Easterly Government Properties, Inc.
Form 10-Q
August 08, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2017

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from To

Commission file number 001-36834

EASTERLY GOVERNMENT PROPERTIES, INC.

(Exact Name of Registrant as Specified in Its Charter)

Maryland (State of Incorporation)	47-2047728 (IRS Employer Identification No.)
2101 L Street NW, Suite 650, Washington, D.C. (Address of Principal Executive Offices)	20037 (Zip Code)

(202) 595-9500

(Registrant’s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company” and “emerging growth company” in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer		Accelerated Filer
Non-Accelerated Filer	(Do not check if smaller reporting company)	Smaller Reporting Company
Emerging growth company		

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes No

As of August 1, 2017, the registrant had 38,928,796 shares of common stock, par value $0.01 per share, outstanding.

INDEX TO FINANCIAL STATEMENTS

Easterly Government Properties, Inc.

Consolidated Balance Sheets

(Amounts in thousands, except share amounts)

	June 30, 2017 (unaudited)	December 31, 2016
Assets		
Real estate properties, net	$1,117,039	$ 901,066
Cash and cash equivalents	6,105	4,845
Restricted cash	3,559	1,646
Deposits on acquisitions	1,000	1,750
Rents receivable	8,284	8,544
Accounts receivable	6,746	5,823
Deferred financing, net	1,437	2,787
Intangible assets, net	127,127	113,795
Interest rate swaps	3,199	3,785
Prepaid expenses and other assets	3,120	1,422
Total assets	$1,277,616	$ 1,045,463
Liabilities		
Revolving credit facility	68,000	212,167
Term loan facility, net	99,132	—
Notes payable, net	173,646	—
Mortgage notes payable, net	204,782	80,806
Intangible liabilities, net	38,175	41,840
Accounts payable and accrued liabilities	14,473	13,784
Total liabilities	598,208	348,597
Commitments and contingencies (Note 10)		
Equity		
Common stock, par value $0.01, 200,000,000 shares authorized, 38,305,101 and 36,874,810 shares issued and outstanding at June 30, 2017 and December 31, 2016, respectively	383	369
Additional paid-in capital	619,668	596,971
Retained earnings	3,632	1,721
Cumulative dividends	(61,226)	(42,794)
Accumulated other comprehensive income	2,661	3,038
Total stockholders' equity	565,118	559,305
Non-controlling interest in Operating Partnership	114,290	137,561
Total equity	679,408	696,866
Total liabilities and equity	$1,277,616	$ 1,045,463

The accompanying notes are an integral part of these consolidated financial statements.

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Easterly Government Properties, Inc.

Consolidated Statements of Operations (unaudited)

(Amounts in thousands, except share and per share amounts)

	For the three months ended June 30,		For the six months ended June 30,	
	2017	2016	2017	2016
Revenues				
Rental income	$27,501	$22,291	$53,521	$44,027
Tenant reimbursements	2,974	2,476	6,602	4,631
Other income	128	154	367	234
Total revenues	30,603	24,921	60,490	48,892
Operating expenses				
Property operating	5,837	5,085	12,186	9,418
Real estate taxes	2,979	2,332	5,714	4,700
Depreciation and amortization	13,462	11,074	26,522	21,937
Acquisition costs	456	346	988	679
Corporate general and administrative	3,142	3,052	6,586	6,088
Total expenses	25,876	21,889	51,996	42,822
Operating income	4,727	3,032	8,494	6,070
Other expenses				
Interest expense, net	(3,714)	(1,995)	(6,131)	(3,924)
Net income	1,013	1,037	2,363	2,146
Non-controlling interest in Operating Partnership	(186)	(338)	(452)	(772)
Net income available to Easterly Government Properties, Inc.	$827	$699	$1,911	$1,374
Net income available to Easterly Government Properties, Inc. per share:				
Basic	$0.02	$0.02	$0.05	$0.05
Diluted	$0.02	$0.02	$0.05	$0.05
Weighted-average common shares outstanding				
Basic	37,408,603	27,484,075	37,151,527	25,812,893
Diluted	39,845,314	29,267,258	39,534,993	27,538,423
Dividends declared per common share	$0.25	$0.23	$0.49	$0.45

The accompanying notes are an integral part of these consolidated financial statements.

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Easterly Government Properties, Inc.

