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Transcript of JLL Income Property Trust
3Q 2018 Public Earnings Call
November 21, 2018

Participants

Allan Swaringen – President and Chief Executive Officer
Gregg Falk – Chief Financial Officer
Sean Meehan – Portfolio Manager
Sam Selzer – Sr. Portfolio Accountant

Presentation

Operator
On behalf of JLL Income Property Trust, I'd like to welcome you to their third quarter 2018 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, 2017, and in our other reports filed with the SEC. The Company disclaims any undertaking to update or revise any forward-looking statements.

In addition, all non-GAAP financial measures discussed during this call are reconciled to their most directly comparable GAAP financial measures in accordance with the SEC rules in our Form 10-Q for the quarter ended September 30, 2018.

Links to a transcript and audio replay of this call will be posted and available on our website, JLLIPT.com. For further information on the Company's performance, we invite you to review our Quarterly Report on Form 10-Q filed on November 13, 2018 and other filings which are available on the Company's website, as well as the SEC's website, sec.gov.

Now I would like to turn the call over to Allan Swaringen, President and Chief Executive Officer and Gregg Falk, Chief Financial Officer. At the conclusion of their comments, we will open the call for your questions.

Allan, if you'd like to begin?

Allan Swaringen – Chief Executive Officer
Thanks, Sam.

Hello, everyone, and thank you for joining us for our third quarter earnings call. JLL Income Property Trust continues to focus on growing and improving our $2.7 billion-dollar portfolio of 71 core properties that span the apartment, industrial, office, and retail property sectors. Our strong operating performance throughout 2018 has positively impacted the investment performance of our portfolio. In the third quarter, we achieved total net of fees returns of 1.8% and 2.0% on our Class A and M shares, respectively. Quarterly dividends have now been paid for 27 consecutive quarters, with an average annual increase of 4.9% over that 6 plus year period. I would like to kick off today by discussing the economic environment in which we operated before diving into the specifics of our accomplishments this quarter.

US GDP grew at a solid pace, a seasonally and inflation-adjusted annual rate of 3.5%. Consumer spending drove economic growth, as personal consumption expenditures advanced by 4%, the strongest growth rate in nearly four years. The business sector grew, but at a slower rate than previously as nonresidential fixed investment rose by only 0.8%, compared to 8.7% in the second quarter. Meanwhile, residential investment weakened significantly with a 4% decline. Rising borrowing costs, growing land prices and tariff-driven pressures on material costs put negative pressures on a recovering housing market. According to Oxford Economics, economic growth is expected to slow slightly in 2019 but should remain positive for commercial real estate demand overall.

The economic tailwinds continue to lift tenant demand for office, apartment, and industrial space. Monthly payroll growth through October has averaged 213,000 year-to-date, 18% faster than over the same period last year. On trade, the recent US-Mexico-Canada agreement has removed one key source of uncertainty. On the other hand, the US-China trade war has escalated into its fourth round of new tariffs enacted, then followed by retaliation. We expect that the already enacted tariffs will be only a modest negative for overall growth, with the largest direct impacts in manufacturing and agriculture-driven states such as South Carolina, Indiana, and Michigan. As tariffs have expanded to include more consumer goods, they may also begin to put some upward pressure on US inflation.

Demand outpaced supply for every major property type in the third quarter based on data from CBRE, CoStar, and RealPage. Office vacancy declined 10 basis points in both the quarter and trailing year and stands at 12.8% nationally. CBD office vacancy is 10.5% and suburban office vacancy is 14.1%. Despite increasing levels of new construction, preliminary data shows that apartment vacancy for stabilized properties declined to 4.4%, approximately 30 basis points lower than a year ago. Industrial, or warehouse, availability declined just over 30 basis points in the last year to 7.1%, the 33rd consecutive quarterly decline. Open-air retail, which includes our grocery anchor strategy, continues to be a positive outlier on both supply and demand. While aggregate retail demand is weak, occupied square feet for open-air retail increased 0.4% in the last year. New construction is also at an all-time record low, with fewer deliveries in the last year than in the depths of previous recessions. This has resulted in a 20 basis point decline in retail vacancy over the last year to 6.6% nationally.

