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Vesta Industrial Real Estate

Second Quarter 2015 Results Conference Call

July 24, 2015

C O R P O R A T E   P A R T I C I P A N T S

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Juan Sottil, *Chief Financial Officer*

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C O N F E R E N C E   C A L L   P A R T I C I P A N T S

Ariel Amar, *Itau BBA*

Vanessa Quiroga, *Credit Suisse*

Marimar Torreblanca, *UBS*

Adrian Huerta, *JP Morgan*

Ivan Enriquez, *HSBC*

Francisco Suárez*, Scotiabank*

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P R E S E N T A T I O N

Operator:

Good morning. My name is Robert and I will be your conference Operator today. At this time, I would like to welcome everyone to Vesta's Second Quarter 2015 Earnings Conference Call. Vesta issued its quarterly report on Thursday, July 23, 2015. If you did not receive a copy via email, please do not hesitate to contact the Company at +52 (55) 5950-0070.

Before we begin the call today, I would like to remind you that forward-looking statements made during today's teleconference do not account for future economic circumstances, industry conditions, Company performance and financial results. These statements are subject to a number of risks and uncertainties. All figures included herein were prepared in accordance with IFRS and are stated in nominal US dollars, unless otherwise noted.

Joining us today from Vesta in Mexico City is Lorenzo Dominique Berho Carranza, the Chief Operating Officer; Juan Sottil, the CFO; and Iga Wolska, the Industrial Relations Officer.

Now, I would like to turn the call over to Mr. Berho. Sir, please begin.

Lorenzo Berho:

Thank you very much, Rob, and good morning, everyone. Thank you for your interest in Vesta and for participating in today's conference call.

Vesta is deeply committed to maintaining our high rate of growth and achieving its sustainable competitive advantage by realizing the Vesta Vision 20/20 growth plan. We are, therefore, developing stronger internal processes and better products for our clients. We call this process "innovesting," which is where innovation and strategy meet at Vesta.

Having built an industrial real estate portfolio in the fastest growing regions of Mexico, we are now at the forefront of the industry's growth wave and ready to capture this demand with more efficient and competitive solutions.

Innovation is at the heart of this strategy. In anticipation of rising demand, Vesta is being proactive, with world-class industrial facilities ready to lease that are adaptable to client requirements, well located and competitively priced. Our Park-to-Suit developments integrate necessary supply chain processes or cluster needs with the best infrastructure. Backed by our "Vest in Class" approach to customer service, we also provide an experienced legal framework, negotiating experience, development planning and execution, and park management solutions, so our clients can focus on their core business.

In line with our Vesta Vision 20/20 growth plan, we are transforming our Company with a new corporate structure and long-term management incentive plan, underpinned by a strong balance sheet and track record of high client retention and satisfaction.

In the first half of 2015, our portfolio grew 1.4 million square feet, representing a major growth period in our history, to reach 18.2 million square feet overall. It is vital we maintain this momentum in order to have facilities available for future clients.

Very importantly, the recovery in the United States and the relatively stronger currency positions Mexico more competitively as a global manufacturing hub. Low inflation, a skilled and competitively priced labor force, proximity to the United States, and ongoing implementation of energy reforms are attracting world-class companies to establish manufacturing facilities in the country.

From a broader economic perspective, as the United States' economy continues to strengthen, interest rate expectations have risen, increasing volatility in capital markets. Nevertheless, the strong fundamentals in Mexico's industrial real estate sector underpin our bright outlook.

Foreign direct investment in Mexico has risen more than 30% to $7.6 billion, with the United States accounting for nearly 60% of this, according to the most recent first quarter figures. The automotive sector represented nearly 54% of foreign direct investment, as the advantages that we have outlined triggered GM, Ford, Toyota, Honda, Volkswagen, Audi, BMW, Hyundai and Mazda to select Mexico as their manufacturing platform for North America and the world.

I am happy to share strong second quarter results, which are a testament to our ability to execute on our strategy.

During the second quarter, our additional capacity with new properties saw an expansion in GLA of 3.68% versus the first quarter. As a result, our total vacancy rate rose to 14.9%, with the same store vacancy rate declining to 10.2% as of June 30, 2015. Vesta has historically rented new buildings within approximately six months, and we therefore expect vacancy rates to normalize in coming months. Funds from operations increased more than 66% year-over-year to $10.9 million in the second quarter; revenues increased 14.4% to $19.3 million; net operating income rose 15.5% to $18.6 million, representing a margin of 96.5%; and EBITDA rose 21.7% to $16.6 million, equaling a margin of $86.2%.

We are proud to celebrate our third anniversary as a public company this month, noting growth of 60% in our gross leasable area and 44.3% in last 12-month revenues to reach $75 million, as we improved our financial efficiency. This growth reflects our “Vest in Class” corporate culture, which focuses on building long-term customer relationships.

We thank you for your continued trust and support and look forward to building our strong track record of growth.

I will now hand the call over to our CFO, Juan Sottil, for a discussion of our second quarter results.

Juan Sottil:

Thank you, Lorenzo. Good morning, everyone, and thank you for joining us today to discuss our results for the second quarter of 2015. We are pleased to report the strong results for the period, with solid expansion in our portfolio and double-digit growth across all key financial metrics during the second quarter. Our total gross leasable areas increased by approximately 630,000 square feet over the three months to June, to reach 18.2 million square feet overall. This expansion extends a period of strong growth in Vesta’s history and is in line with our plan to double the size of the Company by the end of the year 2020.