Consolidated Statements of Comprehensive Income (unaudited)

(Amounts in thousands, except share amounts)

	For the three months ended June 30,		For the six months ended June 30,	
	2017	2016	2017	2016
Net income	$1,013	$1,037	$2,363	$2,146
Other comprehensive loss:				
Unrealized loss on interest rate swaps	(694)	—	(586)	—
Other comprehensive loss:	(694)	—	(586)	—
Comprehensive income	319	1,037	1,777	2,146
Non-controlling interest in Operating Partnership	(186)	(338)	(452)	(772)
Other comprehensive loss attributable to non-controlling interest	221	—	209	—
Comprehensive income attributable to Easterly Government Properties, Inc.	$354	$699	$1,534	$1,374

The accompanying notes are an integral part of these consolidated financial statements.

Easterly Government Properties, Inc.

Consolidated Statements of Cash Flows (unaudited)

(Amounts in thousands)

	For the six months ended June 30,	
	2017	2016
Cash flows from operating activities		
Net income	$2,363	$2,146
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	26,522	21,937
Straight line rent	(493)	33
Amortization of above- / below-market leases	(4,218)	(3,409)
Amortization of unearned revenue	(55)	(50)
Amortization of loan premium / discount	(42)	(43)
Amortization of deferred financing costs	516	432
Non-cash compensation	1,467	1,422
Net change in:		
Rents receivable	787	(517)
Accounts receivable	(923)	(789)
Prepaid expenses and other assets	(1,698)	(449)
Accounts payable and accrued liabilities	318	329
Net cash provided by operating activities	24,544	21,042
Cash flows from investing activities		
Real estate acquisitions and deposits	(249,492)	(129,796)
Additions to operating properties	(901)	(266)
Additions to development properties	(3,911)	—
Restricted cash	(1,913)	179
Net cash (used in) investing activities	(256,217)	(129,883)
Cash flows from financing activities		
Payment of deferred financing costs	(3,225)	—
Issuance of common shares	1,886	84,943
Credit facility draws	108,000	53,750
Credit facility repayments	(252,167)	(10,000)
Term loan draws	100,000	—
Issuance of notes payable	175,000	—
Issuance of mortgage notes payable	127,500	—
Repayments of mortgage notes payable	(1,473)	(1,414)
Dividends and distributions paid	(22,564)	(19,001)
Payment of offering costs	(24)	(3,909)
Net cash provided by financing activities	232,933	104,369
Net increase (decrease) in cash and cash equivalents	1,260	(4,472)
Cash and cash equivalents, beginning of period	4,845	8,176
Cash and cash equivalents, end of period	$6,105	$3,704

The accompanying notes are an integral part of these consolidated financial statements.

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Easterly Government Properties, Inc.

Consolidated Statements of Cash Flows (unaudited)

(Amounts in thousands)

Supplemental disclosure of cash flow information is as follows:

	For the six months ended June 30,	
	2017	2016
Cash paid for interest	$5,271	$3,615
Supplemental disclosure of non-cash information		
Additions to operating properties accrued, not paid	$229	$87
Additions to development properties accrued, not paid	11	—
Financing costs accrued, not paid	173	—
Offering costs accrued, not paid	—	174
Unrealized loss on interest rate swaps	(586)	—
Exchange of Common Units for Shares of Common Stock		
Non-controlling interest in Operating Partnership	$(19,866)	$(88,674)
Common stock	13	58
Additional paid-in capital	19,853	88,616
Total	$—	$—

The accompanying notes are an integral part of these consolidated financial statements.

Easterly Government Properties, Inc.

Notes to the Consolidated Financial Statements (unaudited)

1. Organization and Basis of Presentation

The information contained in the following notes to the consolidated financial statements is condensed from that which would appear in the annual consolidated financial statements; accordingly, the consolidated financial statements included herein should be reviewed in conjunction with the consolidated financial statements for the fiscal year ended December 31, 2016, and related notes thereto, included in the Annual Report on Form 10-K of Easterly Government Properties, Inc. (which may be referred to in these financial statements as the "Company," "we," "us," or "our") for the year ended December 31, 2016 filed with the U.S. Securities and Exchange Commission (the "SEC") on March 2, 2017.

