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Participants

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John Guinee – Stifel Financial
Christopher Lucas - Capital One Securities

Presentation

Operator

Welcome to the Washington Real Estate Investment Trust year-end 2019 Earnings Conference Call. As a reminder, today's call is being recorded. Before turning over the call to the company's President and Chief Executive Officer, Paul McDermott, Amy Hopkins, Vice President of Investor Relations will provide some introductory information. Amy, please go ahead.

Amy Hopkins – Vice President of Investor Relations:

Thank you and good morning everyone. Before we begin, please note that forward-looking statements may be made during this discussion. Such statements involve known and unknown risks and uncertainties that may cause actual results to differ materially, we undertake no duty to update them as actual events unfold. We refer to certain of these risks in our SEC filings.

Reconciliations of the GAAP and non-GAAP financial measures discussed on this call are available in our most recent earnings press release and financial supplement, which were distributed yesterday and can be found on the Investor Relations page of our website.

Participating in today's call with me will be Paul McDermott, President and Chief Executive Officer, Steve Riffee, Executive Vice President and Chief Financial Officer, Drew Hammond, Vice President, Chief Accounting Officer and Treasurer, and Grant Montgomery, Director of Research.

Now I'd like to turn the call over to Paul.

Paul McDermott – President & Chief Executive Officer

Thank you and good morning, everyone. Thanks for joining us on our year-end 2019 earnings conference call. Today I'll discuss our growth outlook in the context of our strategy for long-term value creation. But before

focusing on the path ahead, I think it's important to take stock of our recent accomplishments. I'm going to begin with a recap of how we delivered shareholder value through strategic capital allocation and leasing during 2019.

2019 was a pivotal year for WashREIT on multiple fronts. We executed the largest and most transformative strategic capital allocation in the history of the company. We delivered strong results from our multifamily portfolio and further validated our value-oriented investment strategy. We also achieved the primary goal that was laid out at the beginning of last year, which was to create visibility on future revenue growth by executing commercial leases.

Starting with our strategic capital allocation, we executed $1.3 billion of transactions that recycled capital out of high risk, capital intensive commercial assets into multifamily assets with value-add potential. These transactions improved our risk-adjusted growth profile, lowered the volatility of our cashflows, and improved our FAD growth prospects. The multifamily acquisitions doubled our pipeline for unit renovations, which generated an average return on investment of 14% in 2019 and are expected to generate double digit returns in the future. With lower capital requirements and a fully scoped renovation pipeline, we have solidified a foundation for multiple years of value creation within our multifamily portfolio. We were able to do all of this while maintaining our balance sheet flexibility and liquidity.

The assets that we acquired in 2019 follow our stated multifamily investment strategy. The Washington area continues to under produce new housing units of all types, despite the housing shortage in the region. Over the past decade, the Washington region has produced, on average, 17,000 units of single and multifamily housing per year, which is well below the need for nearly 29,000 units according to an analysis by George Mason University. Due to the high costs of construction, land, and labor it is increasingly difficult for the new product that is being delivered to be affordably priced for the mid-market renters.

WashREIT has focused on investing in assets that offer value-add potential in locations where there is a wider than average differential in price, or "gap" between housing options that are affordable for mid-market renter income segments versus new apartment supply. Our research indicates that mid-market renter households drive 25% of regional rental demand, yet only 5% of new construction built over the past seven years is affordable for these renters.

Prior to 2019, we were predominantly focused on urban multifamily infill locations. However, close monitoring of trends led us to expand our strategy to the suburbs. The DC region has one of the longest average commutes in the country due to the high cost of homeownership near major job centers, which unlike many other large US cities, are more spread out rather than being concentrated in the city. Over 70% of regional household growth is projected to occur in the suburbs over the next five years, driven largely by aging millennials looking for more space and better schools near major employment centers. Given the high cost of home ownership, as the wave of millennials age into their late thirties and early forties, they will continue to rent at rates greater than previous generations – driving up this age group's share of new renter households over the next five years from 30% to nearly 70% according to NMHC.

Turning to our commercial asset sales, the assets that we sold last year demonstrate the continued execution of our plan to eliminate major risks to cashflow stability within our portfolio. We liquidated our exposure to big box retailers this past year, and since our last earnings call, we monetized our exposure to single tenant assets and will close on the sale of our final single tenant office building next month.

