STORE Capital

First Quarter 2019 Earnings Conference Call

May 2, 2019 at 12:00 PM Eastern

CORPORATE PARTICIPANTS

Chris Volk – *President and Chief Executive Officer*

Mary Fedewa – *Chief Operating Officer*

Cathy Long – *Chief Financial Officer*

Moira Conlon – *Investor Relations*

PRESENTATION

Operator
Good morning and welcome to the STORE Capital First Quarter 2019 Earnings Conference Call. All participants will be in listen-only mode. After today's presentation there will be an opportunity to ask questions. Please note this event is being recorded. I would now like to turn the conference over to your host today, Moira Conlon. Please go ahead.

Moira Conlon
Thank you, operator, and thank you all for joining us today to discuss STORE Capital's first quarter 2019 financial results. This morning we issued our earnings release and quarterly investor presentation, which includes supplemental information for today's call. These documents are available in the Investor Relations section of our website at ir.storecapital.com under News & Results, Quarterly Results. I am here today with Chris Volk, President and Chief Executive Officer of STORE; Mary Fedewa, Chief Operating Officer; and Cathy Long, Chief Financial Officer. On today's call management will provide prepared remarks, and then we will open the call up to your questions. In order to maximize participation while keeping the call to an hour, we will be observing a two-question limit during the Q&A portion of the call. Please feel free to reenter the queue if you have follow-up questions.

Before we begin, I would like to remind you that today's comments will include forward-looking statements under the Federal Securities Laws. Forward-looking statements are identified by words such as "will be", "intend", "believe", "expect", "anticipate", or other comparable words and phrases. Statements that are not historical facts such as statements about our expected acquisitions, dispositions, or our AFFO and AFFO per share guidance for 2019 are also forward-looking statements. Our actual financial condition and results of operations may vary materially from those contemplated by such forward-looking statements. Discussion of those factors that could cause our results to differ materially from these forward-looking statements are contained in our SEC filings, including our reports on Form 10-K and 10-Q.

With that, I would now like to turn the call over to Chris Volk. Chris, please go ahead.

Chris Volk
Good morning, everyone, and welcome to STORE Capital's first quarter 2019 earnings call. With me today are Mary Fedewa, our Chief Operating Officer, and Cathy Long, our Chief Financial Officer.

We began 2019 with a very active quarter on the investment front, with investment activity of nearly $400 million, while adhering to the granularity and diversity we are known for. Mary will run you through the numbers in more detail with you, but we are happy with our ongoing success in penetrating the large markets that we address while maintaining our focus on meeting the needs of our existing customers.

With a dividend payout ratio for the first quarter below 70% of adjusted funds from operations, a meaningful portion of our investment activity is being funded through retained cash flow. We paired that retained cash flow with our historic focus on maintaining annual tenant same-store rent contractual growth of nearly 2% to drive the majority of our expected AFFO growth per share. As Cathy will illustrate, we combined this internal growth with external growth that is accretively funded through new share issuances which, for the past two years, have been successfully funded through our efficient at-the-market program.

During the quarter, we closed on our second issuance of public unsecured term debt, a $350 million offering of investment grade rated 4.625% 10-year senior notes. As we have in past years, we expect to pair our unsecured debt offerings with other sources of efficient term borrowings, most notably our Master Funding conduit with its access to highly efficient AAA rated notes. At the conclusion of the first quarter, our pool of unencumbered assets stood at nearly $4.9 billion or about 61% of our gross investments, providing us with flexibility in our financing options and our unsecured noteholders with a very low unencumbered asset leverage profile.

Now, as I do each quarter, here are some statistics that are relevant to our first quarter investment activity. Our weighted average lease rate during the quarter exceeded 7.8%. Add in the average contractual lease escalation for investments made during the quarter of 1.9%, and you get a gross rate of return of just under 10%. Now, incorporate average corporate borrowings approximating 42% of investment cost at a spread over our borrowing costs of around 3.3%, and you arrive at a gross levered total return of better than 13%. This translates into a return after cash operating costs of about 12%. Our outperforming investor returns from STORE and predecessor public companies been mostly driven by having favorable property level rates of return, which is why we take the time to disclose investment yields, contractual annual lease escalations, investment spreads to our cost of long-term borrowings, and our operating costs as a percentage of assets, which are the four essential variables to enable you to compute expected investment returns.

