Transcript of
JLL Income Property Trust
4Q17 Public Earnings Call
March 15, 2018

Participants

Allan Swaringen – President & Chief Executive Officer
Gregg Falk – Chief Financial Officer
Sam Podwika – Sr. Portfolio Accountant

Presentation

Operator
On behalf of JLL Income Property Trust, I'd like to welcome you to their fourth quarter and full year 2017 earnings conference call. This call is being recorded and our audience lines are currently in a listen-only mode. [Other operator instructions.] At this time, I would like to turn the conference over to Sam Podwika from JLL Income Property Trust. Sam, please go ahead.

Sam Podwika – Sr. Portfolio Accountant
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-K for the year ended December 31, 2017.

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 Annual Report on Form 10-K filed on March 8, 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 – President & Chief Executive Officer
Thanks, Sam. Hello, everyone, and thank you for joining us for our fourth quarter earnings call. JLL Income Property Trust continued to deliver strong operational and investment performance throughout 2017 and before we highlight our fourth quarter achievements, I'd like to reflect back on what we have accomplished over the last five plus years since we began our offering in 2012.

In October, we celebrated our five-year anniversary delivering outcomes that we believe match the expectations of our investors. Our since inception total returns net of all fees were 6.5% for our Class A shares and 7.2% for our Class M shares. Over the past five years we have acquired 65 properties and sold 29 non-strategic properties, growing our total asset value from $800 million to $2.6 billion. At a company level, we've reduced our overall leverage ratio from 63% at the end of 2012 to 39% at year-end 2017. We now have a weighted average remaining loan term of approximately 7 years and a weighted average interest rate of 3.6%. In May of last year we increased our cash reserves and enhanced Company-wide liquidity by securing a new $300 million credit facility with a syndicate of six market-leading real estate lenders. The facility can increase to a total of $500 million and has a three-year term with two 12-month extension options. Our accomplishments over the last five years reflect the strength of our vision and ability to execute on our strategic plan to position JLL Income Property Trust as the market leading perpetual NAV REIT.

From a macro perspective, U.S. GDP increased by an annual rate of 2.5% in the fourth quarter. As a result of recently passed tax cuts, forecasts for 2018 economic growth have been revised upwards – the consensus forecast is for GDP growth to be 2.7% in 2018, a 40 basis point upward revision from Q3 2017. Consensus GDP growth for 2019 is 2.4%. According to the Bureau of Labor Statistics, wage growth has finally picked up, increasing by 2.9% in January. Consequently, inflation has returned to markets running close to the Federal Reserve's target of 2% year over year.

The Fed last raised interest rates at its December meeting, increasing the target policy rate to a range of 1.25 to 1.50%. Since economic growth prospects have brightened, there is consensus among markets, FOMC members, and economists that the Fed will raise rates at least 3 times in 2018. Sensing an end to the "easy money" era persistent since the Global Financial Crisis, equity markets fell sharply in early February 2018, before later correcting course; equity and debt markets have exhibited dramatically increased volatility of late. As a result, 10-year treasury rates have increased even further, finishing the month of February at 2.86%, near their highest levels since 2014. Despite interest rate increases, so far real estate pricing in the capital markets has generally held steady across most property sectors as a result of strong underlying fundamentals along with an abundance of capital looking to be invested.

Unemployment continues to fall, and currently sits at 4.1%, its lowest level in 17 years. The U.S. added 200,000 jobs in January, and then topped that by adding 313,000 in February, continuing the trend of consistent monthly job gains. After averaging 181,000 new jobs monthly in 2017, the pace of job creation is expected to slow somewhat since the economy appears to be reaching near full employment. According to Moody's Economy.com, the forecast for 2018 is 95,000 average monthly job gains through 2020.

Real estate values continued to increase in Q4, on the strength of positive underlying property fundamentals, although the rate of increase has moderated. The all-property Moody's/RCA CPPI finished 2017 up 7%, although Green Street's CPPI was roughly flat for 2017, as a result of falling retail mall valuations. As a byproduct of persistent market pessimism, higher interest rates and equity market volatility, US listed REIT prices fell steeply in early 2018 before rebounding somewhat more recently.

Commercial real estate transaction volumes moderated in 2017, down 7% from 2016, according to Real Capital Analytics. For a majority of 2017, monthly transaction volume was choppy. There were wide variations in transactions by property sector: industrial transactions increased by 21%, but retail transactions were down by 16% in 2017. A few warning signs in capital markets have emerged, namely the persistent listed REIT discount to NAV and modestly lower transaction volumes. We will continue to monitor these potential early warning signs in 2018.