Moving onto our commercial leasing achievements, alongside the execution of our strategic capital allocation, our team delivered same-store NOI at the top-end of our guidance range and exceeded our 2019 leasing targets. As we foreshadowed in late 2018, 2019 would be a challenging year with an elevated number of vacancies due to several large commercial lease expirations. Thanks to the strong efforts of our leasing team, we have addressed not only the significant vacancies incurred in 2019 but also 70% of our original 2020 expirations. Additionally, the leases that we signed last year set us up for a strong growth trend during 2020.

Lastly, we have delivered Phase I of our WashREIT-led ground-up multifamily development. The Trove offers a unique value proposition as the only community along the Columbia Pike corridor with substantial rooftop amenities at a price point that is below every other new building in National Landing. We are now in lease-up for Phase I and we remain on track to deliver Phase II later this year, with stabilization expected to occur in 2021.

Moving forward, we are in a much stronger position than we were just a year ago with significantly less commercial NOI at risk and multiple growth drivers across both our multifamily and commercial portfolios.

We have previously communicated that 2020 will be an inflection year. We expect strong growth in the second half of the year driven by key office lease commencements on vacancy that was backfilled during 2019, along with consistently strong multifamily NOI growth. We remain confident in the growth outlook for our multifamily portfolio given the demand that we are experiencing for our value-oriented assets, our ability to drive renovation-led value creation, and the strategic operating improvements we are implementing over the near and long-term. Moreover, we expect the Trove multifamily development to lease up throughout 2020 and to contribute to strong year-over-year growth in 2021 and beyond.

We have designed our renovation programs within each community to provide our value-oriented renters with an improved living experience and compelling value proposition. We attribute our ability to design attractive, cost-effective renovation projects to our deep knowledge of the local markets.

The renovation programs for the Assembly Portfolio and Cascade at Landmark have been appropriately scoped and early feedback from residents and on-site team members indicates that our programs are well designed and positioned for success. These programs are now under way and we expect to complete over 350 renovations within our non-same store portfolio in 2020 at an average cash on cash return in the low teens. Looking forward, we are positioned for multiple waves of growth from our multifamily portfolio driven by renovation-led value-creation, as well as, our near-term development deliveries and longer-term development opportunities.

Regional supply/demand dynamics continue to support our value-oriented multifamily investment strategy and geographic focus. On the supply front, while projected deliveries for the DC Metro are expected to increase in

2020, over 50% of the new supply is concentrated in the District. Deliveries in Northern Virginia, where 80% of our multifamily assets are located, are expected to decline by nearly 30% in 2020 according to Delta Associates.

With new deliveries declining and high labor and construction costs translating to higher price points, we are confident in our multifamily portfolio's relative positioning. Our multifamily investment strategy focuses on the largest and most underserved renter cohorts in our region, which are largely insulated from new supply because building to rent levels that are affordable for the highest growing renter income segments is economically challenging due to high land, labor and material costs. In our region, the supply of apartments with comparable Class B price points remain constrained.

Turning to regional multifamily demand indicators, our assets are positioned to benefit from Amazon's emerging presence combined with the recently enacted infrastructure and education spending, as well as regional growth in the technology sector overall. Over 90% of our Class A and Class B urban infill assets are located within a mile of the Metro and over 75% are located within a five mile radius of HQ2. The Wellington and the Trove are located less than two miles or a five minute shuttle ride from HQ2. The Maxwell is located less than a mile from George Mason's Arlington Campus, which will become home to a brand new Institute for Digital Innovation. Moreover, Riverside, where we have the opportunity to add 767 additional units and will likely break ground in the second half of this year, is located five Metro stops from HQ2 and three miles from Virginia Tech's future Innovation Campus.

Turning to the regional office demand indicators, approximately 60% of our office portfolio is located in Northern Virginia, which posted its largest positive net office absorption since 2006. Tech and cybersecurity demand drove 60% of our Northern Virginia leasing volume last year, and looking forward, we expect tech and cyber demand to continue to grow.

The defense budget is up 16% since 2017 and the 2020 budget delays have been resolved, which is a positive for The Dulles Tech Corridor, which captures 37% of all federal technology contracts. The government is awarding over $25 billion of cloud computing contracts to local private market tenants over the next 12 months, according to JLL. Since migrating legacy systems to the cloud is a federal spending priority, we expect government spending to be a positive driver for real estate demand in this region.

