

***Transcript of
WashREIT
First Quarter 2022 Earnings Conference Call
April 28, 2022***

Participants

Paul McDermott - Chairman, President & Chief Executive Officer
Stephen Riffe - Executive Vice President & Chief Financial Officer
Amy Hopkins – Vice President, Investor Relations
Grant Montgomery - Vice President, Head of Research

Analysts

Blaine Heck – Wells Fargo
Tony Paolone – JP Morgan

Presentation

Operator

Welcome to the Washington Real Estate Investment Trust First Quarter Earnings Conference Call. As a reminder, today's call is being recorded. At this time, I would like to turn the call over to Amy Hopkins, Vice President of Investor Relations. Amy, please go ahead.

Amy Hopkins – Vice President, Investor Relations

Good morning everyone and thank you for joining us for our first quarter earnings call. On the call with me today are Paul McDermott, President and Chief Executive Officer, Steve Riffe, Executive Vice President and Chief Financial Officer, Drew Hammond, Vice President, Chief Accounting Officer and Treasurer, and Grant Montgomery, Vice President and Head of Research.

Before we begin, I would like to remind everyone that this conference call contains forward-looking statements that involve known and unknown risks and uncertainties, which may cause actual results to differ materially, and 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 was distributed yesterday and can be found on the Investor Relations page of our website.

I'd now like to turn the call over to President and Chief Executive Officer, Paul McDermott.

Paul McDermott – Chairman, President & Chief Executive Officer

Thank you, Amy. Good morning, everyone, and thanks for joining us today.

Our first quarter results reflect the beginning of the earnings momentum that we expect to generate over the coming years as we capture the strong rent growth embedded in our portfolio and continue to expand our footprint in the Southeast.

On today's call I will provide an update on our geographic expansion, which is progressing well and is delivering results that exceed our initial expectations. I will then discuss first quarter operating highlights and the historic multifamily market conditions in the Washington Metro and Atlanta. I will also touch on the latest progress on our operating model and technology transformation, which is focused on resident satisfaction, and driving better performance and operating leverage as we scale the company.

Steve will discuss our first quarter results and performance highlights, our 2022 guidance, and the earnings momentum that we are building which will carry over into the years ahead.

I'll start with our expansion into the Southeast. In March we entered into binding agreements to acquire two garden-style communities in Cobb County, Georgia for \$178 million, which completes the full deployment of the net proceeds of our commercial asset sales at a combined cap rate of 4.25%. Following the completion of these acquisitions, our Atlanta portfolio will include over 1,800 apartment homes which represents over 20% of our total apartment portfolio.

The Cobb County communities align with our Class B Value-Add strategy, offering price points that range from 80% to 95% of their submarket averages and the opportunity to renovate a portion of the homes. Following these acquisitions, our total renovation pipeline will grow to 3,000 homes. The communities also offer the opportunity for immediate operational improvements as we onboard them to our daily pricing revenue management system.

Cobb County, Georgia is known for its pro-business environment, superior quality of life, and low real estate taxes – making it a sought-after location for both businesses and residents. The workforce is the highest educated in Georgia and supports a variety of key sectors in the economy, including Aerospace and Advanced Equipment Manufacturing, Bioscience, Healthcare Services, IT & Software Development, Professional and Business Services, Travel and Tourism and Wholesale Trade. The area is home to the second largest university in Georgia, Kennesaw State, as well as multiple Fortune 500 companies and major employers.

We expect to generate strong NOI growth on our Cobb County communities over the next few years with above-market growth driven by value-add renovations thereafter.

Beyond our two latest acquisitions, we have a pipeline of opportunities that would contribute strong NOI growth. Recently, we have seen an increase in opportunities that fit our strategy and offer the potential to gain scale quickly. As interest rates rise and more portfolio deals and other opportunities come to the market, we anticipate the field will continue to become more level for all-cash buyers relative to higher levered buyers.