The Company is a Maryland corporation that has elected to be taxed as a real estate investment trust ("REIT") under the Internal Revenue Code, as amended (the "Code") commencing with its taxable year ended December 31, 2015. The operations of the Company are carried on primarily through Easterly Government Properties LP (the "Operating Partnership") and the wholly owned subsidiaries of the Operating Partnership.

We are an internally managed REIT, focused primarily on the acquisition, development, and management of Class A commercial properties that are leased to U.S. Government agencies that serve essential functions. We generate substantially all of our revenue by leasing our properties to such agencies, either directly or through the U.S. General Services Administration ("GSA"). Our objective is to generate attractive risk-adjusted returns for our stockholders over the long term through dividends and capital appreciation.

As of June 30, 2017, we wholly owned 45 operating properties in the United States, including 42 operating properties that were leased primarily to U.S. Government tenant agencies and three operating properties that were entirely leased to private tenants, encompassing approximately 3.5 million square feet in the aggregate. In addition, we wholly owned two properties under development encompassing approximately 0.1 million square feet. We focus on acquiring, developing, and managing U.S. Government leased properties that are essential to supporting the mission of the tenant agency and strive to be a partner of choice for the U.S. Government, working with the tenant agency to meet its needs and objectives.

The Operating Partnership holds substantially all of our assets and conducts substantially all our business. The Company is the sole general partner of the Operating Partnership. The Company owned approximately 83.2% of the aggregate limited partnership interests in the Operating Partnership ("common units") at June 30, 2017. We believe that we have operated and have been organized in conformity with the requirements for qualification and taxation as a REIT for U.S federal income tax purposes commencing with our taxable year ended December 31, 2015.

Principle of Consolidation

The accompanying consolidated financial statements are presented on the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America ("GAAP") and include the accounts of the Company, including Easterly Government Properties TRS, LLC, Easterly Government Services, LLC and the Operating Partnership. All significant intercompany balances and transactions have been eliminated in consolidation.

Basis of Presentation

The condensed consolidated financial statements included herein are unaudited; however, they include all adjustments (consisting only of normal recurring adjustments) which, in the opinion of management, are necessary to state fairly the consolidated financial position of the Company at June 30, 2017, and the consolidated results of operations and the consolidated cash flows for the three and six months ended June 30, 2017 and 2016. The year-end condensed consolidated balance sheet data was derived from audited financial statements, but does not include all disclosures required by GAAP. The results of operations for the interim periods presented are not necessarily indicative of the results to be expected for the full year.

The preparation of the consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the balance sheet and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

2. Summary of Significant Accounting Policies

The significant accounting policies used in the preparation of the Company's condensed consolidated financial statements are disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2016.

Recently Adopted Accounting Pronouncements

On January 1, 2017, the Company adopted ASU 2017-01, Business Combinations (Topic 805), which clarifies the framework for determining whether an integrated set of assets and activities meets the definition of a business. The revised framework establishes a screen for determining whether an integrated set of assets and activities is a business and narrows the definition of a business, which is expected to result in fewer transactions being accounted for as business combinations. Acquisitions of integrated sets of assets and activities that do not meet the definition of a business are accounted for as asset acquisitions. As a result the Company believes most of our future acquisitions of operating properties will qualify as asset acquisitions and third-party transaction costs associated with these acquisitions will be capitalized while internal acquisition costs will continue to be expensed.

On January 1, 2017, the Company adopted ASU No. 2016-09, Compensation – Stock Compensation, which identifies areas for simplification involving several aspects of accounting for share-based payment transactions. The new guidance allows for entities to make an entity-wide accounting policy election to either estimate the number of awards that are expected to vest or account for forfeitures when they occur. In addition, the guidance allows employers to withhold shares to satisfy minimum statutory tax withholding requirements up to the employees' maximum individual tax rate without causing the award to be classified as a liability. The guidance also stipulates that cash paid by an employer to a taxing authority when directly withholding shares for tax-withholding purposes should be classified as a financing activity on the statement of cash flows. The implementation of this update did not have a material impact in our consolidated financial statements.

Recent Accounting Pronouncements Not Yet Adopted

In May 2014, the Financial Accounting Standards Board ("FASB") issued ASU No. 2014-09, Revenue from Contracts with Customers, which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers and will replace most existing revenue recognition guidance when it becomes effective. This amendment applies to all contracts with customers except those that are within the scope of other topics in the FASB ASC ("Accounting Standards Codification"). In July 2015, the FASB issued ASU 2015-14 which deferred the effective date of ASU 2014-09 by one year to annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period.