The weighted average primary lease term of our new investment contracts continues to be long at approximately 17 years. The median new tenant Moody's RiskCalc rating profile for the quarter was Baa3. The median post-overhead unit level fixed charge coverage ratio for assets purchased during the quarter was 2.7 to 1. The median new investment contract rating, or STORE Score, for investments was favorable at Baa2. Our average new investment was made at approximately 71% of replacement cost. 98% of the multi-unit net lease investments made during the quarter were subject to master leases. In all, 83 new assets that we acquired during the quarter are required to deliver us unit-level financial statements, giving us unit-level financial reporting from 98% of the properties within our portfolio. This fact is critical to our ability to evaluate contract seniority and real estate quality as well as to our access to capital, including our inaugural issuance of AAA rated Master Funding notes in October of last year.

With that, I will turn the call over to Mary.

Mary Fedewa
Thank you, Chris, and good morning, everyone. 2019 is off to a strong start. In the first quarter, we invested nearly $400 million in real estate acquisitions at a weighted average cap rate of 7.83%. This included investments in 44 separate transactions at an average transaction size of just under $9 million. The strong demand for our solutions has enabled us to close an investment every day-and-a-half during the past few quarters. This is how we have built such a highly granular and diverse investment portfolio. At the same time, our portfolio remained healthy with an occupancy rate of 99.7% and with approximately three-quarters of our net lease contracts rated investment grade in quality, based on our STORE Score methodology. Delinquencies and vacancies remained very low due to our strong tenant partnerships and continued active portfolio management. At the end of the first quarter, only eight of our 2,334 property locations were vacant.

Dispositions were light during the first quarter, with only four properties being sold. One was opportunistic and was sold for a 15% gain over cost, while the remaining three sales were part of our property management activities and resulted in an aggregate cash loss of slightly less than $10 million. For our projected sales during the remainder of the year, we expect to realize net gains over our cost similar to our past sales results.

Now, turning to our portfolio performance, our portfolio mix at the end of the first quarter remained steady with 65% of properties in the service sector, 18% in experiential and service-driven retail with a substantial online presence, and the remaining 17% in manufacturing. Overall, our portfolio remains highly granular and well-diversified by design. Our top 10 customers were unchanged from last quarter and at quarter-end, revenue realized from our 10 customers was 18% of annualized rents and interest, down slightly from the end of last year. Our single largest customer, Art Van, represented 2.7% of our annualized rents and interest, which places us below our target of having no tenant exceed 3% of our annual revenues. Heading into the second quarter, we are excited about our prospects for the rest of 2019. Our pipeline remains strong and cap rates are holding steady. The investments we made last year to expand our staff are yielding strong results as reflected in our continued success in penetrating our large target market. Our direct origination team continues to identify plenty of middle market companies across a diverse set of industries and geographies that are in need of the attractive, long-term real estate solutions that we are uniquely qualified to deliver.

And now, I'll turn the call to Cathy to discuss our financial results.

Cathy Long
Thank you, Mary. I'll begin by discussing our financial performance for the first quarter of 2019 followed by an update on our capital markets activity and balance sheet. Then, I will review our guidance. As Chris and Mary discussed, we continue to grow our real estate portfolio and that growth is reflected in our first quarter revenues, which increased 24% from the year ago quarter to \$156.6 million. The annualized base rent and interest generated by our portfolio in place at March 31st also increased 24% to \$646 million. Total expenses for the first quarter increased to \$109 million from \$85.4 million last year, with roughly half of that increase due to higher depreciation and amortization expense related to our larger real estate portfolio.

Interest expense increased to \$38.1 million from \$29.3 million due primarily to additional long-term debt used to fund property acquisitions. The weighted average interest rate on our long-term debt has remained relatively steady, increasing about five basis points year-over-year. G&A expenses for the first quarter were \$12 million, up from \$10.9 million a year ago. As a percentage of average portfolio assets, G&A expenses decreased to 62 basis points from 68 basis points a year ago, primarily reflecting the scale advantages of our growing Company. Property costs increased by \$1.2 million year-over-year, primarily due to the adoption of the new lease accounting standards in 2019. These new standards require us to present items such as impounded property taxes and the ground lease payments our tenants make our behalf on a gross basis as both rental revenue and property costs. This amounted to about \$1.3 million for the quarter.

We delivered another strong quarter of AFFO and AFFO per share growth in the quarter. AFFO increased by nearly 26% to \$107.8 million from \$85.9 million a year ago. On a per-share basis, AFFO was \$0.48 per basic and diluted share, an increase of 9% from \$0.44 per basic and diluted share a year ago. Finally, we declared a quarterly cash dividend of \$0.33 per share while continuing to maintain our low dividend payout ratio of just under 69%.

