Vesta Industrial Real Estate

Second Quarter 2018 Earnings Conference Call

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Eugenio Saldana, *GBM*

Vanessa Quiroga, *Credit Suisse*

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PRESENTATION

Operator:

Good morning. My name is Rob and I'll be your conference Operator today. At this time, I would like to welcome everyone to Vesta's Second Quarter 2018 Earnings Conference Call. Vesta issued its quarterly report yesterday, July 26, 2018. If you did not receive a copy via e-mail, the release may also be found on the Company's website within the investor relations section.

I like to remind you that this conference call includes forward-looking statements based on currently available information. Forward-looking statements inherently involve risks and uncertainties that could cause actual results to differ materially from those predicted in such forward-looking statements. Statements made on this conference call should be considered together with cautionary statements and other information contained within the Company's earnings release dated July 26, 2018, and within the most recent regulatory filings for discussion of those risks.

All figures included herein were prepared in accordance with IFRS and are stated in nominal U.S. dollars unless otherwise noted.

Joining us today from Vesta in Mexico City is Lorenzo Berho, Chief Executive Officer; Juan Sottil, Chief Financial Officer; and Christianne Ibañez, Vesta's Investor Relations Officer. Also present on our call and available for your questions is Lorenzo D. Berho, Vesta's Chief Operating Officer.

I would now like to turn the call over to Mr. Berho. Sir, please go ahead.

Lorenzo Berho:

Thank you, Rob, and thank you everyone for joining us in our call today.

As you may know, 2018 is Vesta's 20-year anniversary. As we celebrate this historic milestone, I would like to take opportunity to reflect on Vesta's remarkable evolution. From our genesis in 1998 as a small young Company with eight buildings and 500,000 square feet of GLA to who we are today, one of the most highly regarded and innovative real estate operators in Mexico, with a diversified portfolio of 187 buildings of fully operational properties, as well as properties under development.

Further, we are on the path to successfully achieving 30 million square feet by the end of the year, with a growing roster of prominent international clients in a wide range of industries.

Importantly, over the last 20 years, Vesta has become a bellwether of best practices in sustainability and corporate governance.

The operational best practices we have implemented throughout our organization have also enabled us to attract a team of some of the most qualified and respected professionals in the industry, who today are positioned at Vesta operations within the most dynamic regions in Mexico, notably the Bajío and Northern regions.

We continue to deliver on an aggressive expansion strategy, driven by our close relationships with our clients, as well as by our country's reputation as a preeminent global industrial manufacturing hub. This is evidenced by our ability to again achieve strong results in the second quarter of 2018.

Juan will discuss our financial results in detail. But I wanted to comment that this quarter's operational performance was again characterized by steady growth complemented by an unwavering focus on balance sheet strength, ensuring we remain well positioned for exciting growth opportunities.

Our timely and accretive building deliveries increased our total portfolio by 1.4 million square feet this quarter, at an expected average weighted return on cost of 11.1%.

Our past quarter's dynamic and disciplined leasing activity also drove revenue growth to 22% and FFO growth to 91.4 year on year.

Early renewals have further strengthened the quality of our future revenues.

Turning briefly to the geopolitical environment, we note that investors' confidence in Mexico has been reinvigorated, and the capital markets reflect renewed investment in Mexican publicly traded companies after our country's general elections on July first. As investment community has placed continued trust in our country, we too remain confident in the sophistication and competitiveness of Mexico's manufacturing and logistics platform.

We continued to see a strong demand for industrial space from high-quality tenants and expect favorable industry trends to drive this demand over the long term.

Further, the world is rapidly evolving towards a new way of producing, a paradigm known as the fourth industrial revolution, characterized by a fusion of technologies that is blurring the lines between the physical, digital and biological spheres, marked by emerging technology breakthroughs in a number of fields including robotics, artificial intelligence, blockchain, nanotechnology, and quantum computing. Vesta's ability to anticipate client demand related to these areas have made us an agent of change and transformation, ensuring our Company and country will flourish in this scenario and in today's climate of renewed optimism for growth. Driven by our confidence in Mexico's new presidential administration, we look forward to continue designing today's most innovative manufacturing and warehousing spaces, to support leading-edge technology that meets both clients' and supply chains' logistical needs.

In conclusion, the above factors instill considerable optimism and confidence in what the future holds for Vesta. Today, we are in a position of significant strength and forward momentum.