The Company will adopt ASU 2014-09 and the related updates subsequently issued by the FASB in January 2018 using one of two methods: retrospective restatement for each reporting period presented at the time of adoption, or retrospectively with the cumulative effect of initially applying this guidance recognized at the date of initial application. The Company has not decided which method of adoption we will use.

The Company is continuing to evaluate ASU No. 2014-09, additional information about the Company's revenue streams and other considerations are summarized below.

Rental income from real property – is derived from rental agreements, whereby 42 of the Company's operating properties are leased primarily to the U.S. Government and three of the Company's operating properties are entirely leased to private tenants. Rental income from real property is specifically excluded from ASU 2014-09.

Tenant reimbursements – is comprised of tenant reimbursements from real estate taxes, and certain other expenses, as well as tenant project reimbursements that consist primarily of subcontracted costs that are reimbursed to us by the tenant.

Other income – is comprised primarily of the management fee income associated with tenant project reimbursements.

In February 2016, the FASB issued ASU No. 2016-02, Leases, which sets out the principles for the recognition, measurement, presentation and disclosure of leases for both parties to a contract (i.e., lessees and lessors). The new standard requires lessees to apply a dual approach, classifying leases as either finance or operating leases based on the principle of whether or not the lease is effectively a financed purchase of the leased asset by the lessee. This classification will determine whether the lease expense is recognized based on an effective interest method or on a straight-line basis over the term of the lease. A lessee is also required to record a right-of-use asset and a lease liability for all leases with a term of greater than 12 months regardless of their classification. Leases with a term of 12 months or less will be accounted for in the same manner as operating leases today. As of June 30, 2017, the Company had a sublease for office space in Washington D.C. expiring in June 2021 and a lease for office space in San Diego, CA expiring in April 2022. The remaining contractual payments under the Company's lease and sublease for office space aggregate $2.1 million. Additionally, ASU 2016-02 will require that lessees and lessors capitalize, as initial direct costs, only those costs that are incurred due to the execution of a lease. Under ASU 2016-02, allocated payroll costs and other costs that are incurred regardless of whether the lease is obtained will no longer be capitalized as initial direct costs and instead will be expensed as incurred. The new standard requires lessors to account for leases using an approach that is substantially equivalent to existing guidance for sales-type leases, direct financing leases and operating leases. ASU No. 2016-02 is effective for reporting periods beginning after December 15, 2018, with early adoption permitted. The standard permits the use of either the retrospective or modified retrospective transition method. The Company is in the process of evaluating the impact of this new guidance.

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230), which provides classification guidance for certain cash receipts and cash payments including payment of debt extinguishment costs, settlement of zero-coupon debt instruments, insurance claim payments and distributions from equity method investees. The standard is effective on January 1, 2018, with early adoption permitted. The Company is in the process of evaluating the impact of this new guidance.

In November 2016, the FASB issued ASU No. 2016-18, Statement of Cash Flows (Topic 230), which requires that the statement of cash flows explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. Therefore, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. The standard is effective on January 1, 2018, with early adoption permitted. The Company is in the process of evaluating the impact of this new guidance.

In February 2017, the FASB issued ASU No. 2017-05, Other Income-Gains and Losses from the Derecognition of Nonfinancial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets. This ASU clarifies the scope and accounting of a financial asset that meets the definition of an “in-substance nonfinancial asset” and defines the term “in-substance nonfinancial asset.” This ASU also adds guidance for partial sales of nonfinancial assets. ASU 2017-05 will be effective at the same time ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606), is effective. The Company is in the process of evaluating the impact of this new guidance.

3. Real Estate and Intangibles

During the six months ended June 30, 2017, we acquired two operating properties, OSHA – Sandy and VA – Loma Linda, in asset acquisitions for an aggregate purchase price of $249.6 million, of which VA – Loma Linda comprised $212.6 million. We allocated the purchase price of the acquisition based on the estimated fair values of the acquired assets and assumed liabilities as follows (dollars in thousands):

	Total
Real estate	
Land	$ 14,837
Building	208,004
Acquired tenant improvements	927
Total real estate	223,768
Intangible assets	
In-place leases	17,676
Acquired leasing commissions	9,402
Total intangible assets	27,078
Intangible liabilities	
Below-market leases	(1,255)
Total intangible liabilities	(1,255)

Purchase price	$249,591

We did not assume any debt upon acquisition of these properties. The intangible assets and liabilities of operating properties acquired have a weighted average amortization period of 16.61 years as of June 30, 2017. During the six months ended June 30, 2017, we included $2.6 million of revenues and $1.0 million of net income in our consolidated statement of operations related to operating properties acquired.

