Transcript of JLL Income Property Trust
4Q18 Public Earnings Call
March 15, 2019

Participants

Allan Swaringen – Chief Executive Officer
Gregory Falk – Chief Financial Officer
Jill Passmann – Sr. Portfolio Accountant

Presentation

Operator
On behalf of JLL Income Property Trust, I'd like to welcome you to their fourth 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 Jill Passmann, from JLL Income Property Trust. Jill, please go ahead.

Jill Passmann
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, 2018, 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 quarter ended December 31, 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 Annual Report on Form 10-K filed on March 8, 2019 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
Thanks, Jill. Hello, everyone, and thank you for joining us for our fourth quarter earnings call. JLL Income Property Trust continues to focus on strengthening our $2.7 billion-dollar portfolio of 70 core properties that span the apartment, industrial, office, and grocery-anchored retail property sectors. Our strong operating performance has continued to support our AUM, NAV and dividend growth. In the fourth quarter, we achieved total net of fees returns of 2.6% and 2.7% on our Class A and M shares,

respectively. Quarterly dividends have now been paid for 28 consecutive quarters, with an average annual increase of nearly 5% over that 7-year period. I would like to kick off today's discussion with an overview of the economic environment in which we operated, before diving into the specifics of our accomplishments this quarter.

Real estate's low beta asset class characteristics were demonstrated in the fourth quarter of 2018, as private commercial real estate performed in line with the healthy GDP growth, rather than tracking volatile financial markets which dipped sharply in the fourth quarter. 2018 US GDP growth totaled 2.9%, boosted in part by the tax cut stimulus and was resilient to the impact of trade protectionism, higher interest rates, and financial market volatility. Our outlook is that growth will slow slightly in 2019, but remain strong enough to drive incremental positive real estate demand. The fourth quarter stock market volatility led the Federal Reserve to put on hold the steady interest rate increases seen in the last two years, and interest rates are now down from where they were in the fourth quarter. The expectation is they will be steady through 2019. Job growth in 2018 accelerated to its fastest pace since 2015, with 1.9% year-over-year growth as of January 2019. This generally fueled real estate tenant demand growth of a similar magnitude. In 2018, based on data from CBRE, industrial warehouse absorption growth was 2.4% of inventory. Apartment and office absorption followed at around 2.0% and even open-air retail absorption showed positive growth of 0.6% of inventory. While the retail property sector is dealing with e-commerce related headwinds, it is important to note that net demand is still positive and growing.

Relative to previous cycles, overall low vacancy rates and moderate new supply are expected to put real estate in a good position to weather a downturn. Vacancy declined for every major property type in 2018 and is near or below its previous cyclical lows for all property types but retail. Construction, as a share of existing stock, is highest for apartments at 3.7%, followed by office and industrial. New retail construction is extraordinarily low at just 0.3% of existing inventory. These pipelines are below the mid-2000s cyclical peak levels, except for apartments where the bulk of demand has shifted from condos to for-rent apartments.

Rents have been growing slightly faster than inflation across all major property types. Industrial rent growth cooled, but continues to be the strongest with 3.5% growth in 2018. National office and apartment rent growth accelerated with both increasing 2.7% last year. Retail rents are also growing, particularly for food and service tenants at grocery anchored shopping centers as open-air retail rents moved up 2.4% in 2018.

According to Real Capital Analytics, real estate capital markets transactions volume rose nearly 10% in 2018 to over $400 billion dollars, with the greatest increase in apartment and industrial transaction volume, while office was down and retail was flat year over year. Real estate capital markets enter 2019 with stable cap rates and ample liquidity. Debt is widely available and capital flows are stable, though investors are focused on the best properties and markets, especially for office and retail. All-in debt costs rose moderately in 2018, driven by rising risk-free rates, which were partially offset by compressing spreads. Our expectation is that transaction volume will be in line with previous years in 2019 and that industrial and apartment will remain the most sought after property types by core investors. NCREIF Property Index appreciation returns slowed in the fourth quarter, with a total return of 1.4% bringing the 2018 total return for this institutional benchmark to 6.7%. The income return for the year was 4.6% in 2018. We expect that to move slightly higher in 2019 and for the majority of the total return to come from income. To combat the risks associated with being late in the cycle and a potential slowdown in the economy, we continue to focus on investing in higher quality, stabilized real estate in primary and strong secondary markets that is diversified across property type and geographic markets.