I look forward to taking on my new role as full-time Executive President of Vesta's Board of Directors, effective August 1, 2018. I will continue to be actively involved in strengthening Vesta's relationships with our key stakeholders while remaining committed to our Company's future strategic direction, working closely with Vesta's new CEO, Mr. Lorenzo Dominique Berho.

In recognition of Vesta's evolution into a leading institutional industrial asset management platform, and in conjunction with the successful implementation of its previous announced succession plan, we would like to highlight the following organizational enhancements.

The Company's former Chief Operating Officer position will be transformed into a newly created Chief Commercial Officer position. Elías Laniado Laborín, Vesta's Vice President of New Businesses for Northern Region, has been appointed as Vesta's Chief Commercial Officer effective August 1, 2018. In his new role, Elías will be responsible for all activities related to marketing, leasing and investing throughout all regions in which Vesta has a presence.

Additionally, Diego Berho, Vice President of Development, who has also served as interim Chief Development Officer since first quarter 2017, has been named Vesta's Chief Portfolio Officer, effective August 1, 2018. In his new role, Diego will be responsible for the oversight of all activities related to asset management and development of the portfolio.

I am confident that the new dynamic team now in place will continue our Company's vision and successfully grow but will also make significant contributions to Mexico's progress.

It has been an honor to lead our Company as its Chief Executive Officer, and I maintain my undiminished enthusiasm as we move to this exciting new stage for Vesta.

Thank you. Let me now turn the call to Mr. Juan Sottil, our CFO.

Juan Sottil:

Thank you, Lorenzo. Good morning, and thank you, everyone, for joining us.

As Lorenzo has discussed, we delivered a strong second quarter to again achieve a double-digit increase in revenues and EBITDA during the second quarter 2018, with solid demand for our facilities as we continue to focus on those regions with significant economic growth throughout Mexico key logistics, manufacturing and trade corridors.

In the second quarter of 2018, Vesta's total portfolio grew to 28.5 million square feet from 27 million square feet in the second quarter of last year. Our strong performance this quarter was due to new building deliveries, of which 585,000 square feet were built to suit facilities for current clients such as TPI Composite and Polymer, which directly fed into our stabilized portfolio, while 843,800 square feet were inventory buildings currently undergoing the release of period.

We signed new leases totaling 759,000 square feet during the quarter, leveraging our client relationships to expand business with existing clients while signing contracts with new clients from a broad range of industries and countries.

Early renewals dropped the percentage of 2018 maturity of GLA to 2.9%, and 2019 maturing GLA to 6.4%. It is important to note that, while new inventory deliveries impacted our vacancies in the second quarter, aggressive leasing activities offset this increase to drive total portfolio occupancy to 91.9%, a 1.58% sequential decrease. Our same store occupancy remained flat during the three-month period.

Turning to key financial metrics, second quarter revenues rose 22% year-on-year to $32.4 million. This increase resulted in a 96.7% margin while disciplined administrative expense management drove Vesta second quarter EBIDTA to 85.9. Both therefore exceed our guidance. Vesta achieved 96.7% NOI margins and EBITDA margins of 85.6; again, exceed the guidance of 95 and 83 respectively.

FFO increased 91.3% from $10 million in the second quarter of last year to $19.1 million in the second quarter of 2018. This was due to a higher dollar-denominated revenue base and to a tax shield resulting from the peso depreciation from year to year.

FFO per share increased 95.6 in the second quarter of 2018 from $0.016 in the second quarter of last year to $0.032 in the second quarter of this year, due to an increased cash generation for the quarter and to Vesta share buy-back program, as the Company took advantage of purchasing its shares at a price to NAV of a discount of 35% average.

Second quarter net operating income increased by 22.4% to $31.31 million while NOI margin increased by 33 basis points to 96.7% due to a higher rental revenue.

As Lorenzo commented, it is important to note that we remain focused on strengthening Vesta's balance sheet. In the second quarter of 2018, Vesta secured additional funding through a $90 million unsecured term loan agreement with Prudential Insurance Company of America and its affiliates, comprised of a seven-year non-amortizing tranche of $45 million with a fixed 5.5 semiannual interest rate and a ten-year non-amortizing tranche of $45 million with a fixed 5.85 semiannual interest rate. To date, Vesta's loan to value has reached 36%, with a seven-year average debt maturity profile at 4.7 fixed average interest rate. This also ensures we can continue to take opportunistic advantage of important non-dilutive growth opportunities.