Space+, our flexible office program continues to drive strong leasing volume at above-market rates with less downtime and lower second-generation capex. In 2019, we grew the Space+ program by more than 100,000 SF of leased space and achieved a weighted average market premium of 10%, which hit a new high of 13% in the fourth quarter with a downtime of less than two months.

We believe that Space+ fills a need that is differentiated and likely here to stay compared to pure co-working providers. Space+ appeals to the graduates of co-working who are willing to pay for a separate identity, more flexible lease terms, and shared amenities. Our deep understanding of the tenant size that we are targeting allows us to maximize our operating efficiency.

For example, we build our spaces to be easily demised or joined without spending significant TI dollars. Additionally, we design branding opportunities in our spaces that can be updated and altered at a low incremental cost as leases turnover. Our ability to effectively design our spaces to re-use capex spend has resulted in 90% of our first-generation TI spend being reutilized for second generation leases. Overall, we are very pleased with the economics we are generating from our Space+ program.

Another shift that we are seeing in the market is that tenants are showing more interest in tenant experience programs that provide services beyond traditional office amenities. As a landlord, we view this as an opportunity to deepen our relationships with our tenants. This year, we are rolling-out an app-based experiential amenity named "&You" that aims to simplify life for our tenants in and out of the office. "&You" is already in the piloting phase at Silverline, Arlington Tower, and Watergate 600.

For our tenants, the value proposition is two-fold. The average employee can access services and information to streamline their lives – both at work and at home. For the office managers, HR teams, and the C-suite, the program contributes to employee attraction and retention, lowers the burden on their staff, and provides important emergency communications to the broader employee base. We expect "&You" to have a positive impact on tenant retention and more specifically, the conversion of shorter-term Space+ tenants into longer-term office leases.

And with that, I would like to turn the call over to Steve to discuss our fourth quarter financial and operating performance and our 2020 guidance.

Steve Riffee – Senior Vice President & Chief Financial Officer

Thank you Paul, and good morning everyone, as Paul described, the highlight of the year was the successful execution of the most significant capital recycling in the history of our company. I'm pleased that we were able to execute these complex transactions while maintaining our targeted balance sheet liquidity and flexibility and successfully executing the steps we laid out last spring.

Now turning to our financial performance, net income attributable to controlling interests for 2019 was $384 million, or $4.75 per diluted share, compared to $26 million, or $0.32 per diluted share in the prior year. The large increase is primarily due to net gains on asset sales from our executed strategic capital allocation transactions.

Core FFO of $1.71 per diluted share for full year 2019 was in line with the mid-point of our guidance range. On a year-over-year basis, core FFO per share declined by $0.15 due to our asset sales, partially offset by the acquisition of the Assembly Portfolio and Cascade, as well as the previously disclosed office vacancies that we have now substantially backfilled.

Overall, same-store NOI declined 0.2% year-over-year on a GAAP basis and increased 0.5% on a cash basis for the full year 2019 due to the 4.6% GAAP decline and 3.6% cash decline in same-store office NOI. Having executed the heavy lift to re-lease space, we delivered same store results at the higher end of our guidance range. As we discussed throughout 2019, the primary driver of the same-store office NOI decline was the

expiration of two large leases at Watergate 600 at the beginning of the year, the majority of which has been backfilled and the lease for the top two floors commenced prior to year end.

Multifamily same-store NOI increased 4.6% for the year and 4.8% in the fourth quarter driven primarily by rent growth. New lease rates increased 220 basis points during 2019, up from 180 basis points of increase in 2018 driven by renovation-led value creation. Renewal lease rates increased 430 basis points, up from 410 basis points of increase in 2018. On a blended basis, new and renewal lease rates increased 340 basis points for the full year compared to 300 basis points in 2018. As lease rate growth remains strong, we are maintaining occupancy levels in the mid-90s, allowing us to optimize NOI growth. Additionally, our focus on customer service resulted in a 200 basis point increase in resident retention in 2019 to 56% on a same-store basis.

Last year, we completed approximately 360 renovations in our same-store portfolio at a weighted average ROI of 14%. While our same-store property renovation programs are now 70% complete, the programs for our newly acquired assets are still in the very early stages. We have over 3,300 units in our pipeline and we expect our recently acquired assets to contribute the majority of our renovation-led value creation within our portfolio over the next several years.