Gregg will now provide a recap of our portfolio's financial performance, before I continue with Q4 results. Gregg?

Gregg Falk

Thanks, Allan. We finished the year off strong, with total year to date revenues of $171 million dollars and net income of $26 million dollars. This represents a growth of 3% and 13%, 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 year ended December 31st, we reported FFO of $65.2 million, in line with the prior year. Our YTD FFO per share was $0.48.

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 in 2018 remained consistent with the prior year at $63.2 million, which equates to $.47 cents per share.

Portfolio occupancy remained consistent at 94% throughout the end of the year. Our occupancies by segment were 94% for Apartment, 93% for Industrial, 92% for Office and 97% for our grocery anchored retail portfolio. Maintaining high occupancies has been an area of focus for our asset management team. Our leasing activity was very strong in 2018 with over 650,000 square feet of new and renewal leases completed, which resulted in an average 10.4% increase in base rent. Our weighted average lease duration at year end was 5.6 years, in-line with the prior quarter.

We strive to offer a reliable and attractive level of current income to our stockholders that has the ability to grow over time. For the first quarter of 2019, our Board of Directors approved an increase to our gross distribution to $0.135 per share to stockholders of record as of March 28th, payable on or around May 1st. This represents an increase of approximately 4% over the prior quarter. These dividends will be paid out to stockholders, but will be reduced for share-class specific fees, if any. 2018 dividends were again very tax efficient with 99% of our dividends paid qualifying as nondividend distributions or non-taxable return of capital distributions.

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 6.7% and 7.3%, respectively. We continue to search for investment opportunities that will further diversify our portfolio, enable moderate NAV growth, and generate favorable risk-adjusted returns.

Our NAV grew to $1.7 billion at the end of the year. Valuation gains were generally attributable to favorable market conditions, driving increases in both rental rates and investor demand. Our daily NAV methodology has provided stable market valuations, as evidenced by our sub 2% standard deviation of share price, and we have realized moderate appreciation in share price since we began the 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 the independent appraisals of the real estate investments we own and the income they generate.

As an SEC registered company, JLL Income Property Trust holds annual stockholder meetings to seek approvals for various proposals, including the election of our majority independent board of directors and occasionally other business. Our annual stockholder meeting is scheduled for June 13, 2019 at 8:30 a.m. in Chicago. Beginning in early April we will be mailing to all stockholders a copy of our Annual Report and Proxy Statement and launch our Proxy solicitation outreach program. We need a majority of our shares of common stock voted in order to have a quorum for the stockholder meeting. We ask for your help in voting your shares or encouraging your clients to vote their shares.

Now, I'll hand the call back over to Allan to highlight some Q4 accomplishments.

Allan Swaringen
Thanks, Gregg.

As far as strategic initiatives, we focused on a key disposition during the fourth quarter. In mid-December, we entered into an agreement to sell 111 Sutter Street, a multi-tenant office property located in the central business district of San Francisco. This sale recently closed for $227 million dollars, or about $800 per square foot. 111 Sutter Street has been one of our best performing investments over the last seven years. That said, we believe that in today's market, it is essential to be a timely seller and to harvest gains and reinvest in properties and markets that we believe represent better risk-adjusted opportunities for our investors. In order to de-risk our portfolio, we have been underweighting our allocation to office properties and focusing on property types that historically have required less ongoing capital investments and have generated more free cash flow from operations. The transaction closed in early February and resulted in an accounting gain of approximately $107 million dollars. Proceeds from the sale will be reinvested across a number of other properties and geographic markets further diversifying JLL Income Property Trust's portfolio.