During the quarter, we signed new leases for inventory buildings in Toluca, San Luis Potosi, Tijuana, Silao, Aguascalientes, with global companies in industries, including medical devices, automotive and logistics. We also renewed or released more than 1 million square feet of our portfolio, which equates to 68% of leases expiring this year. Looking ahead to our expirations for 2016, we also renewed about 14% of the leases that expire next year. The increase in our portfolio size saw a rise in our vacancy rate to 14.9 from 12.4, due mainly to the completion of inventory buildings in Queretaro and Tlaxcala. We expect to lease these buildings in the coming months, as demand for industrial real estate in Mexico remains strong. It is vital for us to stay ahead of the needs of our customers and we expect our vacancy rate to soon normalize. In the second quarter, we made progress in the construction of nine buildings, representing a total GLA of more than 2 million square feet and investments of $108.5 million.

Regarding our financial results, we achieved a strong growth in revenues, net operating income, EBITDA and funds from operations during the quarter. Revenues increased 14.4 year-over-year to $19.3 million, as we were successful in renting new properties. As more than three-quarters of our rental contracts are in US dollars, the majority of our revenues are protected from the peso decline versus the US currency. Most of our costs, on the other hand, are in pesos. This dynamic has helped boost our margins. More broadly, the peso ongoing decline continues to make Mexico appealing as a global manufacturing destination for (inaudible) companies.

Vesta’s lean-cost structure is reflected in low operating costs, which rose to over 1% in the second quarter against the prior corresponding period. Vesta’s Board of Directors is committed to a strong corporate governance practice and sets very challenging targets for our executive management, based on shareholder returns. On the mark-to-market of these compensation metrics, total expense was lower in the second quarter, benefiting administrative costs.

Net operating income rose 15.5% over the same period in 2014, to $18.6 million, with economies of scale helping to lift the NOI margin 90 basis points to 96.5%.

For the second quarter, EBITDA rose 21.7 to $16.6 million, while the EBITDA margin increased 520 basis points to 86.2, from 81% over the second quarter of 2014.

Income before tax doubled to $44.1 million from $22.1 million in the same quarter last year. This resulted in a net operating profit of $20 million for the quarter, up from $50 million in the year-ago period. Similarly, the second quarter funds from operations were robust, raising 66% year-over-year to $10.9 million.

Regarding our balance sheet, Vesta's cash and cash equivalents were $275.8 million at the end of the second quarter. Operating activities generated cash flow of $15.8 million during the period. The other balance of this as of June was $349.1 million. As a reminder, all of our debt is denominated in dollars.

Vesta's strong second quarter results are a testament to the success of our business model. We are confident in our ongoing expansion, as we execute the Vesta Vision 20/20 growth plan against a backdrop of Mexico's rising appeal as a manufacturing hub. We are focused on the fastest growing markets in Mexico and are strengthening our value offering through sustainable projects and value-added services. Our track record is providing high-quality facilities for clients. Our strong financial base puts us in a unique position to capitalize on the demand for the industrial growth market of Mexico. We are excited about our growth opportunities for the second half and will keep you updated on our progress.

Thank you all. I will now open the floor to questions-and-answers. Operator, could we please prepare to answer any questions?

Operator:

Thank you. At this time, if you would like to ask a question, press star, then the number one on your telephone keypad.

Your first question comes from Ariel Amar with Itau BBA. Please proceed with your question.

Ariel Amar:

Good morning, all. Thank you for the conference call and congratulations on the results. I have two questions. The first is regarding, basically, vacancy. Aside from the opportunity cost of not having the rent, obviously, how heavy is the carry for vacant buildings for you guys, especially now that you have and you're obviously delivering a lot of inventory buildings and you're going to have to carry it for a while, until you lease it. I'd just like to understand a little bit in more detail what is, for example, the cost per square meter per month of having a vacant building, just so I can model it better and understand it a little better, as well. That would be my first question.

My second question is regarding your debt renegotiation plans. If I were to guess, and taking into consideration the Company's profile, I would say you'd want to go for a long-term fixed rate debt, which could most probably qualify as a bond. Could you comment on that? I mean, is that what you're thinking about, or are you actually planning to renew the GE debt? How are you going about the renewal of the debt that expires in 2016? Thank you very much.

Juan Sottil:

Let me first answer the second question and then we'll tackle the first one. The second question, look, debt renegotiation—well, they changed our debtor. I don't know if you noticed that, but GE stepped out of the business, now our debtor is Blackstone, and look, basically, what we're going to do is we're going to access either the private debt markets, or the public debt markets, sometime in the last quarter or first quarter next year, we're going to basically issue debt and pay off the outstanding balance of the current debt.

Part of the reason for raising the $50 million in February this year was just to assure us that we had alternative sources of funding from the private debt markets that operate in Mexico in dollars, and given the success of that offering, I don't foresee any problem if we were to issue private debt with a property collector. However, as we have talked in the past, Ariel, I believe that Vesta is uniquely—is very well positioned to issue bonds in the public market. I think that our asset quality is second to none. I really believe that the profile of maturities on our leases, the quality of our portfolio—I won't hesitate to issue public debt in the conditions of the market, and the pricing of such a structure is more convenient for the Company. So, I don't foresee any problem in renegotiating and rolling over that debt with the best available structure in the best market that is convenient for the Company.