Same-store GAAP NOI increased at our remaining retail centers, which we report as other, by 3.4% and cash NOI increased by 4.9% year-over-year, driven by higher value lease commencements at Spring Valley Village as well as higher recoveries.

Turning to leasing activity for the fourth quarter and full year. We signed approximately 46,000 SF of new office leases and 57,000 SF of office renewals in the fourth quarter. We achieved solid rental rate increases of 34% on a GAAP basis and 20% on a cash basis for new office leases, and 27% on a GAAP basis and 12% on a cash basis for office renewals, primarily due to demand for our repositioned assets in the District and Northern Virginia.

Retail signed approximately 9,000 SF of new leases and 8,000 SF of renewal leases during the quarter. The majority of our new lease volume was a 16-year lease for the entire second floor of the new building at Spring Valley Village to a concierge pediatric practice that has been operating in DC for over 90 years. This particular lease drove the increase in tenant improvements during the quarter.

On a full-year basis, we signed 268,000 SF of new leases and 257,000 SF of renewal leases at our same-store assets. As we previously messaged, 2019 was an important leasing year for our office portfolio due to several large lease expirations. As a result of our focused efforts, we signed several large, long-term leases that are expected to generate growth in the second half of 2020.

Now turning to our 2020 outlook, we are guiding to a full year core FFO per share range of $1.53 per share to $1.59 per share. This range does not assume any acquisitions are completed during the year and incorporates the assumed completion of the sale of John Marshall II in Tyson's Corner, Virginia in late March. We expect core FFO to bottom in the first quarter of 2020, driven primarily by our year-end asset sale. We expect strong growth in the second half of the year driven by commercial rent commencements, multifamily rent growth and renovation-led value creation, as well as incremental revenue opportunities resulting from multifamily initiatives.

Since our last earnings call, we issued approximately 1.4 million shares through our ATM program at an average price of $30.77 per share and entered into a contract to sell John Marshall II. We estimate that these two initiatives to further strengthen our balance sheet reduced our 2020 core FFO guidance by approximately three and a half cents per share.

We expect our overall same-store NOI to increase by 1% to 2% in 2020 comprised of multifamily NOI growth in the range of 3.25% to 4.25%, office NOI growth in the range of negative 1% to positive 1% as office growth occurs in the second half of the year when leases commence. We expect Other NOI of $13.25 to $13.75 million. Additionally, we expect non-same store multifamily NOI to range from $28.25 million to $29.25 million.

We expect G&A including leasing expenses to range from $22.25 to $23.25 million and interest expense to range from approximately $42.25 to $43.25 million while development expenditures are expected to range from $42.5 to $47.5 million.

For 2020, we project our FAD payout ratio to be temporarily in the high 80s followed by a return to our targeted level of 80%, or even lower, in 2021 with additional improvement forecasted thereafter. Our capital recycling efforts over the past several years, and most notably during 2019, have stabilized our cashflows, reduced our recurring capital requirements, and improved our FAD growth prospects.

As planned, we ended the year with a strong balance sheet, providing further optionality to grow and improve our multifamily portfolio and to drive future growth through development. We ended the year with a net debt to EBITDA of 5.6 times on a trailing 12 month basis. Although this is an earnings reset year, our current guidance continues to reflect a year end 2020 net debt to EBITDA ratio that is within our targeted range of 6.0x to 6.5x. Since year end, we paid off our final mortgage and eliminated our secured debt, which further increases our flexibility. We see opportunities to extend our debt ladder in 2020 and beyond in what looks to be favorable debt markets.

Before I turn the call back to Paul, I want to speak briefly about our ESG initiatives over the past year, which represents an aspect of institutional strength that is important to this management team, as well as our internal and external stakeholders.

WashREIT is focused on making a difference in this region we call home. In 2019, we won the District's Sustainability Award for being a leader in sustainable building management. We partnered with a Washington, DC nonprofit to donate the electricity generated from solar panels installed on WashREIT's rooftop space to low income families in DC. Additionally, our employees logged over 1,800 active volunteer hours during 2019 in a variety of philanthropic activities geared toward improving the communities where we work and live and providing support for at risk populations. Finally, we improved our GRESB score again in 2019. WashREIT has been assessing our performance through GRESB since 2014 and we've improved our score by 29 points over that period and have achieved a Green Star rating for several years. We expect to continue our commitment to ESG-related initiatives and to more thoroughly report our efforts and results in our 2020 ESG report later this year.

