Transcript of
JLL Income Property Trust
3Q22 JLL Income Property Trust Earnings Call
November 16, 2022

Participants

Allan Swaringen - President and Chief Executive Officer, JLL Income Property Trust
Gregory Falk - Chief Financial Officer, JLL Income Property Trust
Jill Passmann – Assistant Portfolio Controller

Presentation

Operator

On behalf of JLL Income Property Trust, I'd like to welcome you to the third quarter 2022 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 Jill Passmann, from JLL Income Property Trust. Jill, please go ahead.

Jill Passmann

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 September 30, 2022.

Links to a transcript and audio replay of this call will be posted and available on our website, JLLIPT.com until December 13, 2022. For further information on the Company's performance, we invite you to review our Quarterly Report on Form 10-Q filed on November 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, Jill. Hello, everyone, and thank you for joining us for our third quarter earnings call.

As of September 30th, our portfolio aggregated to $7.2 billion-dollars comprised of 136 core properties spanning the residential, industrial, healthcare, grocery-anchored retail and office sectors. And it's worth noting that 80% of our portfolio is in those first three property sectors – residential, industrial and healthcare – three of the top performing property sectors which have had such standout performance that they are euphemistically referred to as "beds, sheds and meds". We realized an approximate 0.9% income return, 0.3% appreciation return and an overall 1.3% total return for the third quarter on our M-I share class. Quarterly dividends have now been paid for 43 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 third quarter accomplishments, I will provide our usual overview of the broad economic environment in which we operated.

Although GDP grew again in the third quarter after two consecutive quarters of contraction in Q1 and Q2, the economy overall is showing signs of slowing and the outlook is more negative than it was earlier this year. Despite a dimming outlook, the labor market remains strong, adding 1.1 million payrolls in Q3. Inflation remains well above the Fed target level of 2%, leading the Federal Reserve to raise its target rate by another 75 basis points in November, bringing the target range to 3.75 to 4% up 375 basis points so far in 2022.

Property market fundamentals are responding to the more challenging economic environment differently by sector, but in most cases, fundamentals are entering this period from a position of strength. Apartment vacancy is inching up from record all-time lows due to softening demand. National apartment vacancy rose from 2.3% in February to 4.2% in September. Sub-3% apartment vacancy was unsustainable, and while rent growth is cooling, owners continue to have pricing power. Q3 apartment rents are up almost 9% from a year ago. Single family rental vacancy remains very low but increased slightly to 2.7% in Q3 2022, up 70 basis points from a year ago based on listed REIT data. SFR blended lease trade-out continued to be quite strong at 11%, beating apartment rent growth. Looking ahead, residential demand is expected to be resilient as home buying is less attractive at the current 7% mortgage rates, a 20-year high.

Industrial warehouse markets remained tight in the third quarter even as new supply out-paced continuing strong demand. Industrial availability rates increased ten basis points quarter over quarter to 4.7%. Warehouse rent growth remains strong, rising in Q3 to 12.8% annually. Industrial demand is forecast to decline with a slowing economy, but a decrease in construction starts means we expect the warehouse markets to remain in-balance and we may continue to see rents move higher over the next 3 to 4 years.

Conventional office remains an underperforming outlier with vacancy rates well above historic average levels. Office demand remains weak and as a result vacancy rates increased. The outlook remains negative for the office sector with job cut announcements being seen across a diverse set of industries, leading office tenants to pause expansion plans, downsize their footprints, and offer space into the sublease market.

Life science leasing has slowed as companies are less aggressive on expansion due to capital constraints. However, the total 2022 leasing is still on pace to surpass recent historical activity. Sublease availabilities doubled in Q3 to 4.0 million square feet. Slowing construction and current low vacancy rates should mitigate softness in this sector. Medical office is largely not impacted by the shifting economic outlook and in the third quarter national vacancy rates improved by ten basis points to 8.7%. Open-air retail vacancy continued its recovery, declining 20 basis points to 6.1%. Rent growth has been positive, at 2.9% year-over-year.

Fed rate hikes, rising long-term interest rates, and anticipation of a recession have been felt in the real estate capital markets. This has resulted in smaller bidding pools and higher cap rates. In addition, higher-leverage buyers are less competitive or out of the market due to debt costs that exceed income yields and life companies and banks nearly closing their doors until next year. Transaction data through September show that volumes have slowed; September 2022 transaction volume of $39 billion was less than half the volume of September 2021. Transaction activity has been limited in part due to the spread between a buyer's pricing and the seller's expectations. Debt financing is becoming more challenging and expensive, still possible, but only for established borrowers. The NCREIF Property Index, or NPI, returns remain positive but are slowing. The quarterly NPI total return was 0.6% in Q3, down from 3.2% in Q2.