The U.S. economy and real estate markets entered 2018 with fundamentals balanced and growth expectations moderate. We will, however, continue to closely monitor risks that could trigger broader changes in markets, specifically global macro risks related to geopolitics, financial system risks, or over-stimulus risks, all having the potential to impact the economy and U. S. real estate markets. Our current view is, however, that capital will remain disciplined and the positive alignment of fundamentals and pricing will persist. The recently-passed tax bill should boost local economies, at least in the short term, and this boost, along with recent wage growth and higher levels of consumer confidence, should be positive for real estate demand, helping absorb elevated supply levels in certain markets. In the real estate capital markets we expect transaction volumes to continue to moderate as a result of higher prices, and we expect income growth to become an increasingly important part of core real estate returns.

During 2017, favorable economic and real estate market conditions have allowed our asset management teams to enhance our portfolio through carefully planned capital investments and by executing leasing opportunities that increased our occupancy and accelerated rent growth. In addition, we were able to effectively invest capital this year, providing our investors with a more broadly diversified portfolio. I will discuss our Q4 accomplishments and 2018 outlook in greater detail, after Gregg gives you a recap of our financial performance. Gregg?

Gregg Falk – Chief Financial Officer
Thanks, Allan. Our success in active asset management, new property acquisitions and strategic dispositions are reflected in our financial results and operating performance. As I highlight our financial results I will discuss the key underlying drivers of our performance.

We reported total revenues of $165 million for the year, an increase of approximately $33 million or 25% over the prior year. The Company had net income of $23 million or $0.16 per share for our Class M shares for the year ended December 31st, an increase of $18 million from the prior year primarily related to a $16.6 million gain on the sale of two of our medical office buildings located in Van Nuys, California and the sale of one of our industrial properties located in Joliet, Illinois. All three assets sold within a very narrow range of their most recent independently determined appraised values. Additionally, there was a $6.5 million unrealized gain recorded on the New York City Retail Portfolio.

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 year ended December 31st, we reported FFO of $69 million – an increase of approximately $19 million or 39% from the prior year, primarily due to the increasing FFO contributions from our new acquisitions. Our per share FFO was $0.51, an increase of $0.05 from the prior year.

We 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 was $64 million for the year ended December 31st compared to $45 million for the same period in 2016, a 40% increase. The increase is primarily attributable to contributions from our new acquisitions. Our per share AFFO was $0.47, an increase of $0.05 or 12% from the prior year.

We generally see the fundamentals across all four primary property types as strong and continuing to improve. In 2017, we focused on reinvesting capital to enhance our portfolio and increase our diversification by property type, geographic region, lease maturity and underlying tenant industries. During the year we acquired four new properties totaling $217 million and invested approximately $15 million of capital improvements in our existing portfolio, all geared towards capturing rent growth and maintaining our higher occupancies. Our asset management teams signed new or renewal leases totaling almost 614,000 square feet in 2017. Additionally, due to our aggressive tenant retention programs we had nearly 50% of our expiring apartment leases renew during the year.

Our apartment occupancy was 94%, a 4% increase from the prior year. During 2017 positive market conditions have enhanced the execution of our “lease to core” apartment strategy at Dylan Point Loma, our apartment property located in San Diego, California. We acquired Dylan Point Loma in August of 2016 during its initial lease-up, with an occupancy of 40%. We were able to successfully increase occupancy by 53%. As of December 31, 2017 the property is stabilized at 93% occupancy.

The occupancy of our retail segment remains very strong at 95%, a slight decrease from the prior year but still exceeding national averages given our focus in the grocery anchored segment.

Our Office occupancy was 94%, a 6% increase from the prior year. During the year we disposed of our office property located in Calgary, Canada. This property was 55% occupied so removing this asset increased our overall office segment occupancy.

The occupancy of our industrial segment decreased this year by 4% to 93% compared to the prior year due to the anticipated move-out at lease expiration of an existing tenant in one of our Atlanta warehouse properties. The overall Atlanta warehouse market fundamentals remain quite strong and we are optimistic about the future releasing prospects for this 409,000 square foot vacancy. During the year, our asset management team successfully executed a lease termination at our O'Hare Industrial Portfolio and quickly backfilled the space at a rental rate that was approximately 43% higher than the previous tenant. That is just one example of the opportunities we see to capture upside rent growth within our portfolio.

We remain positive about the overall 2017 year end occupancy of the portfolio at 94%. At the end of the year our portfolio's weighted average lease duration was strong at 6.3 years and the average minimum base rent per occupied square foot was $13.53, an increase of 8.3% compared to the prior year.