Now, turning to our capital markets activity and balance sheet. We funded our strong acquisition volume with a combination of cash flow from operations, long-term borrowings, and equity proceeds from our at-the-market program. At the end of February, we issued \$350 million of 4.65% senior notes due in the year 2029 and used the net proceeds to pay down our credit facility.

In March, we renewed our $100 million bank term loan and reduced the spread over LIBOR by 10 basis points. Also in March, we issued $41.7 million in 10-year CMBS debt at 4.8%. And finally, we defeased $6.7 million in debt on a property that's pending disposition and included in real estate held for sale on our balance sheet.

During the quarter, we sold approximately five million shares of common stock under our ATM program at an average price of $32.31 per share, raising net equity proceeds of just over $158 million. It's important to note that substantially all our long-term borrowings are fixed rate and our debt maturities are intentionally well laddered. Our median annual debt maturity is currently $287 million, and we have very little non-extendable debt coming due over the next couple of years.

At quarter-end, our leverage ratio was at the low end of our target range at 5.6 times net debt to EBITDA on a run rate basis, or around 41% on a net debt-to-cost basis. Approximately 61% of our gross real estate portfolio was unencumbered at March 31st, giving us substantial financing flexibility. We entered the second quarter with a strong balance sheet, a conservative leverage profile, and plenty of liquidity to fund our acquisition pipeline. Our flexible funding sources include $344 million of capacity on our $750 million equity ATM program that we launched last November and the full amount available under our $600 million credit facility, which also has an $800 million accordion feature.

Now, turning to our guidance for 2019. Considering our strong level of acquisition activity in the first quarter as well as our robust pipeline and positive outlook, we're affirming our 2019 guidance announced last November. Based on projected net acquisition volume of approximately $1.1 billion for 2019, we expect AFFO per share to be in the range of $1.90 to $1.96. Our AFFO guidance is based on a weighted average cap rate on new acquisitions of 7.85% and a target leverage ratio of 5.5 to 6 times run rate net debt to EBITDA. AFFO per share in any period is sensitive to both the amount and timing of acquisitions, property dispositions, and capital markets activities. Acquisition activity tends to be back-end weighted in each quarter. Our AFFO per share guidance for 2019 equates to anticipated net income of $0.88 to $0.91 per share, excluding gains or losses on property sales, plus $0.96 to $0.98 per share of expected real estate depreciation and amortization, plus $0.06 to $0.07 per share related to items such as straight-line rents, equity compensation, and the amortization of deferred financing costs.

Before I turn the call over to Chris, I'd like to note a few changes to our balance sheet resulting from the new lease accounting standards this quarter. First, we recorded right-of-use assets of approximately $22 million for operating ground leases related to our portfolio. The right-of-use assets are shown as a separate line item in our portfolio on our balance sheet. Second, we recorded a right-of-use asset of approximately $5 million related to our corporate office in Scottsdale, which is included within other assets on our balance sheet. And third, we recorded a corresponding operating lease liability totaling $27.6 million, which is shown as a separate liability on our balance sheet. While these changes impact our financial statements, they don't impact our cash flows or the economics of our business. We'll provide additional details and disclosures related to the new lease accounting guidance in our upcoming 10-Q filing.

And, now I'll turn the call back to Chris.

Chris Volk
Thanks so much, Cathy. As is customary for me to do, I will close with the few comments before turning the call over to operator for questions. We're in proxy season, and our proxy has four items to be voted on by stockholders. Three of these are the usual group of proposals, including the reappointment of our auditor, the approval of our Board nominees for next year, and the

approval of executive officers' compensation based upon a review by our compensation consultants. The fourth is new and offers eligible stockholders the option to propose amendments to STORE's bylaws, which proposals would be approved upon a majority vote of the outstanding shares entitled to be cast. From day one as a public company, STORE has pursued best-in-class governance designed to limit management entrenchment, including being amongst the few REITs to actively opt out of MUTA, or the Maryland Unsolicited Takeover Act. In this spirit, this proposal is intended to offer our long-term stockholders an added measure of control.

Our proxy this year also importantly contains expanded corporate disclosure regarding corporate responsibility, which is echoed by a new Corporate Responsibility tab on the front page of our corporate website and even in my recent annual letter to stockholders, which was made available at the time that we filed our annual 10-K with the SEC. Corporate responsibility discussions regarding the obligations of business leaders and Boards of Directors has been constructively promoted by many leading management teams and investment firms. We have taken a more proactive approach to such discussions in 2019 and look to count ourselves amongst these leaders.