While financial conditions have tightened, there continues to be some transaction activity, particularly for property types other than office. Moreover, for low-leverage investors, capital market volatility has created attractive buying opportunities for long-term buyers.

Having covered the industry-wide performance and market update, Gregg will now share a closer look at our portfolio’s financial performance during Q3 before I continue. Gregg?

Gregg Falk

Thanks, Allan. 2022 has been a strong year, with $244 million in year-to-date revenues, as compared to $170 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. Year to date net loss was $12 million dollars compared to net income of $7 million dollars in the prior year. The decrease in net income was primarily driven by non-cash interest expense related to our DST Program of $19 million.

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 nine months, we reported FFO of $47 million dollars, a decrease of 8% from the prior year, primarily related to the non-cash interest expense related to our DST Program. Year to date FFO was $0.21 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 September 30th was approximately $76 million dollars, an increase of $21 million dollars from the prior year, primarily related to the acquisitions we made in 2021 and 2022. Year to date AFFO was $0.34 cents per share.

Stabilized occupancy remained strong through the third quarter with the portfolio leased at 96% at September 30th. Our occupancies by segment were 99% for Industrial, 94% for Residential, 94% for grocery-anchored Retail, 98% for our Healthcare portfolio, and 81% for our Traditional Office. 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 third quarter, we signed new and renewal leases for over 1 million square feet, with a weighted average rent increase of 15% over the previous rental rate or underwritten rental rates. 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 7 years at the end of Q3.

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 November 8th, 2022, our Board of Directors approved a gross dividend for the fourth quarter of 2022 of $0.14 cents per share to stockholders of record as of December 22, 2022. The dividend is payable on or around December 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%, appreciation return of 4.1% for a total return of 8.7% over that 10-year period for our no fee share class.

Our NAV grew to approximately $4.6 billion at the end of the third quarter. Our daily NAV methodology has provided stable market valuations, as evidenced by our 3% standard deviation of share price.

Throughout the third quarter, we reinvested approximately $18.7 million 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 third quarter activities.

Allan Swaringen

Thanks, Gregg.

Our third quarter was exceptionally busy with investing activities as we expanded our portfolio with eight new acquisitions, totaling approximately $425 million dollars. This includes one industrial, two residential, two life science, and three medical office properties. The industrial property we acquired was West Phoenix Distribution Center, a 1.2 million square-foot, Class A industrial property located in the southwest submarket of Phoenix in Glendale, Arizona. The recently constructed, long-term leased, single-tenant warehouse was acquired for approximately $135 million.

Turning to the residential properties, we acquired Oak Street Lofts, a 187-unit recently constructed Class A multifamily asset, located in the Portland suburb of Tigard, Oregon. Oak Street Lofts was acquired for approximately $81.5 million dollars. We also acquired Molly Brook on Belmont in Q3. This is a newly-constructed 180-unit class A multifamily property located in the northeastern New Jersey suburb of North Haledon. We acquired this asset for approximately $89.5 million and assumed a $55 million mortgage at a fixed interest rate of 3.31% that matures in 20 years in 2042.

In September, we acquired a life science portfolio comprised of two buildings, 6300 Dumbarton Circle and 6500 Kaiser Drive. The two buildings total 132,000 square-feet and are located in the East Bay, San Francisco submarket of Fremont, California. The portfolio is 100% leased to three tenants that focus on life sciences, medical devices, and electronics research and development. This portfolio was acquired for $80.5 million.

The final three acquisitions are also related to our healthcare portfolio. The first property acquired was Grand Rapids Medical Center, a recently constructed medical office building in the Grand Rapids suburb of Wyoming, Michigan. The single-story, 25,000-square-foot property is 100% leased to two tenants and was acquired for $9.3 million. We also acquired Glendale Medical Center, a 20,000-square-foot single-tenant outpatient physical therapy and rehab center located in the Glendale neighborhood of Los Angeles, California. This property was acquired for approximately $18.2 million. The last of the healthcare acquisitions was Greater Sacramento Medical Center. This 2012-built medical office building located in Rancho Cordova, California consists of 18,000 square-feet and is 100% leased to one tenant. The property was purchased for approximately $11.1 million. These medical office building additions add substantial lease term to our overall portfolio.

Our portfolio diversification by property type at the end of Q3 was 43% Residential, 31% Industrial, 12% Grocery-anchored Retail, 9% Healthcare, 4% Traditional Office, and 1% Other, which currently consists of two parking garages.

Our overall company leverage ratio was 36% at the end of Q3. Nearly 80% of our borrowings are at a fixed interest rate and we have minimal debt maturities over the next two years. Our portfolio-wide weighted average remaining loan term is five years and our weighted average interest rate on outstanding borrowings is 3.5%. 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.