And with that, I will now turn the call back to Paul

Paul McDermott – President & Chief Executive Officer
Thank you, Steve.

To recap, we completed the most transformative strategic capital allocation in the company's history this past year. We significantly de-risked our commercial portfolio and improved the stability of our cashflows. More importantly, we improved our long-term FAD growth prospects by replacing capital intensive commercial assets with multifamily assets that offer better cashflow growth prospects. Our newly acquired multifamily assets are located in strong submarkets with limited new competitive supply and we have the opportunity to drive long-term renovation-led value creation at these assets.

Looking forward, I believe that this is the most solid foundation that WashREIT has been on in recent history. Nearly 50% of our NOI is driven by our multifamily portfolio with strong value-add growth prospects. The Trove multifamily development will lease-up throughout the year and we expect to break ground on Riverside later this year. Lastly, following a significant reduction in our 2020 expirations and commercial NOI at risk, we are positioned for strong growth in the second half of the year driven by key lease commencements. All in all, we expect very strong year-over-year growth in 2021 and beyond.

Operator
Now we would like to open the call to answer your questions. Our first question comes from the line of John Guinee of Stifel. Please proceed with your question.

Q: Nice quarter, thank you. Booz Allen, what's the GAAP yield on that, just for modeling purposes?

Steve Riffee – Executive Vice President and Chief Financial Officer
We put it in our guidance points, John, it's contributing about $1.1 million of NOI a quarter.

Q: Okay, great. Second, commodity office asset sales are tough in DC these days and you have about $1.5 billion to $1.8 billion left to go. What kind of timing is that? Are you going to try to sell $100 million a year for the next 18 years or $500 million a year for the next three years? And when you reinvest that into multifamily is that 100 basis points dilutive or 300 basis points dilutive?

Paul McDermott – Chairman and CEO
First off, I think what we've said in the past is that we're going to overweight multifamily because we like the demographics in the region and we particularly like the renter cohort that we're focusing on. I think today we see better opportunities for value creation in the multifamily space, and that's why we're allocating capital there. When I look at the mid-market renter cohort that we're targeting, we see a nice runway in front of us. We're not shy about saying we're going to grow our multifamily portfolio, either through acquisitions, renovations, or development.

When you look at the office that we have monetized, we've tried to be very opportunistic in the disposition but I'd like to just take a second and reflect on 2019 because it has a direct correlation to your question. We leased over one million square feet last year and that wasn't just about creating value for our investors. That's about creating

optionality for this company. I don't feel like we have a gun to our head to sell office. Our biggest focus this year is really to make sure that all these leases commence.

In terms of dilutive prospects, I think we took some of our most challenging assets last year and sold them at less than 100 basis points of dilution. I can't speak to the timing right now because we're watching the markets like everybody else is watching. But, when I look at what's going on in Northern Virginia right now having its biggest absorption year since 2006, we're definitely seeing tangible rent movement in Northern Virginia. And by the way, Northern Virginia is 60% of our commercial portfolio. I like our prospects if we need to monetize but I also like our prospects to create value in that submarket, also.

Q: What I'm concerned about is, I think you were down $0.15 '18 to '19, and that was off an artificially high number. 2018 was, I think, enhanced by the FFO generated from the Arlington Tower and the 600 Watergate acquisitions. But, it's $0.15 down '18 to '19, and then '19 to '20 is another $0.15 down, and I'm just asking this to hopefully get a little color that it's not going to happen again in '21.

Steve Riffee – Executive Vice President and Chief Financial Officer
I understand the question, and we took dilution. Obviously if we have strategic opportunities that could alter things, what we've been setting up since the spring when we had the opportunity to buy Assembly was we - were able to lay out, although there were many moving parts, what we were going to execute and what kind of dilution there was. We also knew that we were doing that in a year where we had to get all the leasing done.