From a broad corporate prospective, we take a view that the attention to ESG or Environmental, Social, and Governance issues is another way of thinking about our responsibility to all of our stakeholders. We actually started this Company to meet the real estate capital needs of many real estate-intensive middle-market companies. So, our customers are the stakeholders that inspired the formation of STORE Capital. Then came our stockholders and employees followed by our business partners in the many communities around the country that we seek to positively impact with prudent investment of our capital alongside the growing businesses that are our customers. Our measurement of success has always been to do well by all of our stakeholders. We win if we all win. This has been true for the two prior successful public companies that were founded and led by this leadership team and is highly relevant today.

Finally, I recently authored my first Seeking Alpha post, which you might find interesting. The article addresses the business model dynamics of net lease companies like STORE Capital and the eight variables that we have as business leaders to mathematically drive our internal and external growth. Those eight variables enable the computation of six additional key performance indicators as well as estimates of internal and external growth. Given such quantitative comparability, we started to benchmark ourselves against various peers at the beginning of the year, based upon year-end 2018 data. In my opinion, quantitative business fundamentals like this are the foremost reason for STORE's outperforming and consistent stock performance from the beginning of 2015 to the end of 2018, while our share price AFFO multiple differed little at these two points.

And with that, I will return the call over to the operator for any questions you may have. Operator?

QUESTIONS AND ANSWERS

Operator
Yes, thank you. We will now begin the question-and-answer session. To ask a question, you may press star (*) then one (1) on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star (*) then two (2). At this time we will pause momentarily to assemble the roster. And, the first question comes from Rob Stevenson with Janney.

Rob Stevenson
Good afternoon, guys. Chris, given that you guys get financials on all your tenants, have any of them gotten hit with significant tariffs on Chinese-made goods? I'm thinking furniture and maybe a few of the other businesses? And if so, what impact is that having on coverage?

Chris Volk
Rob, we've been looking as the tariff stuff since actually last summer, so as it started kicking in, we started actually surveying all of our tenants directly. And, we hired a lot of summer interns for the summer, we stuck the interns with doing just that. They were calling up a lot of companies and just finding out exactly what the impacts were. And, the answer to all that is that so far our customers are not impacted at all. And, I think it's because a lot of them import goods away from China. I mean, there are a lot of other places you can get goods, whether it's Vietnam or Thailand. If you're in the furniture manufacturing business, which is what you cited, there are all kinds of other places where you buy parts. And, that's really kind of what happens in furniture manufacturing, you're buying parts from places and then you're assembling them in the U.S.

Rob Stevenson
Okay. And, then how should we be thinking about the pace of acquisitions, and what's the acquisitions market out there for you guys these days? I mean, you maintained $1.1 billion; you guys did $400 million roughly in the first quarter. Is there less product out there that you guys want to deal with on sale leasebacks and everything, or is it just sort of you know April, early May conservatism in terms of raising the acquisition guidance for the year.

Mary Fedewa
Yeah. Hey Rob, this is Mary. Acquisitions are going really well, but you will notice we didn't sell that much in first quarter so sales are a little bit lumpy, as you know. So, right now, 1.1 is a net number. So, I would say that we're pretty much on track from a gross basis. Yes. And things are, the pipeline is good.

Chris Volk
And, we're so much in a flow business it's very hard to be predictive at this point in time. So, we've had a terrific start to the year and we're encouraged by it. But, it's too early to start changing guidance and it's too early to try to measure exactly what the timing and the impact it's going to have on future quarters in terms of the pace of acquisitions or the pace of sales, as Mary just said.

Operator
Thank you. And, the next question comes from Jeremy Metz with BMO.

Jeremy Metz
Hey, guys. Given the success of the model, what are your interests in expanding outside of the U.S., if at all? Is that something you'd consider or is there just more than enough to do here that you just see no need to stretch yourself into other international markets?

Chris Volk
Jeremy, I mean, this is a very personal decision for companies to make. I mean, I would say that we think the market's big enough for what we do here, so that we don't need to do it overseas. I think, also, it reduces the complexity of how we operate and allows investors to buy dollar-denominated assets that are based in America.

Jeremy Metz
All right. And, then just looking at your top 10 list, I know it didn't change much, but you added

about 10 properties with Cadence Education. Could you just give us some more color on what's attractive about early education? And, then given the growing relationship there, do you expect to add more? I think they have over 200 schools out there. So, is that something we could see grow here?

Chris Volk
Well, early childhood education is a service you can't buy over the internet, so you can't educate your kids very easily over the internet. It's a very hot topic in politics today in terms of people wanting to make sure that kids have a way of getting educated and especially having access to early education. It's an insanely fragmented business. So, there are lots of smaller operators. Cadence is an aggregator. It's a brand name you've never heard of probably because they acquire regional chains -- regional players around the country and keep those brand names around the country. So, it's actually a composite of a lot of different names. And, they run it very well. So, we're just big believers in the space.