Thus far we've executed our geographic expansion by targeting specific assets, but we are also evaluating portfolios and other opportunities which would allow us to swiftly scale our portfolio in line with our strategic direction. Fortunately, we are seeing more and more opportunities for continued growth as we build a track record and the interest rate environment shifts. We will continue to remain disciplined with our underwriting and will pursue opportunities that align with our strategy and provide stronger NOI growth and more value for our shareholders.

Nearly 80% of our same-store portfolio is located in Northern Virginia, where the rapidly expanding consumer technology sector continues to drive job and income growth. Year-over-year effective rents in Northern Virginia continue to accelerate, rising nearly 14% on average during the first quarter according to RealPage. New lease

trade outs for the Washington region, which continue to have positive momentum, were up 10% for the first quarter, up 1.7% from the last quarter.

In Atlanta, year-over-year effective rents grew by over 20% in Q1, as reported by RealPage, and remain at near record levels. Occupancy, driven by continued solid demand in the Atlanta region, remains very tight, at nearly 97% for the first quarter. In order to invest in Atlanta without directly competing with new supply, we are targeting submarkets where mid-market renters form the deepest part of the demand curve. These renters are benefitting from economic and wage growth but remain underserved by new supply. Similar to our investment strategy in the Washington Metro, our geographic expansion strategy provides the opportunity to deliver a high-quality living experience while also growing rents without competing with new supply.

Furthermore, as the housing shortage continues the cost of homeownership in our markets has skyrocketed, with home prices up by 29% in the Washington Metro and 57% in Atlanta compared to three years ago, our value-oriented price points are positioned to benefit from favorable supply and demand fundamentals over the long-term.

In addition to these favorable market dynamics that are driving strong fundamental trends, we continue to execute value-add renovations, which is a key part of our growth strategy. We are currently completing renovations at nearly half of our same store communities, and we expect the pace of renovations to pick up significantly in 2022 compared to 2021. As we continue to acquire communities with renovation potential, we expect renovation-led value creation to have an increasing impact on our growth trajectory alongside our geographic expansion.

Before I turn it over to Steve, I'd like to update you on the progress of our operational infrastructure transformation, which is focused on raising the bar for customer service at value-oriented communities. We are executing a major overhaul of our operating model, technology platform, human resource infrastructure and brand strategy ahead of internalizing property-level residential operations later this year. This transformation includes three phases in total, and we are currently in Phase 2.

Since our last update, we have designed our near-term and future-state human capital models and have filled several key management-level positions and are continuing to recruit for corporate positions that will support our internalized model. We are redefining our culture, building out our training program and developing compensation and incentive packages to align all team members with our resident-centric mission and long-term vision and ultimately support our business strategy and growth.

We are implementing our core technology platform and are planning for testing and cutover of third-party data into our new core operating system. We are also creating a resident-focused brand strategy, with plans to launch our new name, brand, and website later this year. A significant component of our marketing will be focused on customer experience and technology enablement.

Phase 3, which starts in the second half of 2022 with expected completion in mid-2023, incorporates the onboarding of our property-level operations to our internal systems. We expect the vast majority of the work that needs to be done to prepare for the onboarding process to be completed by September and for most of the costs related to the broader infrastructure transformation to be absorbed this year in line with the guidance range we

have provided. By the end of 2022, we expect to have the G&A expense base, which will not be substantially different from the level that it's at today, to support a doubling of our unit count. Going forward, we expect to realize significant benefits as we scale the business and optimize our expense base.

Now I'd like to turn the call over to Steve to discuss our performance and trends, the status of our value creation opportunities, our first quarter results, and our near-term outlook as we execute our transformation.

Steve Riffie – Executive Vice President & Chief Financial Officer

Thank you Paul, and good morning everyone.

I'll start with an update on operating trends and will then cover our first quarter results and 2022 outlook.

The year is off to a very strong start. Occupancy and retention remain very strong and are supporting low double digit effective lease rate growth across our portfolio on average.