For the first question, Lorenzo, our COO, is going to answer you.

Lorenzo Berho:

Thank you very much, Ariel, for your questions, and this gives us also an opportunity to give more clarity in terms of our operations. The way we see our occupancy, or our vacancy, is it's really what we like to compare is the same store vacancy, particularly because it could be sort of misleading, the numbers that we give in terms of occupancy, basically because right immediately, when we finish an inventory building, we put it on top of the whole portfolio. Therefore, it might seem that we have increased vacancy, but the reality is because we are adding new inventory buildings to our portfolio. In this case, in this quarter, for example, we increased in Tlaxcala and Queretaro, which we see it as an advantage to most of our competitors, and also an advantage to capture and to attract new clients at the right time. So, therefore, I believe that regarding your question on how we expect the rents to be done for the upcoming months, we have always been able to close at market rent, and we're going to still be doing so. We want to achieve our returns, our hurdles, and that's why we're very cautious on, first of all, hitting our returns, secondly, the type of clients we want to have to our complete portfolio, and in the end to really add value to our development strategy.

So, at the end of the day, the way I think you should take into consideration our vacancy is every time we do an inventory building, we basically assume a six-month vacancy. We're very aggressive in the accounting of our inventory buildings. We don't delay the (inaudible) of our GLA, so that's why we put it up front. Our cost per square foot is still between $45 and $50 per square foot, and the rent depends on the rent per square foot in the markets where those inventory buildings were added, and we're confident that we will lease them up in the second half of this year.

Ariel Amar:

All right, perfect. Thank you very much for the answer, and don't worry, I know this is a very natural part of your operating business, it's a normal part. Thank you very much.

Operator:

Our next question comes from Vanessa Quiroga with Credit Suisse. Please proceed with your question.

Vanessa Quiroga:

Thank you and good morning, thanks for the call. My question is regarding your current views on the markets where you operate. If you can provide a little bit more color on why you decided to delay the completion of some of the developments that you have in your pipeline and tell us whether you sense some kind of temporary oversupply in markets like Toluca, for example, that is experiencing some of the delays. Thanks.

Lorenzo Berho:

Thank you, Vanessa. First of all, I'd like to talk a little bit more about the market dynamics. I believe that real estate fundamentals are stronger than ever. We have, in general terms—well, I'd like to speak more regionally. Talking, for example, about the north part of Mexico, which is for us Tijuana and Ciudad Juarez, it's incredible how much the vacancy has dropped in the last four years. It came from double digits, from approximately 12%, 13%, and today we're facing vacancies of 5%. This is 5% in Tijuana and 7% in Cuidad Juarez. This is for Class A buildings. This is very strong. On top of that, we are seeing that the market rents are increasing. So, this gives us a—this is a great sentiment, in order to be able to develop inventory buildings in the north part of Mexico. That is why we have started a strategy of developing in Tijuana and Cuidad Juarez, as you well know.

The Bajio region has had the highest absorption in whole Mexico and vacancy rates, as you know, are below—close to—even below 5% in certain markets, like Guanajuato and Aguascalientes, even San Luis Potosi. Therefore, we still see that the fundamentals are still very strong, and that's why our strategy of still developing inventory buildings in these markets.

Now, Toluca—in this case, Toluca, our portfolio, I could say that besides the inventory buildings that we developed recently, is almost fully leased, it's almost 100%, and the market is also very strong particularly because of the logistics sector and automotive industry growing in Toluca. Demand is very strong, we have a very good pipeline, and the delays have nothing to do with the market. Actually, the delays particularly in these—the two delays that we announced for the S5 and S6, it has more to do that we today have—we are currently developing Vestapark 2, which is six buildings. We have already developed four of them, in which we are in the leasing process of two of them, the S1 and S2, and the S5 and S6, we were able to move a little bit the timing in order to have them ready for the end of the year, so that we can fill up the existing space this semester while we are constructing the S5 and S6, but bear in mind that even though the buildings are in the construction process and they will be finished by the end of the year, we are already marketing those buildings. Why? Because we're seeing a strong pipeline and we see that we could be close to our future clients even today.

Vanessa Quiroga:

Thank you, Lorenzo. If I can pick up on that, so would you be comfortable in guiding us for a shorter amount of time, a shorter period of time that S5 and S6 will remain vacant after completion?

Juan Sottil:

The idea—every time we submit—the Company is pretty conservative, Vanessa, as you know. Every time we complete an inventory building, we take six months to fill it up. Mind you, our policy of disclosure is extremely aggressive; that is, contrary to what most REITs in the US do, and some of our peers in Mexico, we don't—we do add the GLA of inventory buildings right away. We do that not only because it's fair to our shareholders, to know how much buildings and GLA we have outstanding, but it is also a good measure internally to guide our management of our people, and into the leasing process, which is a key part of our business. So, this aggressiveness has a consequence. We're very open about the empty space. It helps our shareholders know what our vacancy is and the opportunity cost, as the previous question underlined.

What we did on the S5, on these two buildings, is—look, we do have some inventory buildings in that park without tenants. It's imprudent to us to devote our resources in infrastructure in developing the expansion of that park, rather than continue full speed ahead on these two buildings. As Loren pointed out, we're marketing those spaces already, and we're confident that once these buildings are delivered, it will take us the usual six months to fill them up.

