Transcript of
JLL Income Property Trust
2Q 2023 Public Earnings Call
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Participants

Ashley Wessels - Portfolio Accountant, LaSalle Investment Management
Allan Swaringen - Director, President & Chief Executive Officer, JLL Income Property Trust
Gregory Falk - Chief Financial Officer, JLL Income Property Trust

Presentation

Operator
On behalf of JLL Income Property Trust, I'd like to welcome you to the Second Quarter 2023 Earnings Conference Call. This call is being recorded to our audience lines and is currently in a listen-only mode, and we will open the floor for your questions and comments after the presentation.

At this time, I'd like to turn the conference over to Ashley Wessels from JLL Income Property Trust. Ashley, please go ahead.

Ashley Wessels
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, 2022, 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, 2023.

Links to a transcript and audio replay of this call will be posted and available on our website, JLLIPT.com until August 23, 2023. For further information on the Company's performance, we invite you to review our Quarterly Report on Form 10-Q filed on August 14, 2023 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?

<u>Allan Swaringen</u>
Thanks, Ashley. Hello, everyone, and thank you for joining us for our second quarter earnings call.

As of June 30th, our portfolio aggregated to $7 billion dollars comprised of 137 core properties spanning the industrial, residential, healthcare, grocery-anchored retail, and office sectors, and includes over 10,600 residential units. And it's worth noting that over 80% of our portfolio is in those first three property sectors – residential, industrial and healthcare – three of the top performing property sectors over the last three years. Our overweight allocation to the "beds, sheds and meds" property sectors - as well as our move to underweight office over five years ago has served our investors well. For the quarter ending June 30, 2023, we delivered a positive 1.1% income return combined with a negative 3.2% appreciation return for a total return of negative 2.1% on our M-I share class. A tenet of our longer term, core investment strategy is delivering durable income that helps temper the inevitable valuation declines across normal real estate cycles. Quarterly dividends have now been paid for 46 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 highlighting some of our specific second quarter accomplishments, I would like to begin today's discussion by reviewing the economic environment in which we operated during the quarter.

During Q2, economic growth remained solid even as concerns about future growth and a possible recession remained elevated. The second quarter had positive job growth, adding 732,000 payrolls and the unemployment rate was largely stable, up just 10 basis points in the second quarter. While job growth remains solid, it is slowing as this was the lowest quarterly increase since the fourth quarter of 2020. The solid job growth was mirrored by GDP growth, which is estimated to be 2.4% on an annualized rate.

The Fed left their target funds rate unchanged with their pause at the June governors meeting. However, at the July meeting they raised rates to a range of 5.25% to 5.5%. The FOMC statement at this time is that they will be guided by data on future rate changes, and there are two months of data to come before their next scheduled meeting in September. The Fed is focused on inflation and as of June, CPI increased 3.1% year-over-year which is still above the 2% Fed target, but down considerably from the 8.9% year over year growth as of one year prior. More recent inflation data has signaled another pause may be forthcoming.

Second quarter property sector data reflects a moderate slowdown in underlying fundamentals. The office sector remains the most challenged property type by a wide margin with vacancy rates up 40 basis points to 18.2%, bringing the annual increase to 140-basis points in the last year. Medical office, a subsector of our healthcare allocation, shows much greater resiliency as tenant demand has actually increased since the pandemic. This sector has an almost 50% lower national vacancy rate at 9.7%, though it did increase by 30 basis points in the second quarter.

While industrial availability increased over the last four quarters and was up 40 basis points in the second quarter to 5.8%, this national vacancy rate is still near record lows. This modest increase in vacancies reflects an elevated amount of new construction. National apartment vacancy was up 10 basis points to 5.4% and is now up 1.7% from a year ago. Apartment rent growth is cooling, but rents are still 1.6% higher than a year ago. For both apartments and industrial, we expect positive, but slower demand than in recent years and fundamentals to remain healthy and possibly strengthen after the current pipeline of projects under construction is absorbed.

Market data continues to be positive for retail real estate, including our preferred strategy to invest in higher quality grocery-anchored shopping centers. Open-air retail vacancy rates remain stable, driven by buoyant demand and limited new construction. National vacancy rates held steady in Q2 at 5.7%, the lowest level since the first quarter of 2006.