One of our primary investment objectives is to offer an attractive level of current income to our stockholders. Our Board of Directors approved an increase in our quarterly distribution for the first quarter of 2018 to $0.13 per share, a 4.0% increase. The dividend will be paid to stockholders of record as of March 28th, payable on or around May 1st. These gross dividends will be paid out to stockholders, but will be reduced for share-class specific fees. This increase represents the fifth time we have raised our dividend since the first quarter of 2012, and the 25th consecutive quarterly dividend paid, with an average annualized dividend growth rate of 5.4% over that 6-year period.

On tax efficiency, 100% of the distributions paid in 2017 qualify as non-dividend distributions or return of capital. The distribution I previously mentioned for Q1 will be a 2018 tax event and is not reflected in the 2017 tax allocation. As we seek to produce enduring wealth for our investors, we are pleased to once again report having paid out highly tax-efficient distributions to our stockholders. While our primary investment objectives remain durability of income distributions and preservation of capital, for our taxable investors, we also strive to provide them with a longer-term source of tax-advantaged income.

There was an increase in our NAV throughout 2017 for our Class A and M shares of 4% as compared to 2016 as a result of a net increase in the value of our portfolio. Our daily NAV methodology has provided stable market valuations and we have realized moderate appreciation in share price since 2012. As a public company that is not listed on a stock exchange, our share prices are not driven by the same market fluctuations that affect listed stocks. Our share price is determined based on the regular, 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 discuss in detail our accomplishments for the quarter.

Allan Swaringen – President & Chief Executive Officer
Thanks, Gregg. During the quarter we executed on a number of strategic initiatives, which helped drive operational and investment performance while positioning the company for future growth and enhanced stockholder value.

Acquiring high quality, state-of-the-art warehouses in select, primary transportation hubs continues to be a core component of our Industrial investment strategy. In December, we acquired Mason Mill Distribution Center, a newly-constructed 340,000 square-feet Class A industrial property located in Atlanta's northeastern submarket. The northeast industrial submarket is Atlanta's largest and has historically been the favorite of institutional investors and larger distribution tenants. This area has higher barriers to entry due to topography, few developable land sites and the increased resistance by municipalities to permit industrial development, which is curtailing new construction when compared to other Atlanta area submarkets. The property is fully leased to a high-credit publicly-traded global pharmaceutical company for ten years through 2027. We are pleased to add this high-quality industrial property to our portfolio, as we increase exposure to core assets in high-barrier-to-entry markets. The fundamental tailwinds benefitting the industrial real estate sector are numerous.

Additionally, during the fourth quarter we successfully sold one of our industrial properties located in Southwestern Chicago. Investor demand for core industrial assets in major markets is robust with limited product available. As a result, pricing of this property was driven up by competitive bidding achieving a gross sales price of $63 per square foot versus the underwritten 5 year target value of $51 per square foot. This disposition is also a good example of one of our successful leasing strategies. When a major tenant vacated 47% of the building last year, we invested capital to ready the space for relet. With only nine months of downtime, we were able to backfill the entire vacancy and increase the rental rate by 6%. Given this strong growth in rental rate, the robust capital markets, along with our concerns about potential weakness in the southwest suburban sub-market, this sale was in-line with our long-term strategic objectives.

With this 4th quarter acquisition and strategic disposition our portfolio is now comprised of 28 industrial warehouses, 24 retail properties, 5 office buildings, 10 apartment complexes and 2 parking garages. In total, across all 69 properties, we now own almost 14 million rentable square feet. At the end of Q4 our portfolio diversification by property type was 30% Retail, 26% Apartment, 23% Industrial, 19% Office and 2% Other.

During the fourth quarter we repurchased approximately $21 million in shares pursuant to our share repurchase plan. For the first quarter 2018, share repurchases are limited to approximately $78 million which is 5% of the NAV as of December 31st. 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 stockholders who desire to rebalance their asset allocations subject to the quarterly limits and minimum twelve month holding period.

We remain committed to actively managing our real estate assets to provide attractive income returns to our stockholders. We delivered above expected total returns last year, all the while maintaining a higher quality, lower leverage portfolio of institutional-caliber investments. We believe both property type and market selection will continue to be one of the greatest contributors to our strengthening investment performance.

Our target acquisitions for 2018 remain well-located industrial warehouses and grocery-anchored neighborhood and community shopping centers along with conventional apartments in either urban and transit-oriented locations or suburban, supply-constrained markets within highly-rated school districts. We are very pleased with our accomplishments throughout 2017 and over the last five years. We believe we are well positioned to take advantage of the opportunities in 2018 and beyond. We realize that our success is directly attributable to our loyal stockholders, our incredibly talented and committed colleagues across LaSalle and JLL, our expanding roster of supportive distribution partners and the growing community of financial advisors that place their trust in us and continue to recommend us to their clients. We are grateful for your support.