Vanessa Quiroga:

Okay, thanks Juan, thanks Lorenzo.

Operator:

Our next question comes from Marimar Torreblanca with UBS. Please proceed with your question.

Marimar Torreblanca:

Hi guys, thanks for the call. I have a question on how do you think we should expect the development of your money or your cash position, and your leverage potential, in terms of timing? After what you've seen in the recent months, what do you think we should be thinking of?

Juan Sottil:

Look, basically, the Company will continue to develop in a prudent fashion. So, in terms of cash conversion to buildings, we will continue to develop as we see our vacancy rate drop. Just to point out, Marimar, in the third quarter last year, occupancy was above 90% overall for the Company. That's why we started all of this inventory buildings buildup. We reacted to the strong demand in our properties. Today, as we see the overall vacancy rate of the Company of 14%, we will be prudent and slow down our conversion of cash into buildings, bear in mind that our same store vacancy is very attractive and is really under control. So, we will balance these two stances of prudent developing and a control of vacancy. It doesn't help the Company a lot to develop buildings if we already have current buildings in the markets that we operate. So, we're prudent in that respect.

In terms of leveraging the balance sheet, first of all, we need to tackle the debt renegotiation, the debt roll-over, and then, in the next 24 months, we will access the debt markets to increase leverage. As our cash drops below $175 million, somewhere around there, given our pace of investments, then we will begin to lever the company appropriately.

Marimar Torreblanca:

Okay, and what do you think are the chances that we see a new Build-to-Suit project, like the Nissan Park you have? Do you think that we're—have you been in negotiations that suggest that in the next six to 12 months you should be seeing projects of this kind?

Juan Sottil:

Well, I believe, as I said, I think that the market fundamentals are very strong. There is a strong pipeline coming, particularly from the automotive industry, and there's a strong pipeline also from the aerospace industry. So, therefore, we are always marketing not only our inventory buildings, but also Build-to-Suit projects and also Park-to-Suit projects. So, that's the line of our business and I believe that it's—I think some of these projects take—they take a lot of time sometimes. We are currently attending this strong pipeline, and therefore, I think we're pretty much in line to what we have been doing in the past and what we are going to be looking forward. So, as long as we see a strong pipeline, I think that our business is going to be working and it's going to be done as usual.

Marimar Torreblanca:

Okay. Thank you.

Juan Sottil:

Gracias.

Operator:

Our next question comes from Adrian Huerta with JP Morgan. Please proceed with your question.

Adrian Huerta:

Thank you. Hi, Juan and Lorenzo, thank you for the call. My first question is what is the level of GLA that you're expecting to open, or to have ready for lease in the second half of the '15, and the GLA for 2016 - and if some of that is already leased?

The second question, somewhat related to that one, is at what point would you slow down construction of new GLA, in terms of overall occupancy? I mean, you already a closer to '15, you're opening even more in the second half and it is not rented out. I mean, where could we see the overall vacancy ticking in the worst-case scenario before you slow down?

Juan Sottil:

Adrian, it's nice to see you and to hear from you. Look, we're very open about our construction and development pipeline. So, we will end the year somewhere in the 19 million, 19.5 million square feet. We do have some inventory buildings coming on line in the second half. We do have a strong pipeline of leasing. Clients have slowed down the closing of leases, it has taken us a little bit longer to close the leases, but the pipeline has not weakened. So, we will continue to guide you, saying that it takes us six month to lease the buildings.

Now, as I think as I have been answering, it doesn't help the Company to have several inventory buildings on the same market. It doesn't add value to our shareholders. In Vesta, we grow accretively. It doesn't add any value to my Company to have too many inventory buildings, more than one per market, it really doesn't. A growth plan should be dynamic and should reflect our ability to lease in the markets we operate. I think that a 15% vacancy, with our aggressive reporting on inventory completion dates, it should be ticking, should be ticked, and that's the way our Investment Committee is managing the Company. We need to lease up these spaces and then we will resume growth. Again, one year ago, 8% overall vacancy, today 15, because we got ready to continue our expansion. When the 15 drops to 12-ish, 11-ish, we will continue to develop. This is dynamic and this is the way we operate. We put prudency over growth all the time.

Adrian Huerta:

Juan, thank you so much for the answer, and my second question—you guys have a lot of experience in different cycles in this industry. Given your experience in the past, what has been the impact of a drastic move on the FX, on the peso, especially on rents? On one hand, it obviously becomes more attractive for US companies to come to Mexico, but then, on the other hand, given that not all industrial assets are dollarized, I mean, there definitely has to be some type of pressure regarding rental prices denominated in US dollars. I guess, with the small movements on the FX, that doesn't happen, but with larger ones, I wonder what happens.

Juan Sottil:

This is an excellent question and I'm happy you bring it up, because it really allows us to shine, quite frankly. Please look at our balance sheet and look at our accounts receivable. They haven't moved. Isn't it amazing, that the peso has gone through basically a 20% devaluation and our clients are able to meet rent payments? That's picking good clients and that's really managing the credit process of Vesta.