Real estate capital markets experienced further transaction volume declines in the second quarter. Q2 trailing year transaction volume was down 46% year-over-year and the quarterly volume of $51 billion was the lowest since the second quarter of 2020. More recently, there are signs of increasing transaction volumes and the second half of the year usually sees higher sales activity.

At the end of Q2, the 10-year treasury rate was 3.75%, up ten basis points from the end of the first quarter, and it increased again to over 4% in the opening weeks of July. Higher interest rates continue to raise borrowing costs and put upward pressure on real estate cap rates. This contributed to the NCREIF property index total return in the second quarter of negative 1.98%, reflecting continued depreciation. There remains a wide divergence across property types with office returns continuing to deteriorate while industrial, apartments, and retail returns are above the index average.

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. 2023 has been a strong year, with $195 million in year-to-date revenues, as compared to $157 million dollars from the same period in the prior year, which represents a 24% increase. The increase is primarily related to new acquisitions made in 2022 and 2023 and an increase in rental rates. Net loss was $99 million dollars for the first half of the year compared to net income of $14 million dollars in the prior year. The decrease in net income was primarily driven by non-cash interest expense related to our DST Program and non-cash unrealized fair market value losses in our unconsolidated real estate investments.

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 negative $6 million dollars, a decrease of $29 million dollars from the same period in the prior year, primarily related to non-cash interest expense related to our DST Program. Year-to-date FFO was negative $0.03 cent 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 $58 million dollars, an increase of $7 million dollars from the same period in the prior year, primarily related to the acquisitions we made in 2022 and 2023 and increases in rental rates. Year-to-date AFFO was $0.24 cents per share.

Stabilized occupancy remained strong through the second quarter of 2023 with the portfolio leased at 95% at June 30th. Our occupancies by segment were 98% for Industrial, 93% for Residential, 92% for grocery-anchored Retail, 98% for our Healthcare portfolio, and 82% 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 benefits 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 294,000 square feet, with a weighted average rent increase of 10% 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 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. Through the second quarter, we reinvested approximately $15 million dollars of capital improvements into our existing portfolio, all geared toward maintaining our higher occupancies.

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 8, 2023, our Board of Directors approved a gross dividend for the third quarter of 2023 of $0.145 cents per share to stockholders of record as of September 22, 2023. The dividend is payable on or around September 27, 2023. All stockholders will receive $0.145 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 an income return of 4.4%, an appreciation return of 2.8%, for a total return of 7.3% over that 10 plus-year period for our no fee share class.

Our total company NAV grew to approximately $4.4 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.

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

Allan Swaringen
Thanks, Gregg.

During the second quarter, we remained active in terms of new investments, adding to our Single-Family Rental and industrial warehouse portfolios. Throughout Q2, we funded additional investments to acquire single family homes within the joint venture of which we are 95% owners, investing approximately $8 million dollars to this high-conviction sector.

In mid-April, we acquired Louisville Logistics Center, a 1-million-square-foot, newly constructed Class A industrial property strategically located in the top-tier industrial submarket of South Louisville, Kentucky. The building is 100% leased for 10 years to a nationally recognized, global transportation and logistics company. The purchase price was approximately $82 million dollars. Pricing on this investment was around 150 basis points better than could be achieved just 18 months ago.

In an opportunistic expansion to our direct real estate equity portfolio, we closed on our first real estate debt investment in the second quarter. Over the next few years, we intend to originate a meaningful allocation to floating rate, senior secured real estate loans that complement our equity investment portfolio and over time will enhance cash flow and our income returns.

To that end, in May we closed on a $27 million dollar floating rate first mortgage loan secured by an active adult multifamily apartment community located near Austin, Texas. This three year, senior secured loan earns an interest rate of 2.95% above SOFR - the Secured Overnight Financing Rate - which today is 5.3%. This investment should deliver an all-in yield of between 7 to 8%. In an environment where many banks and other debt sources have restricted lending activity significantly, we see opportunities to invest accretively by filling a void in the debt capital markets as a first mortgage lender, a core competency of our firm, with more than $3 billion of real estate loan originations.

Moving on from Q2 new investments, our portfolio diversification by property type at the end of the quarter was 44% Residential, 32% Industrial, 12% Grocery-anchored Retail, 9% Healthcare, and only 3% Traditional Office.