As for our stock transactions, we repurchased approximately $78 million dollars in shares pursuant to our share repurchase plan during the third quarter, which had a quarterly limit of $172 million dollars. Fourth quarter 2022 share repurchases will have a limit of approximately $181 million dollars, which is 5% of our NAV as of September 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 8.7%, 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

At this time, I will open the lines for your questions. [Operator Instructions]. And the first question is coming from Max [indiscernible]. Max your line of live.

Q: Great. Thank you. Interest rates have risen dramatically in 2022. How have higher rates impacted the portfolio and your ability to acquire new assets?

Allan Swaringen

Max, thanks for that. So I think I'll take the second part of that question first, and then ask Gregg to cover the first part second. In terms of our portfolio investing activities. With rising interest rates, it really has caused us to use less leverage, we really don't believe in using negative leverage, where the cost of the debt exceeds kind of going in yield on the real estate. So year-to-date except for one property we mentioned in the prepared remarks related to assuming an in place mortgage, which was very attractive, very low interest rate, the rest of the $900 million or so of investing activities we've done this year-to-date, we've been investing all equity, and that has served to deleverage our fund, which today given the fund is reduced its leverage. And there's obviously, some concerns about the direction of the U.S. economy.

It's a good time we feel to have lower leverage a little more dry powder. And be sure we have liquid reserves for any sort of a downturn. So that's how higher interest rates of impact are investing. Gregg, you want to talk a little bit more about the impacts to our balance sheet specifically?

Gregory Falk

Yes, sure. So just to kind of recap, where we start or where we're at today is we're almost 80% fixed rates. Our weighted average loan term is five years. Weighted average interest rate is about 3.5%. But the real nice thing is that we have no material maturities over the next few years. So we feel really good about that.

Coming into 2022, you -- we were at about a 45% loan-to-value at that time. And we really thought we're going to maintain that 45% throughout the year. Unfortunately, when interest rates started to move against us, we kind of tilted our strategy and went to more of a deleveraging pasture. So today we're at about 36%, LTV.

One of the nice things that we did, and we got really fortunate with our timing. Back in April, we extended and expanded our current credit facility. We went from 600 million of capacity to 1 billion. We added three years of term to it. And we added two one-year option that are at our option to extend this facility. It's with nine banks. We feel really good about where we are with that and our fortunate timing there. It would be a pretty big challenge today to go to the market and try to put that same facility in place. Thanks for that question, Max.

Q: Thank you.

Operator

Thank you. The next question is coming from Joe [indiscernible]. Joe, your line is live.

Q: Thank you. What are you seeing in terms of rent growth, especially in the sectors IPT is focused on?

Gregory Falk

Yes, I'll take that one, Allan. So as I mentioned in my prepared remarks, through Q3, we've had a very strong leasing environment. We did about 1.2 million square feet of leases, these are commercial leases new and renewals. And you had a weighted average increase in the rents of 15% over the prior lease. This was made up of about 1 million square feet of industrial leases in which we were able to achieve about a 30% increase in rates.

And we still believe that our portfolio is about 19% below market on the industrial side. So there's still some room to grow there. We did about 100,000 square feet of leasing at our Grocery-Anchored Retail Centers, with an average increase of about 3%. And then around 50,000 square feet on healthcare and traditional office that generally flat rates.

On the residential side, which we consider our apartments and single-family rental properties. We had an increase of 10% in rents year-over-year. So we've been getting real good rent growth over the past year. We're still seeing additional room to grow our rents going forward, especially in our favorite property sectors. Thanks for that question, Joe.

Q: Thank you.

Operator

Thank you. And the next question is coming from Anthony Fortunato. Anthony, your line of live.

Q: Thanks, Allan. Thanks, Gregg. Public real estate markets are up about 20% year-to-date. And private real estate markets are generally up about 10%. Can you just explain the disconnect between those two markets and how we should think about them from a standpoint of allocating to private real estate?

Allan Swaringen

Yes, Anthony, that's a question that I think has really been a hot topic of late. And certainly, one we're getting from a lot of the financial advisor community that that uses us. And it can be kind of a head scratcher for public real estate to be off. And private real estate to have had a very positive year. And there's three big reasons that we kind of think about that that drives sometimes that dispersion of performance.

First off the publicly traded REIT market, as the shares are listed on stock exchanges. It's publicly traded REITs have a very high correlation to the broader equities market. They, the CEOs of those companies work tirelessly to get their shares included in the S&P 500 and all of the other indexes and there's ETFs, wrapped around them and so while they all went broader holdings that that holdings across those different sectors and sub sectors and funds causes them to move more in sync with the public markets.