Let me compare, let me just put this into perspective. When the real estate market crashed in the beginning of the 2010 period, there was also a very strong foreign exchange movement. At that time, we did see a lot of pressure on rents. That is not only where our accounts receivable grew, some of our clients went bankrupt, some of our extraordinary clients asked us for rent relief, which is not the case right now, and it was a challenging period for a real estate developer. I contrast that with the current situation. The peso has weakened significantly, we have strong client demand in our pipeline, we don't have rental pressure because there's not a lot of vacancy in the markets we operate, and as long as we continue to pick up good clients, do long-term leases, and really worry about the credit rating—as I keep telling at all our meetings, concern number one of my Investment Committee is do business with good clients, don't do business with lousy clients, because when the volatility comes to market, it's really the good clients that let you sleep well at night, and I think that's what you're seeing in our balance sheet. So, in the markets we operate, Toluca and Bajio, we have a strong demand, and we continue to market our buildings in dollars at the ongoing market rate, which is not dropping. The same can be said for the markets we operate in the north, the same can be said in Toluca. So, we just move ahead.

Adrian Huerta:

I guess that's a very good example, and I guess the big difference is that in that crisis, growth in the US came down significantly, which is not the case this time, that we're seeing the currency depreciating, so no?

Juan Sottil:

Exactly. The growth in the US, it is really helping our side of the Mexican economy, which is manufacturing based, and that allows us to keep our pipeline strong, that allows us to keep our pricing solid, and our Company's meeting their financial commitments, no, our clients.

Adrian Huerta:

Yes, but I guess, overall, rental prices, on average, considering that you have a certain percentage of your leases denominated in pesos, the average number in US dollars will be coming down a bit.

Juan Sottil:

Well, of course. I mean, part of the effect of the peso weakening, of course. We do have 25% of our leases denominated in pesos and the peso value has shrinked in our dollar accounting, and that one we didn't foresee at the beginning of the year. So, part of the reason that we have 14.4 against 14.5 is that, well, my leases from my peso clients are not really helping me, are they, no, so well, but, again, that's an externality, that's a volatile externality that the Company cannot foresee. What we can control is good clients, what we can control is leasing pace, what we can control is looking for a strong pipeline, and those things we are under control.

Adrian Huerta:

Perfect, Juan. Thank you so much, always good talking to you.

Juan Sottil:

Same here.

Operator:

Our next question comes from Ivan Enriquez with HSBC. Please proceed with your question.

Ivan Enriquez:

Thank you. Hello, Lorenzo, Juan and Iga. Congratulations on the result. My question has to do with—we saw this margin expansion, EBITDA margin expansion basically on the back of a reduction of 23.4% in administrative expenses, and this was basically due to management, you said management achieving some targets. Can you please elaborate a little bit more on what are these targets and give us more color on these delays and the targets (inaudible).

Juan Sottil:

Absolutely, and, again, I think this is a very good question and I'm very happy that all of you analysts keep us sharp. Look, our Board decided to tie the compensation scheme for management to the total returns that we deliver to our shareholders. Vesta is unique in Mexico in that respect, not only in the realty industry, but in any public company. The concept of that is first comes the shareholder and then comes the management, and we're unique in that. So, if the shareholder has a good return, management will be compensated, a good measureable return, and the measure is total return, dividend plus stock appreciation.

Well, on that scheme, Vesta performance, since December 31 of 2014, has not been stellar, and, well, we are concerned, not only because it is our duty to excel in providing results to our Board and our shareholders, but because it bites on the management compensation. So, what we do is we mark-to-market the management compensation on a quarterly basis. On this week's Board, the Board is thinking about if we should mark-to-market our management compensations on a quarterly basis, because we throw you off. Last quarter, we were basically at target, and this quarter we're very well below target, and that puts volatility in my admin costs and it prompts all of you analysts and shareholders to seek what's going on. So, we may want to revisit that issue on how to—during the year, how to express our admin costs. But, for the time being, they were mark-to-market. Because total returns were not even good, they were very bad, therefore management compensation—and we're talking about 15 employees out of 40. So, management compensation tied to shareholder results cuts deep into the compensation of most of the top managers—let me reiterate, all of the top managers and a third of our—or a fourth of our middle managers.

So, look, that's why our admin costs were down, no? So, please take a look in the notes in the financial statements and you will see the research we created last quarter vis-à-vis the research we created this quarter, and it will be self-evident how accounting for compensation runs into the Company's books, no?

Ivan Enriquez:

Okay, thanks, Juan. I certainly understand this total return-based compensation, but my concern is how can we isolate the management execution, let's say, and also the impact that the share price can have due to other stuff, like the perception of a higher interest rate, because, I mean, not only you, but also the (inaudible) asset class has clearly underperformed, but it's basically—or had some explanation on the interest rate concern, but here you are like, I mean, hurting, or not necessarily doing a bad management execution, and you're certainly reducing the compensation, no? I mean, it's …

Juan Sottil:

Well, look, there are two sides to the same coin. I believe that the performance, management-wise, of the management of the Company—sorry for the reiteration—is very good. I think that we have had, management-wise, a good first half of the year. There's some parts that we should concentrate, leasing clearly is one of them, we have to close leases appropriately, but besides that, I think that we have done a pretty good job. The share price doesn't reflect that. As well, the alignment of interest dictates that our compensation suffers. All of us, all of these 15 people understand that, and that only makes us work better. So, in that respect, I'm very happy about what's happening.