We ended the quarter with an overall balance of debt of just over $699 million, all associated with long-term liabilities; the secured portion of the debt, 48.4% of the total debt, is guaranteed by some of the Company's investment properties, as well as the related income derived. Vesta's debt is denominated in U.S. dollars and is 100% of interest rate has been fixed.

Interest expense increased to $8.3 million at the close of the second quarter of this year, compared to $4 million to the same quarter of 2017. This year-on-year increase reflects a higher debt balance related to the Company's new debt issuance.

In closing, as Mexico leading real estate Company, we look to the remainder of 2018 with optimism. I look forward to Mr. Lorenzo Dominique Berho new leadership as we move forward with benefit of a strong balance sheet, robust demand for our premier industrial facilities, and a commitment to sustainable long-term growth.

With that, we would like to conclude our prepared remarks; let's open the floor to questions. Please go ahead, Operator.

Operator:

Thank you.

We'll now be conducting a question-and-answer session. If you'd like to ask a question, please press star, one on your telephone keypad and a confirmation tone will indicate your line is in the question queue. You may press star, two if you would like to remove your question from the queue. For participants that are using speaker equipment, it may be necessary to pick up your handset before pressing the star keys. One moment please while we poll for questions.

Thank you. Our first question comes from the line of Enrico Trotta with Itaú. Please proceed with your questions.

Enrico Trotta:

Hi. Good morning, all, and thanks for the presentation. I have two questions.

The first one on leasing activity. Specifically, this quarter leasing activity was a bit weak, if you look compared to historical levels, it was the lowest level over the last six quarters, so I would like to understand if there was any specific reason for that, for the weaker leasing activity, or can be partially also explained by the fact that you had been anticipating a lot of contract renewals since last year.

The second question, on the guidance, you have been surpassing your NOI and EBITDA margin guidance, especially looking at numbers that we have so far in the first semester, so I would like to understand if you have any potential for actually surpassing this guidance or if you see SG&A or costs increasing the second semester so your margins should converge back to close to the guidance that you gave in the beginning of the year.

That's basically it. Thank you.

Lorenzo Dominique Berho:

Perfect. Hola, Enrico, this is Lorenzo Berho, Chief Operating Officer. Thank you very much for being on the call and thank you very much for your questions.

Regarding the leasing activity and the renewals, you have it right. We anticipated most of the renewals for 2018 during year 2017. One of the largest one, as you may remember, was Nestlé, which we extended, which had an expiration in 2018 for their three distribution facilities in Jalisco and in the State of Mexico, and we extended those leases for seven more years in early renewal. Therefore, renewals for this particular year or this first semester have been slower than other years. Definitely the only reason is because of how early we like to renew the leases and that's why the result of lower leasing on this particular quarter.

Additionally, in terms of new vacant space, we were able to close a couple leases for almost 500,000 square feet, and I would like to highlight that even they were not that many transactions, they were very important ones. One of them was a deal done in Juárez with DB Schenker which is a logistic company; they are actually going to do the logistic operations for Microsoft in Ciudad Juárez. For us, this is very important since Juárez has been a very active market and Schenker has been a very important logistic player. As you know, Microsoft is a very important company, one of the five largest companies according to Standard & Poor's 500, and we'd like to stay closer to this type of companies: multinational companies.

Additionally, we were able to lease a building that we have in Querétaro with one of our existing clients, Valeo, which is a fantastic company in the automotive industry, and they are agreed to a long-term commitment. It was a building that we delivered last year with a ten-year commitment with Valeo, which I think that represents the commitment of most automotive companies to Mexico, to the OEMs. We believe that is going to be following also in the next quarters.

I would like to add up that, regardless of the closings on this particular quarter, I would like to highlight how active we have been in terms of requests for proposals. This quarter we had a record number of requests for proposals being submitted, so we are very busy this particular quarter. As you know, we receive the request for proposals and it takes us some months to close the transaction, so hopefully in the next couple quarters we're going to be closing most of the proposals that we have had open.

Just to give you an idea, regularly we have close to 40 prospects per quarter that we analyze internally in our investment department, and this quarter we had above 70 prospects or new potential prospects that are in line in our pipeline which represents a growth of roughly 50%. We hope that will translate into closings for the next coming quarters.

Regarding the margins in our guidance, we have been well above our guidance level for the past three or four quarters. I believe that the rest of the year will continue with this trend. I will be more aggressive in providing guidance of EBITDA, but just to remind you, over the last two second quarters of last year and this year, third quarter and first quarter, we have been having EBITDA margins of above 85. I believe that with this trend will be solid enough to be sustained for the rest of the year and thereon.