So publicly traded REITs have especially since the global financial crisis had an increasingly higher correlation to the broader equities market. So they move like stocks. And as stocks move down, or up, they tend to move that way. And I think you get somewhat a disconnect between the ultimate values of the underlying real estate. The other reason I think is we kind of unpack what's in our fund, particularly or many of the other NAV REITs versus what's in the public market domain.

The public REIT market is 250 plus or minus companies, it's about a $1.3 trillion or $1.4 trillion market cap. But there's a lot of different real estate, a lot of different types of real estate, that are held in the public markets, certainly than what we hold within an Income Property Trust. And so 50% of the publicly traded REIT market today is what I would call New Age real estate, or real estate that's not in the four primary property types. So while we've added single family rentals to our portfolio, we mostly think about our kind of primary investment allocations across the four primary full groups of office, industrial, retail and apartments.

But the index is made up of 50% properties that really are not in that sector, any of those sectors at all. It's signage, it's cell towers, it's data centers, it's nursing homes, it's hospitals, it's education in prisons, there's just all sorts of new kinds of real estate that has been securitized on the stock exchange and held in public company format. And so that also creates a wide dispersion between what a fund like ours owns versus the public REIT markets. And I often just to highlight that, ask folks, okay, do you know what the largest publicly traded REIT out there is.

And many folks are just surprised to know that it's American Tower, a company that's got a market cap of last I looked about $950 billion, and that's almost 8% or 9% of the whole index of $1.2 trillion to $1.4 trillion market cap. And so it's just different real estate. And it's not surprising to me that some of those are going to perform differently. So I think there's reasons why you have a disconnect there. And why REITs trade above or below NAV lots of times and why ideally, funds like ours and the NAV reach base, because given our fundamental appraisal based methodology, hopefully we're trading closer to what we think is fair market value for the real estate. So anyway, that's our thoughts on that. I hope that that's helpful.

Q: Yep, thank you.

Operator

Thank you. [Operator Instructions] And the next question is coming from Griffin [indiscernible]. Griffin, your line is live.

Q: Great. Thank you. You guys mentioned that your 4% exposure to the office sector with 81% occupancy, is occupancy declining, and should we be concerned?

Allan Swaringen

Yes, listen we're very pleased today that we have a significant underweight to Office, the 4% office allocation compared to what office is a part of the investable universe is pretty low. I mean, across the $20 trillion of U.S. commercial real estates, about 35% of that is Office. So our 4% allocation is a pretty significant underweight.

I also think if you look at the properties we own, one of them is in Suburban Washington DC right on the Dulles Toll Road long-term lease to Amazon Web Services, we have high conviction about that building and Amazon views that building is a very strategic location for them long-term, it sits right on top of the [indiscernible]. And we also own two buildings in Tempe, kind of Southeast Phoenix area. And those buildings are doing very well.

They're outperforming our underwriting and they've actually rebounded quite nicely after the pandemic and actually performed well throughout the pandemic. I would say the one asset that we're spending a lot of time and attention focused on is a multi-tenant office building we own in Downtown Portland. It's an extraordinarily well-located building, we really believe in the value proposition of Portland.

And if you look at the broad demand drivers of the overall Portland office market, labor costs in Portland, housing costs in Portland and rental rates in Portland are just about half of what they are in turn, as compared to the office jobs that often kind of get -- are looking for locations in either the Pacific Northwest or Northern California, that being Seattle and San Francisco.

So we're long term believers in that Portland market based upon the value proposition, we liked that building, it's Ground Zero, Downtown Portland, we recently renovated the building and redid the lobbies in the elevators. And it's a very attractive building. And so we believe to be a long-term holder in that, but Portland needs to kind of continue its recovery, which has been slow to exhibit, but it needs to continue its recovery from the pandemic and some of the social unrest that kind of followed the pandemic.

So we're keeping an eye on that building. And paying a lot of attention to it from a management leasing standpoint, but long-term, we think it'll be a good value, and we bought it as a long-term hold. So we like our underweight to Office, we think the office markets are going to continue to be challenged for the next two or three years. And I'm glad it's really not a meaningful component of our overall portfolio. But office is going to continue to face challenges and we have very limited exposure to Office.

Q: Great, thank you.

Operator

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

Allan Swaringen

Thank you all for joining us today. Appreciate your time and attention, appreciate your interest in JLL Income Property Trust and we look forward to updating you hopefully in the Spring, feeling like Spring here in Chicago right now but hopefully updating you in the Spring at the end of the year and everyone have a great day. Thanks for your time today. Bye now.

Operator

Thank you, ladies and gentlemen. This does conclude today's conference. You may disconnect your lines at this time and have a wonderful day. Thank you for your participation.