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

Operator
Certainly. [Operator instructions]. Our first questions come from the line of Bert Olson. Please go ahead with your questions.

Q: Thanks very much. Allan, appreciate your comments there. There's really a broad consensus that interest rates will rise this year, could be multiple times. I'm wondering how this will impact the performance of your portfolio.

Allan Swaringen – President & Chief Executive Officer
Bert, thanks for the question and certainly, interest rates and the outlook for interest rates continue to be a pretty hot topic as it relates to real estate. I'd like to first frame my comments more broadly and then I'll ask Gregg, our CFO, to make a few more specific comments about characteristics of the IPT portfolio and our debt profile. Principally, our strategy has been to operate this portfolio at a fairly low leverage rate. At the end of the year, we finished at 39% LTV for a core income oriented strategy. A number of our competitors out there are running their portfolios at much higher LTVs, 50%, 60%, 65% LTV. We think at this stage in the overall real estate cycle, while interest rates are definitely trending up, they're still, by historical comparisons, fairly low. We still feel like being low leverage is the right way to go to really protect investors' principle values in capital, so we operate at very low leverage.

Also, the Fed moving the short rates up is not necessarily impactful to our portfolio because we are principally a long term fixed rate borrower and our borrowing is mostly geared towards the 10-year treasury. Now, the 10-year treasury moved up pretty significantly right at the end of the year last year and coming into this year, once the tax reform was passed and the outlook for growth in the economy was sparked, but still the 10-year is running at about 2.8%, between to 2.9%, and that's still relatively low by historical standards.

Gregg, what would you add to that in terms of the interest rate outlook, or more particularly, the interest rate profile within our IPT portfolio?

Gregg Falk – Chief Financial Officer
Sure, Allan. Thanks. So, right now we're made up of about 85% fixed rate long term mortgages, about 15% floating rate debt, some of that debt also has some interest rate caps associated with us to protect us on the down side. Our weighted average interest rate on our portfolio is about 3.5% and we have almost seven years of weighted average term remaining with our loans outstanding. I feel like we're substantially protected against any real big increases in interest rates, just based on how we designed the portfolio and the overall debt structure of our investments and the mortgage debt.

Allan Swaringen – President & Chief Executive Officer
So, Bert, we continue to be very focused on having a higher quality, lower risk, and less interest rate sensitive type portfolio with how we've approached our borrowing.

Q: Fantastic. Thank you.

Operator
Our next questions come from the line of Matt Blackburn. Please go ahead with your questions.

Q: Yes, thanks. With the continued growth of e-commerce and online shopping, do you expect the industrial sector to continue to outperform other property types? What is your strategy for this sector?

Allan Swaringen – President & Chief Executive Officer
Thanks, Matt. So, we have a healthy allocation to bulk industrial warehouses within our portfolio. We own 28 separate properties spread out throughout the country and it makes up about 23% of our growth assets. As a matter of fact, if we could own more industrial, I think our whole portfolio team would very much like to add that, though industrial was the best performing property type across the [indiscernible] index last year in 2017 and the outlook is for it to continue to grow. Matt, you kind of hit on it. Certainly the growth in e-commerce and online shopping has driven that but there's certainly other factors too, retailers trying to push their supply chains downstream and to own less retail goods in the expensive retail locations and try to move more towards just-in-time delivery. All of those factors are increasing the demand for warehouses and we think that's going to continue to grow.

Our focus in the warehouse space has also been very much to own higher quality, more recently constructed, higher credit tenants, so we're certainly not exclusively net lease or credit tenant type investor, but we do like to know that when we're buying a warehouse, and it has an eight or nine or ten-year lease on it, that the tenant there is going to be a higher credit tenant and we can bank on that rental stream.

The other area that is focused on us in industrial, a lot of folks have a kind of adopted this last mile approach, and it has certain merits but I think you can be last mile in a lot of markets and maybe not have very high quality warehouses. Our focus has been much more about distribution hubs and focusing on owning warehouses in close proximity to transportation infrastructure of the US. That transportation infrastructure, which for us is focused on airports and interstate highways and seaports and railways, that transportation infrastructure of our country, it doesn't move very often, there's billions if not trillions of dollars invested in that transportation infrastructure and so these primary transportation hubs, we've seen that the tenants are very, very sticky. They will pay a higher rent to be in close proximity to these transportation infrastructure and we believe that, again, in the later stages of the real estate cycle here, we're going to be better positioned and we think our stockholders are going to be better positioned to own higher quality buildings in better locations and we really haven't strayed much from A quality or B+ quality warehouses.