I have always talked about how economies of scale should kick in, and that's what we're seeing. We are tightly controlling administrative expenses, and revenues are growing rapidly, so we're seeing these economies of scale. This is why EBITDA has been popping up. In terms of NOI, I only have to say that our very modern portfolio, the most modern portfolio of industrial real estate in Mexico, most of it composed of concrete built-up facilities, requires significant lower maintenance levels than the other buildings that are throughout Mexico. I believe also that, as long as we continue to have a high occupancy rate, our NOI will continue to be as strong as it is too.

Enrico Trotta:

Very clear, thanks.

Lorenzo Dominique Berho:

Thank you, Enrico.

Operator:

Our next question is from the Adrián Huerta with JP Morgan. Please proceed with your question.

Adrián Huerta:

Hi, thank you. Good morning, everyone, and thank you for taking my call.

My question has to do with the construction activity. Basically, since early this year you have been investing a lot on building infrastructure for new lamp lots like in Querétaro and I believe also in San Luis Potosí. Should we expect, given the strong demand that you have seen and all this record level of proposals, the development pipeline to increase from the close to 170,000 square meters of new GLA that you had under construction as of 2Q?

Then, the other question is, the build-to-suit component on the stuff that you have under construction is relatively low versus what you had in previous years; can you just tell us what are you seeing in terms of demand for build-to-suit projects? Thank you.

Lorenzo Dominique Berho:

Hola, Adrián, this is Lorenzo Berho again. Thank you very much for being on the call. I think you address very important questions regarding the pipeline. Definitely, we have been very active in terms of construction. We still have a strong development pipeline. As you well know, we acquire land in the last years, very important land, particularly all in the markets that we operate. You mentioned the Querétaro and the San Luis Potosí project, those were land lots that we acquired last year and we had to develop the infrastructure in those parts, and naturally when we develop the infrastructure we also develop inventory buildings. In Querétaro we finalize the first two buildings currently and the infrastructure of the park is also being finished, so we believe this is going to be a very successful project, this is a 100-hectare project, and we're going to be developing more buildings in the upcoming years, roughly, it's going to take us five years to develop completely. Nevertheless, we are seeing a lot of interest for this particular market, as you also have seen, we have a very high occupancy in the Querétaro market, therefore it was very important for us to anticipate and acquire the land in advance and put the infrastructure in place so that we can, whenever new potential clients come, we already have the buildings and the infrastructure available so we can accommodate their requirements; and the same case for San Luis Potosí, we will be delivering the first two buildings on the end of the year.

Regarding the pipeline, our strategy has been very well, particularly for the spec buildings, in the last couple years. We have seen strong demand in each of the markets. We are very close to our clients and to potential clients, and that's why we have identified that there is a big need in most of the markets for inventory buildings. That's why our strategy has been very strong to that and the results are very clear on our leasing activity in the last six quarters.

The build-to-suit projects normally take longer to negotiate and to deal with our clients. You are right, the development pipeline has very little build-to-suit projects in this particular quarter; nevertheless, you know that this is dynamic, this can change over time, and we are currently working with other potential build-to-suits that we will be announcing whenever they are finished.

Now, bear in mind that this quarter we delivered two important build-to-suit projects, one of them was a TPI project in the Northern Region and the other one was an expansion in Polymer in San Luis Potosí. We are still very active in that regard. We are very confident that the fundamentals are even stronger than ever, and that's why we're taking advantage of delivering great inventory buildings, modern assets, and the result of that is strong leasing activity that we're going to still be showing in the upcoming quarters.

Adrián Huerta:

Thank you, Lorenzo, appreciate it; and just one last question for Juan. What cash tax ratio we expect for the year? How much are you expecting to pay in terms of cash dividends for the year? Sorry, cash taxes for the year?

Juan Sottil:

Look, Adrián, thank you for the question. That's a particularly difficult question for a company like us. The best estimate that I can give you is one that we have of cash taxes at the second quarter, which is $11 million. Let me remind us why this is a difficult number. From a tax point of view, and only from a tax point of view, Vesta is a company that invoices dollars, but really they are peso invoices from a tax point of view, and from a tax point of view my liabilities are dollar-denominated. I am significant affected by the end of the year exchange rate, as Mexican authorities mark to market the debt on a peso basis from the swings on the dollar exchange rate for year to year. Using the closing exchange rate as of the 2017 and the second quarter closing exchange rate, and putting that number in the tax accounting of the Company, my best estimate for the year-end tax bill would be $11 million, assuming everything else being equal. Obviously on the second quarter I would produce another significant bump in revenue, we will produce another $63 million in revenue, roughly, and that will have certain cash tax consequences. But as a percentage, I think that's an accurate figure.