For same store move-ins that took place during the first quarter, effective new lease rate growth was 10% and effective renewal lease rate growth was 9.2%, which blends to 9.5%. For Atlanta move-ins that took place during the first quarter, effective new lease rate growth was 16% and effective renewal lease rate growth was 12.5%, both outperforming our underwriting as we are taking over new assets.

New and renewal lease rate growth continue to trend upward. Renewal lease rates have outperformed our expectations so far this year driven by strong demand and very high retention. For leases signed thus far in April, we achieved blended lease rate growth of 20.5% in Atlanta and 11.5% in the Washington Metro on an effective basis. We expect blended lease rate growth to remain very strong through the spring and summer months.

As we head into the spring and summer leasing seasons, our portfolio is positioned with the best growth prospects in recent history. Occupancy remains strong, with a forward trend that will allow us to continue to increase rents. Same store average occupancy was 95.8% during the quarter, up 150 basis points compared to the year ago period. Total same store occupancy increased to 96% post quarter end.

Our loss-to-lease stands at 16% for our non-same store portfolio and 9% for our same store portfolio which blends to a total loss-to-lease of 10%. We expect to capture our loss-to-lease over the next 12 to 16 months, as in-place rents grow as the portfolio turns. We expect the top end of our loss-to-lease to grow as well, driven by projected significant market rent growth for our markets and submarkets. Average effective market rent growth is expected to be approximately 9% for the Washington Metro area and 18% for Atlanta in 2022 according to RealPage data.

Retention remained very strong at 71% during the first quarter even as we grew our renewal rates, which makes us confident that we can continue to capture both the market rent growth that has already occurred, and which will work its way into our rent roll as activity picks up into the spring, as well as the additional market rent growth that will occur over the course of the year.

As Paul mentioned, these positive trends will be further accelerated by increasing renovation-led value creation. During the quarter we achieved an average cash on cash return of 13% on renovated units and we expect the pace of renovations to increase as the year progresses. We have a pipeline of approximately 3,000 units including our two latest acquisitions which are expected to close next week, and we are targeting \$8 million of

renovation investment in 2022, which represents a substantial increase compared to \$3 million in 2021, when our programs were starting back up after we put them on hold during the pandemic.

Now turning to our financial performance. Net loss for the first quarter of 2022 was approximately \$7.7 million, or \$0.09 per diluted share compared to a net loss of \$1.1 million or \$0.02 cents per diluted share in the prior year.

Core FFO was \$0.20 per diluted share, reflecting a year-over-year decline of \$0.14 due to the impact of our commercial asset sales.

Multifamily same-store NOI grew 7.9% compared to the prior year driven by higher base rent, occupancy, and move-in fee income compared to the prior year period. Our same store NOI growth nearly doubled in the first quarter compared to the fourth quarter as the rapid rebound in core multifamily operating trends that began last summer is now having a more pronounced impact on our financial performance. Average effective monthly rent per home for the quarter increased 3.1% compared to the prior-year period, which also represents a substantial improvement compared to the 50-basis point year-over-year growth achieved in the fourth quarter. Looking forward, we expect these positive trends to accelerate. Approximately 63% of our leases expire between April and September. As we execute leases during this timeframe and capture the balance of post inflection rate increases while also capturing additional market rent growth during the year, we expect same-store NOI to grow at a higher rate during the second half of the year.

Other NOI, which represents Watergate 600, declined 1.7% in the first quarter compared to the prior year period primarily due to the impact of annual expense recoveries. Watergate is performing well despite the challenging market environment for office properties. Our 2022 guidance range for Watergate 600 implies a 3.4% annual growth rate at the midpoint.

Occupancy ticked up slightly since year-end to 91.4% at this one remaining office asset, and with riverfront and monument views, high-quality institutional tenants and a weighted average lease term of approximately eight years, we continue to see opportunity to create value by owning and leasing Watergate 600.