During 2018, we acquired three new properties in the apartment sector across two different geographic regions, for a total investment of approximately $150 million dollars. The addition of Villas at Legacy, located in Plano, TX, and the Tremont and the Huntington, located in north suburban Boston, bringing our aggregate apartment allocation to just over $730 million, today representing 30% of our total portfolio. These investments are in line with our apartment strategy to acquire properties in supply-constrained suburban markets with highly rated schools and strong market fundamentals and demographics.

Our overall company leverage ratio remained consistently low at 39% at the end of Q4. Across our portfolio, 96% of our total debt is at a fixed rate. With limited near-term debt maturities, we have a portfolio-wide weighted average remaining loan term of nearly 6.6 years and our weighted average interest rate on outstanding borrowings is 3.8%. We also expanded our unsecured credit facility by $100 million dollars, increasing it to $400 million and extended its maturity date by one year to Q2 of 2021.

Turning to our stock transactions, in Q4 we repurchased approximately $26 million dollars in shares pursuant to our share repurchase plan, which had a fourth quarter limit of $81 million. For the first quarter 2019, share repurchases will have a limit of approximately $84 million, which is 5% of the NAV of the company 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 the stockholders who desire to rebalance their asset allocations subject to the quarterly limits and a twelve-month holding period.

Going into 2019, we are focused on investing capital in the industrial, apartment, and grocery-anchored retail sectors, as well as complementary low beta strategies such as medical office, which fulfill key portfolio investment goals of stable income and moderate NAV growth over time. During 2018, we reinvested approximately $18 million dollars of capital improvements in our existing portfolio, all geared towards maintaining our higher occupancies. At the end of Q4, our portfolio diversification by property type was 28% for Apartments, 23% in Industrial, 19% in Office, 29% in Retail and 1% Other, which currently consists of two parking garages.

We remain committed to actively managing our real-estate portfolio to generate attractive income returns, preserve investor capital, and realize moderate appreciation over time. Our NAV has continued 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 results in 2018.

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 in the new 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
Thank you. [Operator instructions]. Our first question is from Mike Laudizio. Please proceed with your question.

Q: Yes. Hi, Allan. You had mentioned the sale of your San Francisco office already this year. What are some of your other top priorities for 2019?

Allan Swaringen
Great. Thanks for the question. Overall, 2019 is going to be a pretty active year in terms of adding new investments to grow and further diversify our portfolio. Our deal pipeline is stronger than it's ever been and coupled with proceeds from the Sutter sale that we need to reinvest, we're also seeing capital flows increasing nicely. So we are pretty optimistic about the growth this year in terms of growing the number of properties in the portfolio and just overall diversifying the portfolio. All the while, we're going to maintain our priorities to operate at a lower leverage and continue to utilize more fixed-rate debt than floating rate borrowings.

I think we'll also continue to focus on what we think are low beta investments. One of the themes from LaSalle's 2019 investment strategy annual identified a whole new way of thinking about real estate and low beta opportunities which, from our perspective, we continue to underweight [ph] office but we do like medical office in the later stage in this cycle. We'll also continue to focus on industrial and in the whole portfolio, from an asset management standpoint, we're going to watch near-term lease rollover and aggressively try to lease and re-lease properties throughout the portfolio just to try to extend our lease duration there and try to mitigate any risks around 2021 or 2022 economic downturn.

Operator
Our next question is from Jack Eastman. Please proceed.

Q: Good morning. Thank you, Allan. This is a great update. There was a lot of activity last year. What would you highlight as your most significant accomplishment?

Allan Swaringen
Great. Thanks, Jack. I think first and foremost, we very much like to think probably the most important thing we can do for our stockholders is investment performance and generating right around 8% net of fees across three of the four share classes, we were very pleased with that. That's probably the headline accomplishment that we're most proud of, achieving those returns at the upper end of our target range. I think that's a real complement to our asset management teams and I principally mention that because these returns were primarily driven by revenue and NOI growths with interest rates trending up throughout last year. We really weren't the beneficiary of increasing cap rate compression which would drive the increase in the values of the property. So, a lot of the returns last year were driven by heavy lifting at the property level and increasing revenues and NOI. We actually expect that to continue into 2019 and beyond because we don't anticipate having a lot of benefits of cap rate compression.