We have been trying to and I think showing a very clear path of execution to growth. We have been actually getting those leases signed. We've been pretty clear that '20 is a year of earnings reset. The bottom was supposed to be, and we still expect it to be, the first quarter of this year, following the last asset sale at the end of last year. And, then the leases commence. We've allocated capital to multifamily that has the higher same-store growth and we'll be leasing up the Trove again this year.

Our pattern of expectation, although we don't give quarterly guidance, we believe the first quarter is the bottom. We believe the second quarter should be slightly higher than the first quarter. It might have been a little bit more except that our last single asset sale is happening at the very end of the first quarter. We see growth in the third quarter from the second quarter. We see another jump in growth in the fourth quarter if all these leases commence on schedule and our renovations continue in our pipeline.

We think that's a pretty good run rate going into 2021, and really the Trove hasn't contributed much in '20. But, it's another big growth of '21 over '20. You're right that if there are other major moving parts that it could change the trajectory, but that is stuff that we've done a lot of execution on that we think there's a pretty clear path to progress. That's what we've got out there so far.

Q: Perfect. Just one follow-up because we're just trying to get the numbers right. If you take the John Marshall sale and then the Trove stabilizing, and you look at your forward EBITDA when you factor those two in, and you look at your debt balance, do you have any capacity to be a net acquirer once you just take a look at John Marshall out, the Trove in, debt balance at the beginning of 2021?

Steve Riffee – Executive Vice President and Chief Financial Officer
Obviously we're going to feel the John Marshall absence first. The Trove is going to be leasing up as we go through 2020 so it's going to be growing EBITDA in '21. We have a pretty good low net debt balance starting the year and what we in essence did was pre-fund the opportunity to fund more development and to break ground this year on the Riverside and then stay within our regular guidelines of 6 to 6.5x.

You're absolutely right. We look at it that way, too. Our NOI grows, our FFO grows, and our EBITDA grows, which continues to create capacity.

Today, we do have optionality. We don't always have as much optionality but we have optionality to continue to grow. Because the development is more visible than the acquisitions we would say we've at least covered the development spend for the year.

Q: Okay, so essentially if I look at say an EBITDA of $180 million in 2021, do you have optionality to be a net acquirer or are your sources and uses such that it's pretty much limited to the Trove plus Riverside?

Steve Riffee – Executive Vice President and Chief Financial Officer
I would say we're not going to give our '21 guidance, but our own models, assuming that we execute everything we have in '20, shows EBITDA growing and that we'll have optionality in '21.

Operator
Our next question comes from the line of Chris Lucas of Capital One. Please proceed with your question.

Q: Good morning, guys. Steve, if I could, just digging into the non-same-store apartment contribution for 2020, how much of the Trove lease-up do you have modeled in to contribute to that number?

Steve Riffee – Executive Vice President and Chief Financial Officer
We're going to be conservative right now, Chris. We're in lease-up now. We were able to begin lease-up in the first quarter of this year. So, we have breakeven in the last half of the year, so we're not going to assume that there's much contribution above breakeven for now and just see how our lease-up pace goes for '20. But, that sets us up for a big step in '21, and that's how we're thinking about it right now.

Q: As it relates to the portfolio that you acquired but is stabilized, what sort of organic growth do you see from that pool this year as it relates to—is it consistent with the legacy pool or is it better? What's your expectation there?

Steve Riffee – Executive Vice President and Chief Financial Officer
We've, again, put that out in dollar ranges because we don't have a prior year for a full year to compare it to and we've just begun leasing up. We're pretty happy, for instance, with the January reported renewal trade-outs in that portfolio.

We obviously are just getting started on the renovation programs there. Whenever we onboard multifamily, we start working on optimizing the lease expiration schedule and all of that. The operations team has a good sense on how to manage expenses more efficiently. So, we see a lot of initiatives.

We're reluctant to put a percentage out yet because we just don't have enough track record. But, quite frankly, the expectation is that our growth rate in the second half of the year over last year's second half of the year when we owned the assets for both comparative periods is going to be higher than our same-store growth. But, we'd like to have a little bit more time before we give clear guidance and ranges for those percentages.

Q: Okay, great.

Operator
There are no further questions at this time. I'd like to turn the floor back over to management for any closing remarks.

Paul McDermott – Chairman and CEO
Thank you, everybody. Again, I would like to thank everyone for your time today, and we look forward to seeing many of you at the upcoming conferences over the next several weeks. Good afternoon.