Operator
Thank you. And, the next question comes from Ki Bin Kim with SunTrust.

Ki Bin Kim
Thanks. Good morning out there. Can you just talk about some of the types of tenants that are moving that fixed charge coverage ratio up and the other category of tenants that are maybe pulling that number down?

Mary Fedewa
Ki Bin, this is Mary. When you're talking about the fixed charge coverage ratio, it's much better. So, our customers are doing really, really well, and they're growing. And, we have some – they're acquisitive, as Chris just mentioned, on several of them. A lot of them are integrating acquisitions that they've made and so forth, so they've had increased expense and some leverage and they'll realize the volume coming forward. So, we have really strong units and we're in really favorable places on capital stacks on our units that are driving a lot of that coverage.

Ki Bin Kim
And, how does furniture figure into that mix? It does seem like more -- I mean furniture is traditionally always thought about being very internet resistant, but you look at Wayfair's numbers and their sales are up 40% year-over-year. So, maybe that brings it into question kind of long term how resistant it can be?

Chris Volk
Yes. This is Chris. I would say that furniture is itself a fragmented business. And, Wayfair's sales -- well, I mean, let's put it this way. But, a lot of it is what I'll call smaller home furnishings. A lot of it is stuff that you can just put together easily, just some assembly. You have the bed in the box type stuff, which obviously is for people, like the Mattress Firms and whatnot of the world, to some degree. On the other hand, it's very hard to ship a sofa. And, when you deal with furniture stores, they do more than just provide you with furnishings, they provide you with financing as well and they provide you with consulting and design. So, I mean, there's no successful retailer in America in my personal view that doesn't have a high service component to it. I mean, so that's where the industry's all going to. So, if you're buying stuff over the internet, don't expect a lot of service from that. If you're buying stuff in a facility, then you do expect service from that. And, so all the successful furniture retailers are providing high levels of service. And, they're providing immediacy of delivery. So, it's hard to get like a one-day delivery of a sofa or anything like that. So, all of all these places have distribution facilities. If Amazon ever wants to get in the furniture

business, which -- by the way, I think that -- when you deal with online retailing, all the low-hanging fruit has been taken. I mean, you start off with books, it's the lowest hanging fruit there is. I mean, it's a complete commodity, and then you move from there. So, the low-hanging fruit has been very heavily invaded. Now, you're getting at a high-hanging fruit. And, I think furniture is high-hanging fruit. It's there, you can get some share, no question. But, there's just a lot of furniture that just is very, very difficult to ship and deliver, with same-time delivery, people want to try out furniture. It's a personal preference in terms of what they do, and they want to pick out their fabrics. So, for all those reasons, furniture retailers and successful furniture retailers will continue to be successful, and guys like Wayfair will find their niche.

Ki Bin Kim
So, just to clarify, you are kind of -- if you look at the coverage ratios then sales trends look pretty healthy?

Chris Volk
Yes, I would say so. I mean, if you look across our furniture retailing, I would say probably same-store sales is pretty flat, but it's not down. I mean, and we have some, by the way, that are down and some that are up. But, if you look at the overall number, it's been flat, if you look at the overall coverages. And, we've dabbled some in furniture manufacturing too, by the way, and, there you have on the furniture manufacturing side, you have people that are delivering to retail storefronts, but then you also have the ability to take advantage of some of the online sales as well. So, on that side of the business, you get to cover more fronts of distribution.

Operator
Thank you. And, the next question comes from Collin Mings with Raymond James.

Collin Mings
Thank you. Good morning, everybody. Just looking at the pipeline sector distribution graphic, restaurants ticked down again, continuing a trend that would seem to suggest this is maybe less of an opportunity set than it once was. You discussed your restaurant exposure a couple of quarters ago on the call. But, can you just maybe update us on your thoughts as it relates to both where the portfolio currently sits as far as restaurant exposure and the flow of deal opportunities coming through the door?

Chris Volk
Well, we like the space a lot, you know. And, so -- but I would say that we've been seeing less deal flow through the restaurant space, in general, and we've also been seeing a lot of heightened competition and not really necessarily from the public players but from a lot of other folks as well. And, so when you start seeing some of these barbeque restaurants going off in the mid-6 caps, you know that there's a lot of money out there chasing restaurant deals. So, we're out trying to be value buyers, and we're buying real estate and making investments that we think generate great risk-adjusted returns. And, while we think that some of these barbeques or other types of restaurants have been selling at low cap rates are potentially interesting investments, we just don't like the returns as much. So, that's why we made that decision.