Real estate capital markets have so far taken rising interest rates in stride. Increases in rates have long been expected as the economy strengthened. Steady NOI growth – 4.0% for NCREIF properties over the last year - acts as a counterweight to the risk of potential real estate cap rate increases. Recent rate movements increase the likelihood that income rather than appreciation returns will be the primary driver of core real estate returns over the next several years. Property cap rates have been stable in 2018 and transaction activity has been healthy for all property types except for retail, where transaction volume has slowed. According to Real Capital Analytics data, US transaction volume through September was 6% above the same period in 2017 with approximately $289 billion in commercial properties trading hands.

Looking back on the topic of e-commerce sales we discussed last quarter, our focus on investing in grocery-anchored retail centers with a tenant mix of largely necessity-based retailers gives us confidence that our performance in the retail sector will continue to be strong. Research by the U.S. Census Bureau shows that 91% of retail sales take place in physical stores, with 97% of grocery sales taking place in-store versus online. Further, the national demand for industrial space has benefitted from e-commerce sales, as it generates demand for warehouse space. We believe our portfolio is well positioned for the downside risks of a slowdown in growth in the economy. Gregg will now provide a recap of our portfolio's financial performance, before I continue with Q3 results. Gregg?

Gregg Falk – Chief Financial Officer
Thanks, Allan.

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

We reported total revenues of $128 million dollars and operating income of $22 million dollars through the first nine months of the year. This represents a growth of 4% and 2%, respectively, over the same period in 2017.

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 nine months ended September 30th, we reported FFO of $52.8 million, an increase of approximately 1% from the prior year, primarily due to the contributions from our new acquisitions. Our YTD per share FFO through September 30th was $0.39.

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 remained consistent in Q3 at $16 million and totaled $47 million dollars for the full year. Our per share AFFO for the recent quarter ended also remained consistent with Q2 at $.12 cents per share.

Portfolio occupancy increased since last quarter to 94% at September 30th. Our occupancies by segment were 95% for Apartment, 92% for Industrial, 92% for Office and 96% for Retail. The overall improvement in occupancy percentage is driven by increases in occupancy across all segments as a result of asset management's focus on leasing strategies.

Leasing activity was high in Q3 with 346,000 square feet of new and renewal leases completed during the quarter and 458,000 square feet leased over the past 9 months. Our weighted average lease duration at September 30th was 5.7 years, in-line with the prior quarter.

We strive to offer an attractive level of current income to our stockholders. This quarter, our Board of Directors approved a gross distribution of $0.13 per share to stockholders of record as of December 28th, payable on or around February 1st. These dividends will be paid out to stockholders, but will be reduced for share-class specific fees, if any.

Since we launched our initial public offering in October 2012 we have provided net of fees annualized total returns for our Class A and M shares of 6.5% and 7.1%, respectively. We continue to search for strategic investment opportunities that will further diversify our portfolio, as well as strategic dispositions that will generate profits for our portfolio and provide steady returns for our investors.

Our NAV grew to over $1.6 billion at the end of the third quarter. This translates to per share increases of 0.9% on both Class A and Class M shares when compared to Q2. Valuation gains were generally attributable to favorable market conditions, driving increases in both rent rates and investor demand. Our daily NAV methodology has provided stable market valuations and we have realized moderate appreciation in share price since we began this offering in 2012. As a perpetual life, daily NAV REIT, JLL Income Property Trust is not subject to the same market fluctuations that affect the pricing of listed stocks. Our share price is determined based on independent appraisals of the real estate investments we own and the income they generate.

Now, I'll hand the call back over to Allan to highlight our Q3 accomplishments.

Allan Swaringen – Chief Executive Officer
Thanks, Gregg.

This quarter we focused on our strategic acquisition initiatives. In July, we entered into a joint venture agreement with the Nordblom Company, a highly-regarded real estate developer, investor, and operator in the Boston market, to invest in The Tremont and The Huntington apartment communities. These apartment communities contain a combined 297 units with highly desirable amenities and are located in the Boston suburb of Burlington. The acquisition of these properties is in line with our investment strategy given the desirable location which boasts highly rated schools, an affluent population, and strong market fundamentals. We have been quite active in 2018 in the suburban multi-family sector, acquiring three new properties with a total investment of just over $150 million dollars.