During the six months ended June 30, 2017, we incurred $1.0 million of acquisition-related expenses including $0.8 million of internal costs associated with property acquisitions.

Pro Forma Financial Information

We did not have any business combinations during the six months ended June 30, 2017. As such, the unaudited pro forma financial information set forth below presents results for the six months ended June 30, 2016 as if the ICE – Albuquerque and NPS – Omaha acquisitions had occurred on January 1, 2015. The pro forma information is not necessarily indicative of the results that actually would have occurred nor does it intend to indicate future operating results (dollars in thousands):

Proforma (unaudited)	For the six months ended June 30, 2016
Total rental revenue	$49,940
Net income (loss) [1]	2,996

(1) The net income for the six months ended June 30, 2016 excludes $0.7 million of property acquisition costs.

Consolidated Real Estate and Intangibles

Real estate and intangibles consisted of the following as of June 30, 2017 (dollars in thousands):

	Total
Real estate properties, net	
Land	$127,660
Building	993,657
Acquired tenant improvements	40,863
Construction in progress	8,498
Accumulated amortization	(53,639)
Total Real estate properties, net	$1,117,039
Intangible assets, net	
In-place leases	$140,338
Acquired leasing commissions	32,586
Above market leases	10,631
Accumulated amortization	(56,428)
Total Intangible assets, net	$127,127
Intangible liabilities, net	
Below market leases	$(57,753)
Accumulated amortization	19,578
Total Intangible liabilities, net	$(38,175)

4. Debt

At June 30, 2017, our borrowings consisted of the following (dollars in thousands):

Loan	Principal Outstanding	Interest Rate [1]	Maturity Date
Revolving credit facility:			
Senior unsecured revolving credit facility [2]	$ 68,000	L + 140bps	February 2019 [3]
Total revolving credit facility	68,000		
Term loan facility:			
Senior unsecured term loan facility	100,000	3.12% [4]	September 2023
Total term loan facility	100,000		
Less: Total unamortized deferred financing fees	(868)		
Total term loan facility, net	99,132		
Notes payable:			
Senior unsecured notes payable, series A	95,000	4.05%	May 2027
Senior unsecured notes payable, series B	50,000	4.15%	May 2029
Senior unsecured notes payable, series C	30,000	4.30%	May 2032
Total notes payable	175,000		
Less: Total unamortized deferred financing fees	(1,354)		
Total notes payable, net	173,646		
Mortgage notes payable:			
CBP - Savannah	14,562	3.40% [5]	July 2033
ICE - Charleston	20,369	4.21% [5]	January 2027
MEPCOM - Jacksonville	11,234	4.41% [5]	October 2025
USFS II - Albuquerque	17,044	4.46% [5]	July 2026
DEA - Pleasanton	15,700	L + 150bps [5]	October 2023
VA - Loma Linda	127,500	3.59%	July 2027
Total mortgage notes payable	206,409		
Less: Total unamortized deferred financing fees	(2,045)		
Less: Total unamortized premium/discount	418		
Total mortgage notes payable, net	204,782		
Total debt	545,560		

(1) At June 30, 2017, the one-month LIBOR (“L”) was 1.23%. The current interest rate is not adjusted to include the amortization of deferred financing fees or debt issuance costs incurred in obtaining debt or any unamortized fair market value premiums. The spread over the applicable rate for the Company's senior unsecured revolving credit facility and senior unsecured term loan facility is based on the Company's consolidated leverage ratio, as defined

in the respective loan agreements.

(2) Available capacity of $332.0 million at June 30, 2017 with an accordion feature that provides additional capacity of $250.0 million, for a total facility size of not more than $650.0 million.

(3) Credit facility has two six-month as-of-right extension options subject to certain conditions and the payment of an extension fee.