Collin Mings
Okay. And, then moving back to furniture real quick, just drilling down, any incremental color you can provide on increased exposure to Ashley and DSG in the quarter, and just what the pipeline of each opportunities exist with them?

Chris Volk
So, Dufresne Spencer Group is the largest Ashley distributor in the country. So, they don't have franchisees, they have licensees. So, they are the largest licensee. And, they have been growing in part through acquisition. And, so that increase to Dufresne Spencer during the quarter resulted from their acquisition. And, Dufresne Spencer by the way is very heavily owned by Ashley Corporate, and, so in a way, it's part and parcel of the entire vertically integrated system.

Operator
Thank you. And, the next question comes from Nate Crossett with Berenberg.

Nate Crossett
Hi. Thanks for taking my question. I wanted to touch on cap rates and the growth spread over your cost of debt. And, I know you have a slide in your presentation that shows you had the highest spread of the net lease players. So, my question is, we've seen some of the larger players willing to acquire at a lower and lower cap rate versus what they've done historically. And, so I just want to get a sense from you as to is there a level of spread that you just won't go below? And, do you think you'll be able to kind of achieve that roughly 5% spread over the medium-to-long term?

Chris Volk
Okay. The answer is that we've run public companies with far less spread. We've run successful public companies in previous lifetimes with less spread than we're getting today. And, so there is room to bring in our spread and still generate nice rates of return. That being said, we're not just in the spread business. I mean, spread is nice, but the numerator matters. So, whether you're investing a 7-cap or a 6-cap or whatever, I mean, the absolute dollar -- the absolutely numerator does matter from a shareholders return perspective. And, so we're mindful of both the spread and what the numerator is. As I said earlier to the prior question, we are value investors, so we are looking to generate high rates of return. It's important that we be able to buy assets at yields that are in excess of where the auction marketplace would be at any given time. We'd like to be able to sell the asset the following day and actually make money on it, if that's what we wanted to do.

So, we want to buy things you can't buy at cap rates you can't get, it's really what we like to do with leases that you can't get. And, now in terms of margin for error, we have a flat ton of margin for error. So, if your investment AFFO yield is sub 11, which essentially says to you that, if our AFFO yields gets hammered from 17, we'll just say, down to 11, we could still actually buy stuff up to that point and still make it work in terms of making incremental rates of return. That spread is probably the highest in the net lease space, and it means that we're the most -- we have a very resilient platform, which we're very proud of. It also is a very big reason why we've been creating more compound MVA per share growth than anybody else in the space, which is also an exhibit on the pages that you were talking about. So, our defined definition of a win is not just hitting AFFO growth per share, but it's also hitting and creating the most shareholder value growth on a compound basis over the cost of our equity capital. And, we're mindful of that. And, if we have -- if our cap rate or if our multiple goes to 20 or it goes higher, we're not going to take advantage of that multiple to say, gee, we can go, do a lot to keep our stuff. You know, we've been at high multiples and they were nice multiples, but we've been in higher multiples. And, we haven't gone and run after investment grade tenants or whatnot, we've made a decision to go after the middle market, stick to our knitting, and that's what we're doing.

Nate Crossett
Okay. That's helpful, thank you. And, then you mentioned on the call earlier that there were staff

investments last year. Just curious as to how that continues to grow as you continue to get bigger. Are you expecting further investments this year? Maybe just a little color there.

Chris Volk
Yes. Mary can join on this, but I would say last year we spent a lot of time sprucing up certain areas. I mean, there are certain parts of this Company that are just going to grow on the staffing front, and one of them is on the asset portfolio management side. We've been spending a lot time also in terms of beefing up our middle management in this Company a lot, and so we did that. That being said, if you were to look at our numbers, and I'm going to do something the way you don't normally do it. But, if you were to take our property costs, so basically the cost of running all the property costs and back out all the reimbursable stuff. So, Cathy Long talked to you about what's reimbursed tenants in terms of ground leases and that kind stuff, so if you were to look at our net cash property costs and you were to add our cash G&A costs, which back out the shareholder compensation, which is an add back to AFFO and is non-cash anyway and you were to take those cash costs, those collective cash costs and divided it into average assets and you were to do this -- I didn't do this for this quarter, but at the end of last quarter -- at the end of FY18 it would be around 60 basis points, maybe 59 basis points to run this. That would be as efficient a net lease company as there is, you know. And, we're not even the biggest.