Now turning to our outlook for the balance of the year. We are reiterating our full-year Core FFO per share guidance range of \$0.87 to \$0.93 per share. We expect same store multifamily NOI growth of between 7.75% and 9.75% with higher growth occurring in the second half of the year. NOI growth for same store and Trove combined is expected to be between 11.5% and 13.5%. Trove was fully invested in both years and represents true year-over-year growth on the same capital investment.

Non-same-store multifamily NOI, which consists of Trove, The Oxford, Assembly Eagles Landing, Carlyle of Sandy Springs, and the two Cobb County, Georgia communities is expected to range between \$22.5 and \$23.5 million, of which Trove represents approximately \$7 million. Same-store Other NOI, which consists of Watergate 600, is expected to contribute between \$13 million and \$13.75 million of NOI.

We expect to close the \$178 million acquisition of two properties in Cobb County Georgia in the very near term and our FFO guidance range incorporates approximately \$100 million of additional acquisitions beyond that. When fully invested, we expect our leverage to be in the mid-5x range on an annualized basis.

G&A, net of core adjustments for severance costs, is expected to range between \$25.5 and \$26.5 million, excluding the impact of transformation investments for our future platform and our full integration. Interest expense is now expected to range between \$25 and \$26 million, which incorporates the potential impact of higher interest rates on our line of credit balance during the second half of the year.

We expect our Core AFFO payout ratio for the year to be in the mid-70s, and as we continue to invest in multifamily assets, which are less capital intensive than the commercial assets we sold, we are establishing an AFFO growth profile that should provide us with additional flexibility to grow the dividend.

And finally, we continue to expect Transformation costs to range from \$11 to \$13 million. As we previously outlined, these costs are related to our strategic transformation including core system implementation, branding and human capital initiatives, operating platform design and retention and termination benefits. By the end of 2022, we expect to have the infrastructure in place to manage all of our communities in house and will be positioned to achieve expense efficiencies and to deliver operating leverage as we scale the business. Furthermore, as Paul mentioned, we believe that our current G&A expense level can support doubling our unit count. As we complete onboarding the remaining communities to our systems and platform in 2023, we expect we will incur minimal transformation costs in 2023.

Considering our outlook as we move further into 2022, we are building momentum that will carry over into the years ahead. While 2021 was our year of transformation where we shifted our portfolio from commercial to multifamily, 2022 is our year of building earnings to a higher run-rate level and we see a lot of momentum building as the year progresses. There are several growth drivers that represent substantial momentum above our fourth quarter of 2021 baseline that are worth highlighting. The first is acquisitions, with \$230 million of cash on hand at the end of last year, most of the acquisitions that we've completed or expect to complete this year will provide income directly to the bottom line as we are not incurring a new cost of capital to pay for them. Second, our loss-to-lease of approximately 10% is expected to be substantially captured throughout 2022 and early 2023. Third, the outsized market rent growth that is projected to occur this year will drive the top end of our loss-to-lease higher as our in-place lease pool turns. Fourth, Trove will provide meaningful growth experiencing a full year of stabilized occupancy coupled with initial lease up concessions burning off. Finally, our renovation program is expected to fully ramp back up and accelerate growth with \$8 million of spend in 2022 forecasted at low to mid-teens cash returns. Our first quarter results are only beginning to reflect these impacts and as NOI ramps up throughout the year, we will be establishing significantly higher earnings run rates to grow from a strong trajectory thereafter.

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

Paul McDermott – Chairman, President and Chief Executive Officer

Thank you, Steve.

To conclude, we are pleased with our strong start to the year and the solid fundamentals that we are seeing across our portfolio which signal outsized growth this year and into 2023. Our Atlanta acquisitions continue to outperform our initial expectations and lease rate momentum at our Washington Metro apartment communities is the strongest we've seen in over 20 years.