(4) Entered into two interest rate swaps with an effective date of March 29, 2017 with an aggregate notional value of $100 million to effectively fix the interest rate at 3.12% annually.

(5) Effective interest rates are as follows: CBP - Savannah 4.12%, ICE - Charleston 3.93% , MEPCOM - Jacksonville 3.89%, USFS II - Albuquerque 3.92%, DEA - Pleasanton 1.8%.

The table below sets forth the costs included in interest expense related to the Company's debt arrangements on the accompanying Consolidated Statement of Operations for the three and six months ended June 30, 2017 and 2016 (dollars in thousands):

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Costs Included in Interest Expense	For the three months ended June 30, 2017	2016	For the six months ended June 30, 2017	2016
Amortization of deferred financing fees	$265	$216	$516	$432

On May 25, 2017, the Operating Partnership issued $175 million of fixed rate, senior unsecured notes (the "Notes) in a private placement pursuant to a purchase agreement among the Operating Partnership, the Company and the purchasers of the Notes (the "Purchase Agreement"). The Notes are unconditionally guaranteed by the Company and various subsidiaries of the Operating Partnership (the "Subsidiary Guarantors").

Subject to the terms of the Purchase Agreement and the Notes, upon certain events of default, including, but not limited to, (i) a default in the payment of any principal, "make-whole" amount or interest under the Notes, and (ii) a default in the payment of certain other indebtedness of the Operating Partnership or of the Company or of the Subsidiary Guarantors, the principal and accrued and unpaid interest and the make-whole amount on the outstanding Notes will become due and payable at the option of the holders. The Purchase Agreement and Notes also contain various covenants (including, among others, financial covenants with respect to debt service coverage, consolidated net worth, fixed charges and consolidated leverage and covenants relating to liens). If the Operating Partnership or the Company breaches any of these covenants, the principal and accrued and unpaid interest and the make-whole amount on the outstanding Notes will become due and payable at the option of the holders.

The Operating Partnership may prepay at any time all, or from time to time any part of, the Notes, in the amount not less than 5% of the aggregate principal amount of the Notes then outstanding at (i) 100% of the principal amount so prepaid, together with accrued interest, and (ii) a make-whole amount that is calculated by discounting the value of the remaining scheduled interest payments that would otherwise be payable through the scheduled maturity date of the applicable Notes on the principal amount being prepaid. The Operating Partnership has the right to make tender offers and is required to make other prepayment offers under the terms set forth in the Purchase Agreement.

On June 28, 2017, the Company, through a wholly-owned subsidiary of the Operating Partnership, entered into a $127.5 million mortgage loan secured by VA – Loma Linda.

Financial Covenant Considerations

The Company was in compliance with all financial and other covenants as of June 30, 2017 related to its senior unsecured revolving credit facility, senior unsecured term loan facility, senior unsecured notes payable and secured mortgage notes payable.

Fair Value of Debt

As of June 30, 2017, the carrying value of our senior unsecured revolving credit facility approximated fair value. In determining the fair value we considered the short term maturity, variable interest rate and credit spreads. We deem the fair value of our senior unsecured revolving credit facility as a Level 3 measurement.

As of June 30, 2017, the carrying value of our senior unsecured term loan facility approximated fair value. In determining the fair value we considered the variable interest rate and credit spreads. We deem the fair value of our senior unsecured term loan facility as a Level 3 measurement.

At June 30, 2017, the fair value of our notes payable was determined by discounting future contractual principal and interest payments using prevailing market rates. We deem the fair value measurement of our notes payable instruments as a Level 3 measurement. At June 30, 2017, the fair value of our notes payable was $177.9 million.

At June 30, 2017, the fair value of our mortgage debt was determined by discounting future contractual principal and interest payments using prevailing market rates. We deem the fair value measurement of our mortgage debt instruments as a Level 3 measurement. At June 30, 2017, the fair value of our mortgage debt was $205.2 million.

5. Derivatives and Hedging Activities

As of June 30, 2017, the Company had two outstanding forward-starting interest rate swaps with an aggregate notional value of $100.0 million that were designated as cash flow hedges. The forward swaps have an effective date of March 29, 2017 and extend until the maturity of our senior unsecured term loan facility on September 29, 2023. The forward swaps effectively fix the interest rate under our senior unsecured term loan facility at 3.12% annually based on the Company’s current consolidated leverage ratio and a variable interest rate of one-month LIBOR.