Adrián Huerta:

Very clear, Juan. Thank you. Thank you, Loren.

Lorenzo Dominique Berho:

Thank you.

Operator:

Our next question is from the line of Marimar Torreblanca with UBS. Please proceed with your question.

Marimar Torreblanca:

Hey guys, good morning; thanks for the call. I just had a question on your buy-backs program. Could you give us an update on what you're thinking about buy-backs right now, if you think it's the right time to put together buy-backs or not, or how are you thinking about this going forward?

Lorenzo Dominique Berho:

Thank you for the question, Marimar. As you know, buy-backs is an important part of our strategy of deployment of capital. Basically, what Management does, and this is the best role that any management can do, is to allocate capital investments among the different alternatives. We believe that, at the prices we did the buy-backs, which were—at this semester we did a few buy-backs, I mean, from the top of my head around $3 million this trimester, and we did them below 25 pesos per share, roughly speaking.

I believe that the Company still has a steep discount to NAV. I also believe, we also believe as Management that we have a lot of opportunities to develop new buildings that will add long-term value to our portfolio, so therefore from the perspective of the Management, even though our discount to NAV is significant, we are focusing our activities at the moment on an aggressive development pipeline as you have seen on our development sheet. Buy-backs would be, for the moment, a little bit subdued. We will be ready, however, if for whatever reason the opinion of the market is that the price of the stock should come down, we will continue, we will reinstate the buy-backs aggressively as we have done before.

Marimar Torreblanca:

Perfect. Thank you.

Operator:

The next question is from the line of Cecilia Jiménez with Santander. Please proceed with your question.

Cecilia Jiménez:

Thanks. Hi, good morning, Loren, Juan. Congrats on the anniversary and on the new responsibilities. I have a more open question. I know you have mentioned technology several times and it's quite important on the strategy. My question is, how technology is actually impacting your business, and what changes should we expect in the future regarding investment in the construction process of the properties, or the type of properties you are having or investing in the portfolio. That will be my question. Thank you.

Lorenzo Berho:

Thank you, Ceci, for your question, and I believe that this question goes exactly to the event that we held last night, when we celebrated our tenth anniversary. We published a book called *Innovating Mexico's Industrial Platform*, in which we specifically talk about how important technology is evolving rapidly, especially about manufacturing 4.0, applied to most of our clients today from the aerospace to the automotive and how important it is for them to be ahead on those trends that are completely changing the way we produce and the way we consume.

On the other hand, on the development side, our parks and our buildings need to fulfill the needs of those evolving trends. That's something that we are following very, very close, in terms that our parks work in order so we can increase the productivity of our clients. That's exactly what we presented yesterday. I will encourage you to go deeper in our book to see the trend, how we see the future, and Vesta will be a top niche on that regard, making sure that the way we build and the way we design and the sustainability wove in the buildings, and the way we manage, control the energy in our buildings, will be according to what our clients needs and according to the new trends.

Cecilia Jiménez:

Thanks, Loren. That was exactly what I was thinking of. In terms of investment, shall we see any particular investment in the near future related to the technology part of the business, or have you been including already it in the current CAPEX of the properties already?

Juan Sottil:

I can say that what we are seeing, some clients that are requiring buildings, specifically logistic buildings that require certain investments in technology, certain specific requirements of the way they want to manage the supply side of the building, we're adapting our format to suit those needs. We're very careful however that specific investments do not surpass our comfort level of investment per square foot. As you know, we feel very comfortable in $50 per square foot including land, we're not as comfortable of levels well beyond that. There's always a guidance with the clients of we understand what they need, we are ready to accommodate what they need on the buildings, but we are very stringent in the returns and the amount of—how heavy the building investment is. That's typical, that we have managed that process in the aerospace business for example, quite successfully. But yes, some of the new clients are requiring this type of way of thinking.

Cecilia Jiménez:

Thank you, Juan, very clear.

Operator:

Our next question is from the line of Eugenio Saldana with GBM. Please proceed with your question.