Our overall company leverage ratio remained consistently low at 39% at the end of Q3. Across our portfolio, 91% of our total debt is at a fixed rate, which gives us confidence in this rising interest rate environment. Driven by strong economic conditions, the Federal Reserve increased interest rates in September by 25 bps to a range of 2%-2.25%. They have signaled that given the current trajectory of the economy, rates are likely to rise again in December. Core real estate tends to be more sensitive to the long-term rates, and in the third quarter, the 10-year rate trended higher throughout the quarter, ending above 3% where it has remained since then. With limited near-term debt maturities, we have a portfolio-wide weighted average remaining loan term of nearly 6.7 years and our weighted average interest rate on outstanding borrowings is 3.8%.

Turning to our stock transactions, in Q3 we repurchased approximately $15 million dollars in shares pursuant to our share repurchase plan, which had a third quarter limit of $80 million. For the fourth quarter 2018, share repurchases will have a limit of approximately $81 million, which is 5% of the NAV of the company as of September 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.

For the remainder of the year, we are focused on investing capital in the industrial, apartment, and grocery-anchored retail sectors, as well as complementary strategies such as medical office, which fulfill key portfolio investment goals of stable income and moderate NAV growth over time. During the first nine months of the year, we invested approximately $13.4 million of capital improvements in our existing portfolio, all geared towards maintaining our higher occupancies. At the end of Q3, our portfolio diversification by property type was 28% for Apartments, 23% in Industrial, 18% in Office, 30% in Retail and 1% Other, which currently consists of two parking garages.

We remain committed to actively managing our real-estate assets to provide attractive risk-adjusted returns to our stockholders and realize modest appreciation over time. Our NAV continues to steadily increase as our asset management team continues to strengthen our portfolio through carefully planned investments and leasing opportunities. Financial Advisors and Portfolio Managers are looking for increased diversification and alternative sources of income for their client portfolios and core real estate is well positioned to provide both. Investment performance is the most important measure of success and our sustained focus on active asset management, portfolio diversification and leverage reduction has driven our positive third quarter results.

JLL Income Property Trust continues to deliver a competitive current yield and attractive annualized total returns all the while maintaining a high-quality portfolio of institutional-caliber investments. We believe both property type and geographic market selection will continue to be one of the greatest contributors to our strengthening investment performance. We are confident that we will continue to add value to our portfolio and, under the prevailing economic conditions, generate modest appreciation over time and we look forward to the opportunities that await us in the future.

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.

Allan Swaringen – Chief Executive Officer
Operator, we would now like to open the call for any questions.

Operator
Thank you. [Operator instructions]. Our first question comes from the line of Jack Eastman.

Q: Good morning. Your economic outlook is relatively stable for the near term. Over a longer timeline, how is your portfolio positioned for increased uncertainty or an economic downturn?

Gregg Falk – Chief Financial Officer
Hi, Jack. Thanks for that question. This morning we're joined by Sean Meehan, who is the Portfolio Manager for JLL Income Property Trust, so I'll let him start off, and maybe he can give it back to me to add some final comments on that.

Sean Meehan – Portfolio Manager
Sure. Thanks, Gregg, and thanks, Jack, for the question. Overall, our view is that we are indeed late cycle, and as for investing in such a time, we believe that maintaining a sharp focus on our identity is key. So investing in high-quality assets in great locations that are well leased will be extra important at this time in the market—a stick to our knitting strategy, so to speak.

Also, I'd like to point out that this is a perpetual offering that it is designed to hold through cycles, so in addition to a focus on location and quality, we seek to achieve more stability through diversification.

We're invested in the four main commercial real estate property types and across major markets nationwide and leased to a diverse array of tenants.

Finally, and perhaps most importantly, as we sit here late cycle, we are maintaining purposefully a low leverage profile, which I think we believe is a fairly unique position among the NAV REIT universe, and in fact it could be argued that over-leveraging was the most fundamental misstep, or one of the most, for commercial real estate owners in the GFC ten years ago.

With that, maybe I'll turn it over to Gregg to add some further color on our debt strategy.