Our overall company leverage ratio was 37% at the end of Q2. Nearly 90% 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 four years and our weighted average interest rate on outstanding borrowings is 4.0%. While our portfolio is substantially immunized from current 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 have repurchased 100% of all redemption requests, approximately $81 million dollars in shares pursuant to our share repurchase plan during the second quarter, which had a quarterly limit of $168 million dollars. For nearly eleven years now, we've never had to limit share redemptions. Third quarter 2023 share repurchases will have a limit of approximately $161 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 7.3%, while consistently focusing on core, stabilized lower-risk investments.

JLL Income Property Trust continues to deliver a competitive current yield and attractive since-inception 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 our greatest contributors to our long term 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.

As an institutionally sponsored real estate fund, JLL Income Property Trust was designed to be an all-cycle investment vehicle, providing the potential for attractive, tax-efficient current income, portfolio diversification, modest capital appreciation and wealth preservation across a wide range of economic conditions.

Thank you for your time and attention today, I hope you found our remarks informative. Operator, we would now like to open the call for any questions.

Operator
Certainly. Everyone at this time will be conducting a question-and-answer session. [Operator Instructions] Your first question is coming from [Jack Radley] [ph]. Your line is live.

Q: Thanks, Allan. You commented earlier about NCREIF returns. How IPT's returns compared to core institutional real estate indices?

Allan Swaringen
Yeah, thanks for that, Jack. So, I think at first it's probably important to give a little background on NCREIF and what they do and kind of the history of the institutional benchmark. This is an organization that was established over 40 years ago, it's the National Council of Real Estate Investment Fiduciaries. Since that time, it served the institutional real estate investment community, developing real time benchmarks based upon underlying appraisals. And today, it represents the largest and robust database of U.S. specific real estate assets and their performance. LaSalle was one of the founding members of NCREIF, and we've been a participant in it. And we report all of our returns to them, including the returns from Income Property Trust.

The benchmark that we focus on within that index is the ODCE fund, or the ODCE benchmark. The ODCE stands for Open-End Diversified Core Equity. It's an index of 25 institutional funds totaling nearly $320 billion of gross real estate and thousands of properties. And, again, this has been an index that's been up and running since around 1978. And as we commented about returns being down in Q2 for NCREIF comparing our returns to them, at least as it relates to recent time periods.

For Q1, the NCREIF was down 2.8%, we were down 2.1%, including our income plus the negative appreciation. So we outperformed that benchmark in Q2 by 70 basis points. And year-to-date, through the first half of the year, the NCREIF was down 6.2% and we were down 5.3%, so again outperformance of about 90 basis points. And if you look at even the 12-year time period, the NCREIF over the last 12 months has been down 10.7% and our total returns have been down about 6.7%. So we have about a 300 basis point outperformance. There's a lot of comparisons out there by different folks that track performance.

We think NCREIF is probably one of the most reliable ones. It truly is a consistent valuation methodology of every single property being independently appraised every single quarter. All of the NAV REITs have different valuation methodologies and procedures, and we often get asked to kind of compare our performance to theirs. And there just continues to be a fair amount of dispersion across the NAV REIT industry in terms of the frequency and the independence of valuations. We think the institutional benchmark is really the most applicable over the long-term, and our valuations line up consistently in terms of the methodology and from a return standpoint outperformance.

And I also think, if you look at that outperformance, you can really look at what is in the NCREIF versus what's in IPT. Our significant underweight to office, our significant overweight to industrial and residential is really a pretty key attribution characteristic as to why we would have outperformed that benchmark just based upon our over-weights versus that benchmark and how it's weighted.

So anyway appreciate the question, I hope we get a little bit of a primer there on NCREIF and how IPT's returns line up against it, Jack.

Q: Thank you.

<u>Operator</u>
Thank you. Your next question is coming from [Anthony Fortunato] [ph]. Your line is live.

Q: Thanks, Allan, and thanks, Greg. In some of your prepared remarks, you made some comments on your leverage. Could you expand on the debt capital position?

<u>Gregory Falk</u>
Yeah, I'll go ahead and take that one, Allan. So, as Allan mentioned in his prepared remarks, our overall leverage is at 37% at the end of the quarter, with approximately 90% of our borrowings at a fixed rate. So that means if you look at our total $7 billion balance sheet, it's capitalized with about $4.4 billion of equity and about $2.6 billion of debt.