Now, you're also touching another question, which is the impact of interest rates, and there, I have a disagreement with the market. I believe that given the type of company we are, a developer in the dynamic center of Mexico, in the right place of the Mexican economy, export-led growth, given that the US is growing substantially and therefore they have to hike rates to keep their economy healthy, I think that the impact of interest rates is not that strong in Vesta. I have no comment on my peers, you're the better of judges of that, but in the case of Vesta, I don't think that interest rates should have a huge impact on us, not only because the base business, the real business remains strong, but also because we will access the debt capital markets, as I pointed out, for a 10-year transaction in the fourth or first quarter of next year. So, the impact of interest rates in the particular case of Vesta should be pretty well minor, no?

Ivan Enriquez:

Mm-hmm, no, no, I completely agree with that discrepancy, so I just wanted to point that out. Finally, in terms of the guidance, do you have any NOI guidance or revenue for 2015?

Juan Sottil:

For 2015, well, we already gave it, no, growth …

Ivan Enriquez:

(Inaudible)

Juan Sottil:

Well, look, certainly, we're 0.1 below guidance in revenues, and, well, a lot of it, it has to do with exchange rate fluctuation and like 25% of peso leases, and of course on our need to close up leasing of vacant space.

In terms of NOI and EBITDA, I think that we're meeting the margins more than comfortably, and I took into account the effective level of compensation of management, so there's nothing that prompts me to say that I'm not going to meet the guidance on those metrics. In fact, I am quite comfortable with the growth of FFO, which is really what we—at the end of the day, we funnel the cash, no, and FFO is a good measure of cash generating ability, no?

Ivan Enriquez:

Okay. Thanks so much and congratulations again on the GLA growth on a yearly basis, guys. Thank you.

Juan Sottil:

Thank you.

Operator:

Our next question is from Francisco Suárez with Scotiabank. Please proceed with your question.

Francisco Suárez:

Hi, good morning, gentlemen. Francisco Suárez from Scotiabank. Basically, my question relates with your guidance on your FFO margin. Currently, you have a 66% FFO margin. For sure, you conserved lower funding costs, and we are eager to see that improvement next year, Juan, since you are able to refinance your current debt, but assuming that the overall cost of funding remains flat—I'm sorry to bug you with another question related with absorption rates, you know, on spec property, but what may happen to overall FFO margins if vacancies are still high on spec property going forward? What can you guide us with? Any color would be very much appreciated. Thank you.

Juan Sottil:

Okay, let me—I paid attention to one of your questions, Loren paid attention to one of your questions, and I think I missed one, but let's answer and you remind us what we're missing, because we don't want to leave anything on the table.

First, Francisco, I'd like to talk to you, we do not give guidance on FFO, please remember that, we do give guidance on EBITDA, but I will be very open about FFO. FFO came in strong, basically, as expected, as we expected internally, and the kicker in this quarter—on the first half of the year, I should say, is that taxes came out—cash taxes came out significantly lower. Please remember that in the case of the Vesta—and I think that we should talk about an adjusted FFO, because we do pay taxes, and tax cash outflows could be considerable, but because of the foreign exchange movement, we're not going to pay much of a tax bill in the coming years, if the peso remains at the levels they are today. Now, given the niceties of the tax implementation in the entering of the years, we do have to pay some taxes during the years, but at the final tax tally, most or all will be adjusted. But, again, taxes, we're not paying, so FFO benefits greatly from that.

Please remember that, on FFO, all of these extraneous items, like management compensation, which it is not cash flow, is not taken into account. That's why we like FFO. Foreign exchange fluctuations, the appreciation of the value of our property, all of these things come out. We follow the cash, cash is very strong.

But, taking a look at taxes, if I were a (inaudible), and certainly the (inaudible) don't pay taxes, but to make numbers comparable, you'd have to make a guess of how much taxes shareholders pay under (inaudible) holdings to make the FFO comparable, no, or, conversely, add back the taxes to my FFO to make us comparable, whatever suits your need.

So, that's one question.

The other question is on absorption, perhaps Loren can comment on absorption rate, and then you remind me the question that I forgot.

Francisco Suárez:

Yes, perhaps we can actually talk on your EBITDA margin guidance. My guess here is that if the current absorption rates actually deteriorate and for some reason your overall vacancies on the spec property continue to deteriorate in the future, if that actually happens, that may affect your overall EBITDA margins, and what would be your guidance on EBITDA margins for this year?

Juan Sottil:

Well, okay, look, we're not changing guidance at this point, because we see a very strong pipeline, Francisco. Our level of concern is that because we account for development immediately after the building is available, we don't hide when our properties are going to impact our GLA, and we use that as a metric internally and we share that metric with you. That's why the vacancy came up. We strongly believe that we will be able to lease our buildings within our expected rate, and therefore, given the pipeline that we have, we will not change guidance during the second quarter. If we were to see the pipeline decreasing, then we would talk about changing guidance. The guidance, we'll hit our revenue line, and therefore the rest of the metrics will be affected, no, but so far I'm confident in our ability to reach these targets, no?

Absorption rate, the market absorption rate remains strong. Customers are taking longer just to close the leases. Was that due to volatility in the markets globally, was that due because of elections, was that due—we do not know, but we're talking to a lot of clients—new clients pop up very often and we follow them on the prospect level to the closing level, and we remain confident in our ability to close, and in the pipeline that we have, that we're seeing coming up from the regions we operate.

Francisco Suárez:

Thank you very much, and take care.

Operator:

Our next question comes from Alvaro Garcia with BTG International. Please proceed with your question.