Over the coming year, we are focused on growing and geographically expanding our portfolio, capturing significant market rent growth as our portfolio turns, executing value-add renovations, launching our new resident-focused brand and culture, and weaving ESG into every aspect of our business as we execute our internal infrastructure transformation ahead of internalizing property-level operations.

Operator

Thank you. Ladies and gentlemen, the floor is now open for questions. Our first question today is coming from Blaine Heck with Wells Fargo.

Q: Paul, can you talk about what you're seeing in terms of pricing in each of your key markets? Have you seen any backup in cap rates in any segments of the market given the rising rate environment? Or has pricing remained really competitive, kind of throughout the beginning of this year?

Paul McDermott – President & Chief Executive Officer

I'd answer that a couple of ways. We have not seen any material movement in cap rates. I know that we've had, over the last 12 months cap rate compression in DC. First quarter to first quarter year over year, it's been about 40 basis points in Atlanta. The cap rate compression has been about 45 basis points. But what we have seen with a rising interest rate environment is on the seller side. We're definitely getting more feedback from selling brokers about a preference for cash buyers where we're seeing more portfolio deals come to the market. People are trying to minimize execution risk for the second half of the year. I would say our deal team is getting calls more on a premarketing basis. Brokers are going to their sellers saying, hey, I've got three to five cash buyers. Do you want me to do a quick pre-market and see if we can select from here rather than doing a full, protracted marketing process? And the sellers are saying yes, and they're following that up, at least some of the larger portfolios that we've looked at are trying to stay away from fully lever buyers and don't want to take on any type of appraisal risk in the process. But it's clear to us, that certainty of execution has really jumped up the chart. And you're going to see a bit of a thinning of the herd as the year progresses.

Q: That makes a lot of sense. And then just sticking with the potential impacts from rising rates and inflation as well, you think of renters of Class B properties are any more sensitive to rising rates and rising prices. It doesn't seem like you've seen any pushback on rent increases that might be attributable to that squeeze on, on your tenant's purchasing power, do you think there is any tipping point on that subject in the future?

Steve Riffie – Executive Vice President & Chief Financial Officer

I'll add to that and then maybe Grant will throw in a little color, too. So far, all of our indicators are, we're getting record retention. We're getting the strongest trade-offs that we've had historically. We're really not experiencing bad debt in a significant way. In fact, year-over-year, our forecast for bad debts is down 20%. So all the early indicators are that we're not really seeing any credit issues in our portfolio. Grant always researches as part of our capital allocation process who the employers are for the cohorts that we're allocating capital to. We attribute a lot of that to knowing who our tenants and residents are.

Grant Montgomery – Vice President, Head of Research

We are seeing, in terms of our rent to income ratio, over the last 12 months, it's remaining stable where we have seen historically and as Steve said, we track income ratios, but we also look at more high frequency data that Steve touched on, like collections and retention, because we do believe they do give you an immediate look at any changes that are occurring. We are seeing strong income growth in Atlanta, for example it's up 6.6%. And we

do look at the industries that we have exposure to and as I have mentioned in the past, some of the ones that we were exposed to most such as trade, transportation, utilities and professional services, are actually outperforming some of the headline numbers that you may see around the market. So thus far, we are not seeing anything showing up in our portfolio performance, even in these early indicators that Steve mentioned.

Q: Paul, can you give us an update on any conversations or potential interest you've had regarding the sale of Watergate? Have you seen any kind of positive signs in the investment sales market that might suggest it's getting closer to that optimal time to sell that property or vice versa?

Paul McDermott – President & Chief Executive Officer

Well, a couple of things, let's start with leasing. The top leasing in the market in DC right now is probably a short term, two-to-three-year spec suite that's basically turnkey ready to go. And with that as a backdrop, we still have a couple of years left at Watergate that we would like to complete. We've only had about 90 days to establish a fact pattern. And I still think there's ample room for recovery here and I don't want this, as you know we put a lot of blood, sweat and tears into that asset, renovating it and getting it. It still has eight years of WALT left on it. And we just don't want to have that asset positioned as any type of distress sale. So we're still letting the market recover. It is not a super long-term hold for us, as we've said on other calls. We'll know it when we see it, but we'll keep you apprised of it as we move forward.