Now, if you really want to unpack the debt, it breaks down into a couple of different types of loans. First, in our largest portion, and really what's unique to us in the NAV REIT sector is property level non-recourse fixed rate or swap to fixed rate secured debt, so mortgages, which are collateralized by specific properties in our portfolio. This debt represents about $1.8 billion of our $2.6 billion, or about 70% of our borrowings. We generally get this debt from life insurance companies. These are typically 5, 7, or 10 year fixed rate mortgages. Our current weighted average maturity for this type of borrowing is over 5 years, and our weighted average interest rate is pretty low at only 3.3%.

The other source of debt is our credit facility. It had an initial 3-year term with two 1-year extension options pushing the maturity out to 2027. The credit facility has an aggregate capacity of $1 billion, which can be expanded to $1.3 billion.

In the credit facility, we borrowed $400 million of it as term loans. The remaining duration of these loans is about 4 years, and we've swapped the interest rate here to derisk our borrowing risk given rising interest rate environment we've experienced over the last year-and-a-half. The average all-in interest rate on these term loans that have been fixed is about 4.9%.

The other portion of the credit facility is the revolver, which has a capacity of $600 million and we really only use that more for short-term borrowing needs for working capital type activity. We've kept the first $200 million of this at an all-in interest rate of about 5.95%. The remaining balance is floating though and it is our highest cost of debt as it truly does float. It's tied to SOFR plus a spread of 1.45%, with SOFR being at about 5.3% today. So our all-in cost of borrowing for this floating portion is about 6.75%. But as I said, we generally only use this for short-term working capital needs.

Our credit facility is supported by over 60 properties with no leverage on them at all, with an aggregate value of about $2.3 billion. Overall, we operate under a conservative debt philosophy. We have negligible loans coming due over the next 24 months. The loans we do have coming due in late 2025 are about $550 million across 8 mortgages at a loan to value which is about 50% today. And these are properties that are in some of the best performing sectors, which gives us comfort and our ability to refinance those loans.

One last point I would say is as compared to some of our competitors it is worth noting that we don't mark our debt to market, which does tend to understate our competitors leverage and may tend to overstate their net asset values given the rising interest rate environment we've experienced. These NAV write-ups for debt are temporary and they do get written down over time as the loans approach maturity. So that kind of sums up where we sit on the leverage right now. Thanks for that question, Anthony.

Q: Yeah, thank you.

<u>Operator</u>
Thank you. Your next question is coming from [Max Stegner] [ph]. Your line is live.

Q: There's been some continued headline news about share repurchase programs at other NAV REITs. Can you provide some additional color on IPT redemption activity?

<u>Allan Swaringen</u>
Yeah, Max, thanks for that. So we've certainly been watching the news and headlines across the NAV REIT space, especially with two of the larger, but more recent entrants into the NAV space

started seeing elevated repurchases in the third and fourth quarter last year, in fact, fortunately for us, and knock on wood, I always say that whenever you talk about this, because you never know when things might change for you. When we look at our historical share repurchase activity really over the last 4 quarters, we've been operating right at about 50% of our 5% capacity limit. So we've averaged about 2.5% a quarter against our 5% cap.

We're quite pleased with that that repurchase activity is higher than normal, because we have nearly 11 year history of repurchases. And I would say throughout that history, repurchases have generally kind of been in the range of 1% to 2% a quarter. They are up kind of in this 2.5% range kind of 2% to 3%. But so far they've not been kind of beyond the SEC limits. So we're quite thankful for that. I think some of it we get asked a lot, why have we been different?

I think we've tried since we launched this fund in 2012 to explain to folks that this is not a market timing strategy, this is a hold-through strategy. We're not trying to time the market, we're not market timers, and that we think they should be long-term investors than us. We typically invest properties to hold them 5, 7, 10 years or longer, and investors should be thinking about holding us that time.

I also think we've really done a good job of sticking to our knitting and being in property sectors that have outperformed and really having negligible exposure to office or malls or hotels or casinos we really stuck to our knitting. So we continue to watch it. We are seeing interesting and attractive investing opportunities, and we continue to talk to investors about the outlook generally improving. There's been a lot of publicity lately about new capital coming into the market. We think that's great.

Again, I would remind people this is not a market timing strategy. We're long-term patient hold-through cycle investors, and we think if investors think about holding us long-term that they'll be rewarded. And our SRP capacity is out there for advisors and clients that want to maybe change their allocation over time. Anyway, that's an update on our SRP, Max. Thanks for the question.