Alvaro Garcia:

Hey, guys, thanks for the call. Most of my questions have been answered, but I was wondering if you could drill down maybe a little more on S1 and S2 in Toluca, and maybe you can give exact examples. I don't know how much color you could give exactly, but maybe has it not been leased, maybe, because you're looking for a tenant with a longer timeframe, or are you looking for a particular type of tenant there? Any sort of color with regard to S1 and S2 would be really appreciated.

Lorenzo Berho:

Absolutely, Alvaro, and let me tell you, first of all, I'd like to take the opportunity also to share how the market is moving, again, in Toluca. In Toluca, we have approximately 4 million square feet of leasable area, and it's actually fully leased, so we are very confident that we need more space in order to be able to rent and to have more of our existing customers.

S1 and S2, those are buildings very similar to the S3 building. It's approximately 150,000 square feet each. Let me tell you, the S3, in this last quarter we leased it up with two existing clients, one of them being Ryder Logistics, which was already our client in Queretaro and in Toluca, so we are repeating business with them. The other one is Recall, who is doing business processing outsourcing, and we lease already a property with them in Toluca. We're getting long-term leases. I'm talking, even in some cases, even above 10 years. So, first of all, we are growing with our existing client base and we're leasing up our only two available buildings. Therefore, we want to be very careful and try to maintain the same kind of clients and the same kind of leases looking forward. We are marketing the existing two buildings, and therefore, we're very confident that we are going to be very—I think we're going to be very successful in the S1 and S2, and also in the S5 and S6 that are currently under construction.

Another important item about Toluca is that today, if you go to Toluca and try to find land to develop an industrial building, it's very scarce land, and prices have increased dramatically. So, that gives us a big advantage on the land that we acquired some years ago and that we're currently developing.

Alvaro Garcia:

Great, that was a very complete answer. Just one last thing, I was wondering if you could provide a little color on the plot of land you bought in Aguascalientes, as well. I noticed that was the biggest jump in your land reserve this quarter. Any sort of color there would be greatly appreciated, as well, maybe, with regard to the land prices in Bajio relative to what you mentioned now, about how land prices in Toluca have increased. Thank you, guys, I really appreciate it.

Lorenzo Berho:

Sure. About Aguascalientes, as you know, we have the DSP Park of Nissan. Nissan will start the construction of a new manufacturing facility, together with Infinity and Daimler, Mercedes-Benz, right next to the DSP Park, and therefore we believe that demand is going to come very strong in the upcoming years. Therefore, we are taking advantage of a market that we already know and we are very well established, and we are buying land before we start up marketing more buildings, and we are doing it in the proximity of the Nissan Park, because we know that the demand is going to come in this same area. So, that's why for us it's very important to secure the land in advance, so that we are in a more advantageous position in the upcoming future.

Regarding land prices, that's why for us it is key to buy land. Not only we are acquiring land in Aguascalientes, actually, we're going to still be acquiring land in Aguascalientes, and we are going to still be buying land in Bajio, because we believe that securing land is going to give us a big ability to market buildings, and we know if we buy land today, we can even get it at discount prices to what we see the trend is going in the upcoming future. Land prices have also increased in the Bajio region. That's why tying up land for us is going to be key in order to be able to get to the growth plan that we have in those regions.

Juan Sottil:

Again, from an overall perspective of the balance sheet, land reserve, for our more than a billion-dollar portfolio of relative properties, should not be higher than $90 million, $100 million, no more than that. We're currently at $66 million. So, we're prudently buying where we think demand will be important.

Alvaro Garcia:

Perfect. Lorenzo, Juan, thank you very much.

Operator:

As a reminder, if you'd like to ask a question, press star, then the number one on your telephone keypad.

Our next question comes from Javier Gayol with GBM. Please proceed with your question.

Javier Gayol:

Hi, guys, good evening, congrats on your results. My question is on the development side. I mean, with this lower peso, do you think that your investments showed in your press release for your ongoing projects should lower, I mean, because you are showing it in US figures, and if the case, how much you're going to benefit in terms of development cap rate, or something like that, in this project going forward?

The second question, with this price that you pushed forward, I mean, is there any kind of penalties that you have to pay to your general contractors, or something like that?

Juan Sottil:

Okay, both very good questions. Let me start by the second one, because it's an easier one. No, no, we didn't have any penalty from our contractors. They are working very hard on our Toluca Park 2, providing the infrastructure, so it was a matter of redirecting them to secure the infrastructure of the park rather than erecting the walls of the buildings. It was nothing more dramatic than that. But, they don't erect the walls, continue to do the infrastructure. It was just that. So, there is no penalty.

On the first question, the first question is very sharp. Construction costs haven't increased, and our construction costs are denominated in pesos. Of course, at the end of the day, what we are—and that is the reason why we have a peso balance on our checking accounts. It is because pesos—the cash of Vesta are really buildings for the future. As construction costs have not risen, because the devaluation is not trickling down to inflation—I mean, still cement, the basic raw materials of our buildings are not rising in price—we keep our money in pesos to match those expenses.

When we calculate—when we approve these buildings in the Investment Committee, we commit to a certain hurdle return, unlevered—it will spread the hurdle return, which is an IRR type of analysis, it will spread that return in terms of cap rate. We committed to 11-ish for inventory buildings, and we're confident that we will achieve that.