Cash Flow Hedges of Interest Rate Risk

As of June 30, 2017, our forward swaps were classified as an asset on our consolidated balance sheet at $3.2 million. The effective portion of changes in the fair value of derivatives designated and qualified as cash flow hedges is recorded in accumulated other comprehensive income and will be reclassified to interest expense in the period that the hedged forecasted transactions affect earnings on the Company’s variable rate debt. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings into interest expense. For the six months ended June 30, 2017, the amount of unrealized loss recognized in accumulated other comprehensive income on interest rate swaps was $0.6 million and the amount of loss reclassified from accumulated other comprehensive income into interest expense was $0.1 million. Additionally, during the six months ended June 30, 2017, there was no ineffectiveness.

The Company estimates that less than $0.1 million will be reclassified from accumulated other comprehensive income as an increase to interest expense over the next 12 months.

Credit-Risk-Related Contingent Features

The Company has agreements with each of its derivative counterparties that contain a provision where the Company could be declared in default on its derivative obligations if repayment of the underlying indebtedness is accelerated by the lender due to the Company's default on the indebtedness. As of June 30, 2017, the Company did not have any derivatives in a net liability position.

6. Fair Value Measurements

Accounting standards define fair value as the exit price, or the amount that would be received upon sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The standards also establish a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are inputs market participants would use in valuing the asset or liability developed based on market data obtained from sources independent of us. Unobservable inputs are inputs that reflect our assumptions about the factors market participants would use in valuing the asset or liability developed based upon the best information available in the circumstances. The hierarchy of these inputs is broken down into three levels: Level 1, defined as observable inputs such as quoted prices in active markets; Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs in which little or no market data exists, therefore requiring an entity to develop its own assumptions. Categorization within the valuation hierarchy is based upon the lowest level of input that is most significant to the fair value measurement.

Recurring fair value measurements

The fair values of our interest rate swaps are determined using widely accepted valuation techniques, including discounted cash flow analysis on the expected cash flows of each derivative. This analysis reflects the contractual terms of the derivatives, including the period to maturity, and uses observable market-based inputs, including interest rate curves and implied volatilities in such interest rates. While the Company determined that the majority of the inputs used to value its derivatives fall within Level 2 of the fair value hierarchy, the credit valuation adjustments associated with its derivatives utilize Level 3 inputs, such as estimates of current credit spreads to evaluate the likelihood of default by the Company and its counterparties. The Company has determined that the significance of the impact of the credit valuation adjustments made to its derivative contracts, which determination was based on the fair value of each individual contract, was not significant to the overall valuation. As a result, all of the Company's derivatives held as of June 30, 2017 were classified as Level 2 of the fair value hierarchy.

The carrying values of cash and cash equivalents, restricted cash, accounts receivable, other assets and accounts payable and accrued expenses are reasonable estimates of fair values because of the short maturities of these instruments. For our disclosure of debt fair values in Note 4, we estimated the fair value of our unsecured senior revolving credit facility based on the short term maturity, variable interest rates and credit spreads (categorized within Level 3 of the fair value hierarchy), estimated the fair value of our senior unsecured term loan facility based on the variable interest rate and credit spreads (categorized within Level 3 of the fair value hierarchy) and estimated the fair value of our other debt based on the discounted estimated future cash payments to be made on such debt (categorized within Level 3 of the fair value hierarchy); the discount rates used approximate current market rates for loans, or groups of loans, with similar maturities and credit quality, and the estimated future payments included scheduled principal and interest payments. Fair value estimates are made as of a specific point in time, are subjective in nature and involve uncertainties and matters of significant judgement. Settlement at such fair value amounts may not be possible and may not be prudent management decision.

The table below presents the Company’s assets and liabilities measured at fair value on a recurring basis as of June 30, 2017, aggregated by the level in the fair value hierarchy within which those measurements fall.

	As of June 30, 2017		
Balance Sheet Line Item	Level 1	Level 2	Level 3
Interest rate swaps - Asset	$—	$3,199	$ —

7. Equity

The following table summarizes the changes in our stockholders’ equity for the six months ended June 30, 2017 and 2016 (dollars in thousands):

	Common Stock Par Value	Additional Paid-in Capital	Retained Earnings (Deficit)
Shares			