Operator
Thank you. Your next question is coming from [Peter O'Con] [ph]. Your line is live. Once again, Peter, your line is live. Your next question is coming from [Henry Johnson] [ph]. Your line is live.

Q: Thanks, Allan, Greg. Is there currently too much money chasing too few properties right now, obviously, malls and office are not performing well? But what is available and is it being purchased at a premium with debt at higher rates? Thanks.

Allan Swaringen
Yeah, Henry, we don't think there's too much capital chasing too few properties. There's $21 trillion of investable real estate in the United States, only about $1 trillion of it is listed on the stock exchange with publicly traded REITs. So the private market, real estate market is very deep. And, in fact, the lack of debt has actually slowed down transaction activity significantly. I think in my prepared remarks that over the last 12 months, transaction activity is off 50%, and I know in the first 2 quarters of the year it's been off 70%.

Now, transaction activity does tend to accelerate in the third and fourth quarter. So we'll see if it comes back, but it's our view that really the lack of debt and available attractive financing and higher interest rates is one of the key reasons why transaction activity is down. It's also one of the reasons why we've recently added an allocation to floating rate first mortgages secured by real estate. We feel like it's an attractive time to be a lender, not shedding our equity investing strategy, because we think long-term equity investing should get higher returns. But in the current market environment, debt is a very attractive yield. And so, we'll continue to focus on doing some lending, which is accretive to our current dividend yield and should generate good cash flow for us.

So a lot of headlines out there about new funds, chasing money and a lot of flows, but we still think there's some bid ask spread between buyers and sellers and that's actually dampening the volume versus too much capital chasing property right now. Thanks for the question.

Operator
Thank you. Your next question is coming from [Peter O'Con] [ph]. Your line is live.

Q: Thanks, Allan. So, with refinancing risk due to skyrocketing rates, what impact will that have on lenders and will it roll downhill and impact the broader sector?

Allan Swaringen
Peter, thanks for that question. I was wondering if you were shy there, I'm glad you came back with your question. We like to cover everyone here. So, listen, we started talking to our distribution organization to get out in front of what we were anticipating negative headlines about 6 months ago, principally about real estate valuations and principally in the office market. And we were not wrong in calling that there was going to be a lot of negative headlines. The popular press tends to prefer writing stories about challenged property sectors and underperformance and predicting doom and gloom. And that's certainly what has transpired for the last 6 months, predominantly from the office sector.

We think the next shoe to fall that is going to continue to grab negative headlines is this refinancing risk and the challenges of loans coming due, whether they be construction loans or short-term repositioning loans. There's been a lot of value add and opportunistic funds more in the closed end sector that were transitioning assets and borrowing money or putting construction loans and those loans are starting to mature and, unfortunately, they're maturing at much higher interest rates than the interest rates that maybe the loan was in place.

And so, we think there's going to be increased foreclosures, increased default rates, and it may in fact put some stress on the banking sector in terms of their balance sheets and setting up reserves. So, unfortunately, the one thing that's going to get the office sector off the negative headlines, we think is going to be defaults and debt maturities and refinancing challenges. Again, that's one of the reasons why we're stepping in to provide capital to do that with our lending program, which we think is going to be very attractive and accretive.

Now in the core space, which is most of what we are in the NAV REITs, as Greg captured, we're typically borrowing long-term fixed rate debt from insurance companies. We have negligible debt maturities over the next 2 years, so we feel good about our debt capital stack. Our overall leverage is pretty low at 37%, so we've got a lot of equity and we got good dry powder. But we don't see it having some sort of contagion effect or overall kind of impairing the broader real estate markets, because in general the fundamentals of real estate are very strong, occupancies are pretty strong.

We're still seeing good rent growth, especially in the sectors where over-weighted now in the mall market, and the office market, and some of the other niche sectors you're seeing some other challenges, but in residential, industrial, healthcare, grocery-anchored retail, where we're focused we're seeing really good fundamentals. So we're not concerned about our debt maturities. I would say broadly most of the debt in the NAV REIT is well positioned, but I think there's a lot of closed end funds and developers that are going to see more challenges, and certainly office loans are going to present challenges as those loans come due. So, Peter, thanks for that question. Hopefully that was kind of covering your concern there.

Q: Perfect. Thanks.

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 for our second quarter update. We look forward to speaking to you next quarter at the end and giving you a review of 3 quarters. Thanks, everyone, and have a great day.