As our revenues are mostly denominated in dollars, the appraisal process values our buildings in dollars, so these inventory buildings are being valued as soon as we start construction in dollar terms, and the mismatch between our valuation, or the appraisal, and our commitment of the Investment Committee and the peso costs give us leverage on the pricing stance. Mind you, it's the same leverage that any other developer in the area has, we're basically in that regard comparable, so, at the end of the day, the devaluation does not allow us to price more aggressively, but certainly we keep an eye on that.

In the appraisal process, buildings that have rents in pesos are appraised in pesos, and we adjust the appraisal process to take into account that. Again, if you go to the notes on the appraisal, you will clearly see the impact of the peso/dollar fluctuation for those buildings that are being leased in pesos. But, the appraiser also considers that the buildings that are under development will have dollar rents, because that's the currency where the majority of our rents are denominated.

I don't know if I covered what you wanted to listen to in the question.

Javier Gayol:

Yes, perfect. Thank you very much.

Juan Sottil:

Thank you.

Operator:

Our next question comes from Cecilia Jimenez with Santander. Please proceed with your question.

Cecilia Jimenez:

Thanks. Hi, guys, good morning, and thanks for the call. I have two questions. The first would be about "innovesting." I would like to know if this could have an impact and implication on the maintenance cap ex investments you are doing today and going forward. That would be my first question—in the properties, I mean.

Juan Sottil:

Thank you for the question, Cecilia, nice to hear from you. Look, in Vesta, we take innovation very seriously. We really want to put very hard marks on how to guide the Company. That's why we changed our compensation procedure, and I think it's very (inaudible). We restructured the Company, and we're continually trying to be very innovative in the way we do business. Yes, one of the things that our task force that we have set up in the Company focuses on is how to achieve maintenance—how to keep maintenance costs as small as possible, and I think we're doing that. I think that's one of the things that we're focusing on. Part of the reason that we favor concrete buildings is because buildings tend to last for a long time and concrete buildings are very easy to maintain and don't demand so much maintenance cap ex from us or from our clients, and that's part of having the newest building portfolio, industrial portfolio in Mexico, no? But, certainly, "innovesting" means that we're trying to reinvent ourselves every year. It is really having a goal to be best-in-class, not only in the way we do business and the way we treat our clients and the way we select the clients and the way we report to all of you, but also in the way we manage the portfolio, and we have set up different leaders in each of these fields to try to innovate that, to try to look at how should things be done in the best of fashion, and that is what "innovesting" means to us in the Company.

Cecilia Jimenez:

Okay, but we should see the same, let's say, percentage of maintenance cap ex that we have seen so far, we shouldn't see that increasing, or should we?

Juan Sottil:

No, no, no, maintenance cap ex, what we do in our projections, is when leases mature, we assume that we have to invest around $0.50 per square foot. If you average that out in our portfolio, it comes to around $0.10 per square foot per year, somewhere around there, sometimes less, sometimes more, but that's a good working figure of maintenance cap ex. Obviously, part of our focus is how to optimize that and how to minimize those impacts with a lot of corrective measures, with a lot of the way we should do business on the ground. It may be very different things that we just have to focus on doing, cleaning the roofing, painting the buildings, be on top of our customer, so that they do their part of the equation as quickly as possible and at a schedule. All of those little things (inaudible) to a low maintenance cap ex, no? But, again, the way we forecast our numbers is as I just mentioned.

Cecilia Jimenez:

Okay, thanks, Juan, and then the second question is regarding prices. I wanted to see if you see stable prices in dollar terms, or if you have seen so far negotiations with your tenants trying to lower the price due to the FX appreciation so far, or do you see them as stable.

Juan Sottil:

No, no, no, the prices—in the markets that we operate, prices aren't quite—well, deep, I should say, using that financial expression. There is not a lot of empty space in the Toluca region, so prices are being maintained. There's high competition. Some of our clients, or some of our potential clients, are naturally peso-based clients, and as well, what we do, is we look at our alternative clients that are based in dollars. Unfortunately, at 15 pesos per dollar, that makes it challenging to get peso clients. That's the color I would give you. My dollar clients, we have competitive prices. Dollar-based clients are aware of this and prices are not coming down. The effect is that if—12 months ago, I was able to seek out high-quality customers that are peso-based, maybe because they are local district operations. Right now, it's a hell of a lot more challenging to go after them, and that's a reality. That is a real effect of the devaluation.

Lorenzo Berho:

I think that for the clients that are dollar-based clients, it hasn't had any impact. I think that the rental prices move more, more correlated to the supply and demand, and we believe that certain markets, supply is low, therefore demand is stronger, and therefore we can maintain the same prices in US dollars, particularly for manufacturing companies.

Cecilia Jimenez:

Perfect, that's great color. Thank you very much.

Juan Sottil:

Thank you, Cecilia, thank you for the question, really good question.

Cecilia Jimenez:

Thanks.

Operator:

There are no further questions at this time. I'll turn the call back over to Mr. Berho for any closing remarks.

Lorenzo Berho:

Thank you, Rob, and thank you all for participating in Vesta's Second Quarter 2015 Conference Call. We look forward to speaking with you again when we release our third quarter results. If you have any questions in the meantime, please do not hesitate to contact our Investor Relations Department, Iga Wolska. Thank you and have a great day.

Operator:

This concludes today's teleconference. Thank you for your participation. You may disconnect your lines at this time.