Gregg Falk – Chief Financial Officer
Yes, thanks. Thanks, Sean. You know really when we think about our debt strategy it's focusing on low leverage and avoiding interest rate risk, are our two primary tenets there. We're 39% LTV today. Lower leverage lowers our risk. We utilize primarily long-term, fixed rate mortgages. Our loan duration is almost seven years today. When we look at our debt portfolio, we've got about 90% fixed rate. We utilize swaps and caps to limit any exposure we have to increasing interest rates. Today our weighted average interest rate is at 3.8%, and we think that is a very, very positive position to be in, and we're not going to take excess risk looking down the liquidities or the leverage side of the balance sheet. So we're very positive on where we sit today. Thanks, Jack.

Operator
Thank you. And our next question comes from the line of Michael Addizio [ph].

Q: Yes. Hi, Sean. Your investment strategy related to the retail property sector could be seen as somewhat contrarian. Could you provide some additional color on the nuances of that strategy?

Sean Meehan – Portfolio Manager
Sure, Mike. Yes, about 30% of our portfolio is invested in retail. So as you say, that could be seen as somewhat contrarian. However, we are narrowly focused on one specific subsector of retail, which is the open air grocery anchorage format and so we have avoided the other types of retail, that being malls, power centers, high street retail, etc.

In making our grocery anchored center investments, we're guided by a proprietary database here at LaSalle that tracks 40,000 plus centers across the US and are focused on the very best locations and the best demographics nationwide.

Our retail segment has performed quite well for us. It's our highest occupancy sector at 96% and is a great driver of both income and bottom line cash flow to our investors.

And I'd say also our view is that the grocery anchored format and the ancillary services, the tenants that locate adjacent to grocers, are the most internet resistant of all types of retail. And for that, maybe I'll kick it over to Gregg for a couple more details on those types of tenants.

Gregg Falk – Chief Financial Officer and Treasurer
Yes, sure. Thanks, Sean. One of the things that we look at as we go to make a new investment in a grocery anchored shopping center is the types of tenants, the inline tenants, the ones that are lined up next to the grocer that provide services and goods that cannot easily be bought over the internet.

So when we look at our portfolio, 79% of our inline tenants of less than 10,000 square feet have goods and services that can't be easily be replaced by the internet, such as restaurants, haircut place, nail salons, spas, doctors' and dentists' offices, going and getting your Starbucks. We feel pretty confident that most of these are pretty resistant to any internet coming in and replacing them. So definitely a focus of our retail strategy is to find these types of service providers that can add diversification to our portfolio. Thanks, Mike.

Operator
And our next question comes from the line of Max Stegner [ph].

Q: Thank you. You recently highlighted JLL Income Property Trust Sustainability Award. What role does sustainability play in constructing and managing your portfolio?

Sean Meehan – Portfolio Manager
Thanks, Max, I will take that one. Yes, in September we did receive a 4-star rating from GRESB, that stands for the Global Real Estate Sustainability Benchmark, and GRESB, it's a leading global nonprofit focused on measuring ESG, so environmental, social governance initiatives for the commercial real estate sector.

What our score meant is that we placed in the top quintile relative to a universe of about 900 submissions to GRESB. And we believe we're the first and only, at this point, NAV REIT to do so. I say what that score indicates is how well we implement sustainability practices, the measurement of certain green initiatives such as energy, waste, and water efficiency. And also then the management and policy commitment to doing so.

For us, I'd say environmental factors are top of mind in the context of long-term investing and owning real estate and will certainly impact long-term occupier and investor demand. So we do believe there's this so-called green premium and that we can do well by doing good, so to speak.

And finally, we often hear from financial advisors that ESG factors are important, and increasingly more important to their clients. So that said, we are honored to have been recognized with that 4-star rating from GRESB and we will look to continue to be a leader in this space. Thanks, Max.

Operator
Thank you. [Operator instructions]. And since we have no further questions, I would like to turn the floor back over to Gregg Falk for closing comments.

Gregg Falk – Chief Financial Officer
Well, thank you. Thank you for all listening to our third quarter recap of our performance and we wish all of you a Happy Thanksgiving weekend. Thank you.