and procedures where every single property in our portfolio is reappraised independently every single quarter.

And so what happened during the appraisal cycle of Q1 was we were seeing two impacts of the appraisals both declining capital, declining capital market metrics, principally declining cap rates and declining discount rates. And we were also seeing strong rent growth, which I mentioned in the earlier question. And both of those impacts drove returns up significantly to actually, Q1 was our strongest investment performance in a single quarter in our 10 year history. And so that led to that somewhat abnormally happily with strong Q1 investment performance.

We had a shift in Q2, given the interest rates and movements. And what happened there was we actually saw cap rate and discount rate trends reverse with modest increase to cap rates, modest increase to discount rates, but we still saw strong rent growth. And when you drop those into the long-term outlook over the 10 year cash flow, the appraisals, the rent growth went out over the capital markets metrics. And so we still saw a positive Q2 return, which we were quite happy with. Our 1.7% return in Q2 was our normal 1% income, and about 0.7% appreciation. So we felt good about that. I don't think in as we continue to the balance of the year and based upon what we're looking at in terms of acquisitions and where pricing is going, I think we're likely to continue to see some softening, not major softening, but some softening of capital market trends.

So you might see flat to modestly increasing cap rates and discount rates. But we're still seeing that strong appreciation numbers. So our outlook is 0.4 returns probably more in line with what actually happened in Q2 than what happened in Q1, which still puts us in line for a pretty strong return year. So we're happy about that. I think I'd say about that is what we do like is the high level of occupancy we have in our portfolio, 96% leased and occupied, in our world core real estate is anything generally over 90% occupied and anything over 95% is relatively heroic.

So we're quite happy with how our portfolio is positioned. We feel good about the sustainability and outlook for our dividend. And also we're seeing better pricing. So as cap rates and discount rates have moved out, our underwriting for future transactions is quite positive. We're seeing while

slower deal flow because interest rates have -- higher interest rates have chased out the leverage buyer, we're seeing less competition for transactions. And we're pretty enthusiastic about the opportunities to invest our dry powder, kind of after Labor Day late in the third quarter and early in the fourth quarter. It's historically where we see some of our best deal flow and our best pricing, all sorts of reasons why folks are motivated to sell and get something sold by the end of the year. And so anyway, we'll see how that plays out.

But pleased with the returns today, outlook is a little bit more muted long-term, still positive. But also good transaction activity where we think we can invest more accretively in the back half of the year than maybe what we were able to in Q1. Hope that's helpful. And as you think about going forward, Joe.

Q: Thank you, Allan.

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

Thank you all for joining today. We look forward to updating you at the end of the third quarter on how things will look through 9/30. Thanks for joining us today.