So, we are incredibly efficient, and we've been efficient because we have an exceptionally high occupancy rate, we have very little in the way of double net lease properties requiring us to have any obligations for them. And, we have invested a lot in IT technology, which has allowed us to be more efficient. And, we've outsourced certain aspects of our servicing platform, which has allowed us to be more efficient, so that basically this Company today has 90 employees running over 2,500 properties with almost no administrative employees at all. And, we've basically outsourced all of that. So, from an operating perspective, I just want to point out that if you were to sort of do the math and you have to do it a little bit forensically, so you have to peel back all these numbers, you would find that we're just insanely efficient relative to anybody else.

Operator
Thank you. And, the next question comes from John Massocca with Ladenburg Thalmann.

John Massocca
Good afternoon, now. So, properties not operating but subject to lease jumped a little bit kind of quarter-over-quarter. Can you provide some color on what caused that and maybe the lease term roughly remaining on those assets or any potential resolutions for those properties?

Mary Fedewa
Sure. John, this is Mary. So, yes, I would say that the majority of those are in – the majority of those individual properties are in master leases, so a little over 70% are in master leases. And, they are just simply individual properties that we're working through with tenants in a master lease that they're looking to make some change. And, in one case in particular they're actually closed site to remodel and reimage and then they're going to reopen that site. So, it's a combination of those kind of activities, operational flexibility. But, as you know, we have a substantial portion of our leases in master leases. I think it's like 91% in master leases. And, so that's helpful. See, they're individual property covered by the master lease and we're working with tenants on that. It is, there's no concentration in any one tenant; it's an entire diverse list of tenants.

John Massocca
Okay. Understood. And then...

Chris Volk
And by the way, John, I think we may be -- this is Chris. I don't know how many people even disclose the number of properties that are empty but paying rent, you know. I mean, it is very common to disclose properties that are empty and not paying rent. I mean, we've been disclosing this intentionally just because we think it's just important to keep abreast of it, and it forces us to keep that number down. So, our servicing group works with the tenants to basically minimize that number and find ways to either close stores, sublease stores, swap stores out. We're doing a transaction right now with one of our tenants to swap out 10 properties, so 10 properties they don't like for 10 properties they do like. So, this is all part and parcel of the business that we're in.

Mary Fedewa
Keeps our master leases really healthy.

John Massocca
That makes sense. And, then your exposure to manufacturing has kind of grown steadily over say roughly the last 18 months. What is making those types of assets attractive, especially given kind of continued cap rate compression in that space in the amounts of capital chasing industrial, and how are you able to kind of source acquisitions that have returns kind of in-line with your kind of historical averages?

Chris Volk
Well, I mean, we do a fair amount of business direct and that always helps. I would say that the businesses that we're doing tend to be very basic blocking and tackling businesses. They are not sexy. And, they've been around for a long time. And, we think they have no functional obsolescence and they're going to be around for a while. We'll probably -- my guess is that we'll probably get manufacturing, will stabilize between 15% and 17% of where we are. And, so I don't think that you're going to see it creep up a lot more from where it is.

Operator
Thank you. And, the next question comes from Todd Stender with Wells Fargo.

Todd Stender
Thanks. For the acquisitions in the quarter, lease escalators came in above your overall portfolio average. You've already got the highest rent bumps in the net lease space. Can you talk about how you ask for these or require these, I guess, in your negotiations? And, then should we expect this to keep edging up closer to 2% over time?

Mary Fedewa
Hi Todd, it's Mary. So, the direct origination engine here actually asked for these escalations. So, it's really simple. You go meet with a CEO or a CFO or someone on the leadership team and you talk about what value we can add and how they can better off if we own their real estate versus them. And, we -- generally there is some sort -- there is always use for the funds, so they're either recapitalizing their balance sheet, they're making an acquisition, maybe there is some estate planning going on. So, we're creating a solution for them and adding value. And, once we figure that out, we say that will be -- thank you very much, the rates -- the escalations will be this and on this frequency. So, our sales people are actually paid to ask for higher escalations and more frequent escalations. So, they make the ask, and it's really that simple. And, I think that 2% annual is sort of the market escalation rate. So, generally, you will see -- I don't see you'll see much higher than that as we move forward.

Chris Volk
If you were to like look at LoopNet or something like that, it's very common to see escalators of like 10 for five, which would be common, which actually works out to like 1.9 years, something on a compound basis, 1.8 on a compound basis. We tend to push for the annual escalations, because we don't want to wait around for five years. And, because we ask for 10 every five, then in the last periods, you sometimes just don't get those escalations, they mystically go away. And so, we do that in, and so the majority of our escalators are annual.

Todd Stender
Okay. Thank you, appreciate that. And, then just look at medical and then medical dental and then behavioral health keep ticking up. Can you guys talk about how you're underwriting those, maybe length of leases, and then just speak to the fungibility of the real estate?