I think second—in addition to our investment performance, what happened in the fourth quarter across all other asset classes, there was a significant amount of market volatility and concerns about trade war and saber [ph] rattling and certainly uncertainties in the global economies and the UK and the continent and so I think, probably secondarily, we were most proud of that IPT really showed up being that shock absorber in client portfolios. We position income property trust as a good source of reliable income but also a preservation of principal and capital for our clients and certainly, in the fourth quarter, where there was significant volatility across all other asset classes, we felt like our performance in the fourth quarter was a bright spot for financial advisors in an otherwise kind of bleak and noisy and bumpy ride in the fourth quarter. Overall aggregate performance and then smoothing out volatility across other classes was, I think, our highlights for last year.

Operator
Our next question is from Jim Melnick [ph]. Thank you. Please proceed.

Q: Yes. Good morning and thank you for taking my question. In terms of looking at the forward projections of the US economy that you touched on earlier in the call, I was just wondering what risks you see on the horizon this year for commercial real estate and JLL Income Property Trust in particular?

Allan Swaringen
Great. Thanks, Jim. 2018 was a strong year overall for real estate fundamentals. Leasing was strong and occupancies are up and rent growth was up, so there was a lot of positive at the overall fundamental level for real estate and we expect that to continue. From a risk and things we're focused on, I would kind of go back and focus on what we accomplished in terms of what Greg and I both highlighted in our

comments about the 111 Sutter sale. I think that's just such a great example of our focus on de-risking the overall IPT portfolio.

Sutter was an asset that had grown significantly in value. It was approaching nearly 10% of the growth assets of our overall fund and it being a multi-tenant office building and one of the more volatile office markets in the country, that being San Francisco, we just think an example of kind of harvesting those gains and redeploying that investment is probably one of the best things we can do from an overall risk management standpoint.

Our goals, instead of having single, lumpy risk exposures in a highly volatile market, we'll take the proceeds and redeploy those in the three or four different assets across different property types and across different geographic markets, which we think, you know, overall diversification is about the best risk management tool we have and we're going to continue to demonstrate that through active and thoughtful selling and then capital redeployment and diversifying the portfolio. So that's kind of our highlight for last year and what we're going to continue to focus on this year.

Q: Great. Thank you.

Allan Swaringen
Operator, any other questions?

Operator
Yes our next question is from Max Stergner [ph]. Please proceed with your question.

Q: Yes, thank you. The 111 Sutter news seems to be a great sale, but given the size of the transaction and the significant long-term capital gain, could you share the details of the tax implications?

Allan Swaringen
Yes, Max. Great question. I'm going to ask Greg, our CFO, to cover that one.

Greg Falk
Yes. Thanks, Max. Yes, we are very pleased with the execution we had on 111 Sutter. Being disciplined sellers is really an important part of our active asset portfolio management strategy. As far as 2019 tax outcomes, they won't be finalized until we issue our 1099 in Q1 of 2020 but, likely a larger percent of our dividends paid will be allocated to long-term capital gains.

As we think about taxes internally, while it's a very important second goal for us, it's really secondary to our investment performance. How we try to do this is we try to allocate the least amount of our dividends to ordinary income, the highest tax rate at 29.6%. We try to get the largest amount allocated to return of capital which is a 0% tax rate, though it's really just a deferral of income taxes as it reduces everyone's basis in their shares, with the middle ground being long-term capital gains. When we talk to investors and financial advisors we really tell them, long term we try to achieve 50% taxable, 50% non-taxable return of capital outcomes. But from year-to-year, this will vary widely. With good tax planning, we hope that we can be able to shift some portion of the ordinary income taxable piece to long-term capital gains which will be at a lower tax rate.

While I have the stage here, I'd also like to just make one more plea for our stockholders, to vote their shares so we can elect our board of directors. The best way to avoid being contacted by our proxy solicitors is to vote your shares early and avoid all of that. Thank you very much for your question, Max.

Operator
There are no other questions. This concludes today's call. I will hand the call back over to Allan Swaringen for closing remarks. Allan?

Allan Swaringen
Great. Thanks everyone for joining us today. We look forward to updating you next quarter.