So, if you look at our locations, we're going to be in and around these primary markets, like this new building we just bought in Atlanta, but we own warehouses in and around Chicago O'Hare airport, we own warehouses in and around Seattle and the seaports, we own warehouses in and around DFW airport in Dallas. Those are the markets that we like and we're going to continue to selectively add to the portfolio when we can find good risk adjusted returns. It is a competitive environment though. A lot of investors have jumped on this theme and continue to bid up prices, so we're going to be disciplined, and to be honest, we only added one warehouse to our portfolio last year. We would have liked to have done more, but we're going to be selective and in some cases even prune where we feel like the market may be valuing a property more than we think its long term outlook might be, which led to our sale of a warehouse also. So, we're going to be quite thoughtful about our overall approach there.

Q: Thank you.

Operator
Thank you, and our next questions come from the line of Joe Werner. Please go ahead with your questions.

Q: Hi, Allan. Thanks for that information. A question I have is, how have the recent tax reforms affected commercial real estate, REITs and then your outlook in general?

Allan Swaringen – President & Chief Executive Officer
Thanks for that question. That's pretty timely, too. I am going to make a few broad comments and then I'm going to ask Gregg to also provide a little more color on this question, and I would say there's still a lot of digestion going on as it relates to the tax reform bill. It was passed very quickly and there's still a lot of tax lawyers and tax accountants around the world analyzing it and trying to understand exactly what it means and how it will impact all asset types and certainly commercial real estate. So, a lot of moving pieces on it, but at a headline comment, and I guess somewhat not surprising, given the President we have in office, the tax bill was extraordinarily favorable to real estate as an asset class.

There were many concerns coming into the tax reform process, concerns relative to maybe losing the 1031 like kind exchange, which was actually protected and maybe potentially massive changes to the write off or the depreciation of real estate, which for the most part was not changed substantially, but overall, the tax reform bill was very favorable to real estate and even in more particular with real estate, very favorable to REIT. So, while there's still more work to go, to be done determining how it will affect IPT and our ability to generate tax advantaged cash flow to our stockholders, the outlook for that has actually been improved, so we continue to be quite optimistic that investors, first off should be investing in us for long term preservation of capital, and modest appreciation and then some nice, hopefully, tax advantaged income, but if nothing else, good reliable [indiscernible] income.

Gregg, why don't you provide a few more comments on some of the specifics of the tax reform bill and our thoughts about it from what we've been able to determine already.

Gregg Falk – Chief Financial Officer
Yes, thanks. Definitely real estate was one of the protected industries out there in this tax bill. Allan mentioned the 1031 like kind exchanges. They were done away with for everyone except for real property owners, so we were very much protected there. We do utilize those strategies to try to offset any gains that we have at properties with buying other properties to try to protect investors' taxability. Another thing is where most industries lost part of their interest deduction, real estate can make an election to fully deduct the interest expense that we pay on our mortgage loans. In exchange for that, we do have to lengthen the life of a few of our assets, but not materially, for instance, commercial properties are increasing from 39.5 years to 40-year depreciable life and residential real estate goes from 27.5 years to 30 years, so we'll definitely make that trade off at any point in time, so we were happy with that.

State and local property taxes are fully deductible for pass through entities, so we're not getting hit with any of the caps like individual tax payers are, so we were pleased with that. Then finally, should we have any ordinary incomes come through on our 1099s, the maximum rate on that has decreased from 39.6% at the federal level to 29.6%, so definitely favorable for real estate in a number of ways, so very pleased with the outcome of the tax bill so far.

Allan Swaringen – President & Chief Executive Officer
Yes, and while there's still some more work to do on that, it appears that the tax writing legislation is this lower interest rate, this pass through rate that Gregg talked about, it's really going to only be available to investors who directly invest in REITs or own REIT shares of publicly traded companies or a non-traded REIT such as us, but that you won't get that same benefit if you own a REIT mutual fund or if you own REIT ETFs. A little more work to be done on that, but we think it's actually going to continue to enhance stockholders in programs such as ours

and give them really some of the best tax breaks you can find out there. So, generally pretty favorable in the outlook for us and our after tax returns is still pretty positive.

Q: Wonderful. Thank you for that information.

Operator
Okay, thank you. We'll pause for a few more moments to see if there are any further questions. [Operator instructions]. And it seems that we have no further questions. I'd like to turn the floor back over to management for any closing comments.

Allan Swaringen – President & Chief Executive Officer
Thank you, all, for joining us today and we look forward to speaking to you after the end of the first quarter with our first quarter 2018 update. Thank you for your time today.