Chris Volk
Behavioral health is staying sort of flat for the last three years, and that includes everything from eating disorders to drug rehab, alcohol rehab. We've done a handful of those, but I wouldn't say we have a big push on it. On the medical dental, we've been seeing some of that. There've been just roll-up concepts of dental practices and certain medical practices, and whether it's dermatology or whatever. In terms of how fungible they are, really -- they are really fungible. I mean, their assets that often times had other previous uses prior to being medical or dental facilities, sometimes they are in areas where there is nothing but medical and dental offices around, so that they are in a hub like that. But, I would say they're highly fungible.

Operator
Thank you. And, the next question comes from Craig Mailman with KeyBanc.

Craig Mailman
Hey, everyone. Maybe just to ask an earlier question a little bit differently. I know you guys don't like to address investments and guidance at this point in the year. But, could you maybe just give us a little bit of color on where you stand on the remaining dispositions? Because if you just annualized this quarter's AFFO, you're kind of penny below the midpoint of the range, so just trying to get at what are kind of the puts and takes here as we go through the balance of the year that kept the midpoint unchanged.

Chris Volk
The midpoint, well okay, I would say that we don't -- are you suggesting we should lower our guidance?

Craig Mailman
No, no. You guys are -- just this quarter, you're already at $1.92 annualized and you typically do more acquisitions toward the end of the quarter, so...

Chris Volk
Okay. I would say, I mean, some of the questions we've got from people are why we're not raising our guidance and the answer is just because we're in a flow business and there is a lot of things that can happen. And so for the last three years, I'm proud to tell you that we have given guidance in November of the preceding year, and we've actually come in the range of that guidance for basically three years straight without really adjusting outside of that range. So, we've been very predictable in terms of what we've been doing. With any luck, this year will be not too far off from that -- from a guidance perspective.

And, in terms of property sales activity, property sales activity really waffles from quarter to quarter, so, and you could look last year and see from quarter-to-quarter that we did some -- some were incredibly busy disposition quarters, some were not. We've been selling $250 million plus or minus worth of real estate for the last two years. I think that you can see us selling $250 million to $300 million worth of assets and potentially more, I mean, during the course of this year. This last quarter, we actually lost money on the assets we sold. I mean, Mary pointed out we made a lot of money on one asset, but it was offset by money on assets that we sold that we lost some money on.

But, during the course of the year, my expectation is that you'll see us make a fair bit of money on selling assets in the aggregate, which is what you're trying to do. And, then we have a disclosure in our book on the property sales where you can see that they've been -- our property sales and -- from a cap rate perspective tend to be a lower cap rate on property sales than their investment cap rate, which has allowed us to roll the cash accretively. Last year, it added a half a point to internal growth. In most years it adds less than that, so last year was just a good year. On the average it adds about 10 basis points to internal growth, but it's sort of there as part of the engine of balancing the portfolio and adding another way to grow our AFFO per share.

Craig Mailman
That's helpful. I guess, what I was trying to get at is you guys only did $17 million of dispos in the first quarter. Do you have anything else under contract or any visibility? And, kind of is it going to be more backend weighted in the year is what I'm trying to get at?

Chris Volk
Well, the answer is sure. I mean, the answer is we do have items under contract today. We always have items under contract. We don't give disclosure on that. I can't tell you how the second quarter is going to pencil out. I mean, I could probably give you an indication, but I won't. But, it will vary. And, I think that we'll hit our numbers for this year. Do you assume it's back-end weighted for the purposes that your investment? If you assume it's backend weighted, then basically it doesn't really take away as much from AFFO per share. So, it causes you to raise your estimates. So, if you assume it's more front-end weighted, then it will be sort of more neutral through estimates of AFFO per share. I would probably assume that it's more neutral.

Cathy Long
Yeah. And, we've prior had a large second quarter of sales, Q2 sometimes has a lot of sales. And, if note on our balance sheet, we do have real estate investments held for sale of $15 million. But, with the intent it would go out pretty quickly, if that helps.

Operator
Thank you. And, we have reached the end of the question-and-answer session. At this time I'd like to return the conference over to Chris Volk for any closing comments.

CONCLUSION

Chris Volk
Well, thank you all for attending the first quarter 2019 earnings call. Mary and Cathy and I will be attending REIT Week in New York City in June. So, let us know if you'd like to arrange a meeting then. And, until then, we're around for any follow-up questions as usual during the day. Have a great day, everyone. Thank you.

Operator
Thank you. The conference has now concluded. Thank you for attending today's presentation. You may now disconnect your lines.