Operator: Our next question comes from Anthony Paolone with JP Morgan.

Q: I think you mentioned your G&A is effectively at a level that can support, twice as many units as you have. And so I'm just trying to think through what the governor is in terms of really getting to that higher unit count and whether it's just the need for maybe more equity or more capital. Or is it just the pipeline is what it is, and you'll get the deals done as they happen?

Steve Riffie – Executive Vice President & Chief Financial Officer

I'll start it. And Paul can probably round it out a little bit. We've said this all along and we've executed a lot of transactions, over \$5 billion of trades and repositioning this company. We say it and I think we live it, that we work both sides of the equation at the same time. So we look for the opportunities to scale and then we match the right capital to do it. We're solving for two things at the same time. One is to profitably scale the company and the other is to geographically diversify it. There's multiple levers that we look at and evaluate. Pulling sometimes equity to do it will help with both. Sometimes we're looking at opportunities with portfolios where a structure, including units, will help you tie up and scale faster. We keep a low leverage and complete pretty vanilla balance sheet and we have our maximum liquidity. So it gives us leverage and debt as a potential. And then there's our research that is always looking at what's the right inflection point to recycle out of some assets into higher growth profile assets or assets where we wouldn't want to continue to reinvest capital into an asset because we see a greater and higher value. We'll continue to play all elements of the playbook. What we've done so far is a one at a time thing and we've certainly used our transformation capital. We've seen some portfolio opportunities where there might be some value in what we can provide structurally above just normal equity prices. And we're looking at that as an option too. The whole playbook is open, clearly the world's volatile and what might be the right way to go today might be different in a couple of months. So we keep evaluating all options.

Paul McDermott – President & Chief Executive Officer

The only other thing I'd add to that is, we consistently get calls from outsiders in terms of privates and that want to do ventures that are looking to see something. I can tell you that since we've made the switch and signal more expansion into the southeast markets, we've never seen more portfolio deals than we're seeing right now. So I think our ability to scale. If you had asked me this time last year where I felt like it was really more of a one-off environment, we're probably underwriting five or six portfolios right now, and that has been a bit of a shift from 2022 from 2021.

Q: is it fair to say that there's 100 million that you outlined for midyear to kind of round out the initial repositioning? That's one thing. But there's a chance that we could see like a portfolio or something that we're turbocharged.

Steve Riffie – Executive Vice President & Chief Financial Officer

You're exactly right. We're only guiding what's visible and what we don't need additional capital for. But we are exploring all of those creative options. It's our goal to both scale the company profitably and to geographically diversify.

Q: Just another item. The renovations. What are you spending per unit on those these days and, you mentioned \$8 million in 2022, just curious like in 3,000 units, what the governor is and doing either more or less of that.

Paul McDermott – President & Chief Executive Officer

Right now in the DC Metro market on renovations like the Assembly, we're probably \$13,000 to \$15,000 a door and then Carlyle that we bought down in the Atlanta markets. That's probably \$10,000 to \$12,000 a door. And we're looking, as Steve highlighted, at low to mid-teens for those. It's also based on availability. You've known us for a long time, we're trying to maintain that affordability gap when we do those renovations, it's based on availability, we've had pretty high retention in the first quarter here. We're not actually getting access to the same amount of units that we normally would, but as that fluctuates, you asked what one of the governors was high retention and then also are we going to get paid for it while maintaining that affordability gap. So we try to include all of that in our calculus as we evaluate renovation opportunity.

Operator

Thank you. We have no further questions in the queue at this time. I would like to turn the floor over to Paul for any closing comments.

Paul McDermott – President & Chief Executive Officer

Thank you again. I would like to thank everybody for their time today. And we look forward to seeing many of you in the near future.