Eugenio Saldana:

Hi guys, congrats on your anniversary and your results. Yesterday Mr. Berho announced some strategies for the next 22 years, one of them being increasing your exposure to e-commerce and new geographies such as Monterrey and Guadalajara. My question is, how much of your current land bank do you believe has the potential to serve e-commerce? Secondly, after complying with the 2020 expansion plan, are you going to focus more on developing on those new regions, or where your land reserve is going to be, or how do you see your land reserve evolving after complying with the 2020 expansion plan? Thank you very much.

Lorenzo Dominique Berho:

Gracias, Eugenio. This is Lorenzo Berho again, Chief Operating Officer. You're right, I presented yesterday the framework to the short- and mid-term strategy, now as new CEO starting next week, and the first point was to conclude the 2020 plan successfully as we have been doing as of today. It was a very ambitious growth plan in 2015 when we presented it to our investors, and we have been very successful doing accretive investments, creating value for shareholders, and therefore the most important thing today is to conclude that particular project which still is a couple years ahead.

The second point that I mentioned yesterday was how important it is for us to increase our exposure to different industries that are growing in the market, particularly e-commerce; e-commerce, as all of you know very well, in the developed countries represents roughly 15% to 20% of total retail sales are done online. That's something that Mexico is lagging. Today we present close to 2% of total sales are done online. There's definitely a new opportunity in the e-commerce business. We are probably seven to 10 years lagging to other countries. Nevertheless, I think that it's a right moment to start analyzing it. Some of our peers have been doing it, at some point. Nevertheless, I think that Vesta is very well positioned to take advantage of a new trend, that it's a global trend that will be coming in Mexico for sure.

E-commerce is definitely coming to all regions, which we are present, and of course it is important that Mexico City, Guadalajara and Monterrey being the largest cities, will be some of the largest users of e-commerce business. Therefore, we'll be tapping a little bit more on this particular market, in addition to the ones that we are right now. As you know, the markets where we are, are high-growth markets, growing way ahead of the national average GDP, and therefore it has been very important for us to be in those markets, and it's good for us also to tap new markets if we find good opportunities that still can be accretive for our investors, and that still can be adding value for our existing portfolio.

Eugenio Saldana:

Just a quick follow-up on this. If my numbers are accurate, there could be a huge land bank that's going to be left after complying with the 2020 plan in the regions that you already have presence. If try tap into new markets ,you're still going to be developing on these high-growth markets, along with the perhaps e-commerce opportunities on Mexico City, Guadalajara, Monterrey, and all those markets that look appealing to you….

Lorenzo Dominique Berho:

Yes …

Eugenio Saldana:

… Can you mention any proportion that you see that is perhaps going forward? How much are you going to be developing in either of these two types of markets?

Lorenzo Dominique Berho:

Sure, well, as you know, with the land reserves that we have today we could develop roughly 14 million square feet, and we still need land reserves for the next couple years to finalize the 2020 plan, which will be about 6 million square feet, so you're right, we still have some land available for potential development after the year 2020, which in the end is also part of our plan. Sometimes we need to anticipate to acquire land before we require it, to put the infrastructure in place and so, and for example the project in Querétaro is going to take roughly five years to develop, and that's why we're going to have land after 2020 to keep on developing and to keep servicing the industries that are demanding this type of spaces in the Querétaro area, which is logistics, automotive, aerospace, and consumer goods and some others. Even potentially e-commerce we believe that is coming to Querétaro soon.

We currently are serving seven very important markets, and adding three more markets is something that we believe could easily be achieved without really making a major change in our portfolio, in our structure and in the end it will be another good proportion of our portfolio looking into the future. Nevertheless, our portfolio will still be growing in the existing markets. Even if we tap into new markets, the largest proportion will still be in the markets where we are today, which I repeat they are high-growth and very dynamic markets. That's why we want to maintain our leading position in those particular markets.

Eugenio Saldana:

Thank you, that was very good. Thank you, Loren.

Lorenzo Dominique Berho:

Thank you.

Operator:

Our next question is from the line of Fernando Ulacia with Credit Suisse. Please proceed with your question.

Vanessa Quiroga:

Hello, this is Vanessa Quiroga, also congrats on the results and the new responsibilities, Lorenzo and Lorenzo. I have three questions.

First, if you can mention any market that you see currently on the soft side, do you see any markets where your presence is decelerating in demand in any way?

The second is if, with the new government, you foresee any delays or changes in the administrative processes for getting permits, which is important given your profile of development?

The third one is, on your sources of funding for future growth, what are the options that you are considering, and if you have analyzed the option of issuing a Fibra. Thank you.

Lorenzo Berho:

Thank you very much, Vane, for your questions and your interest in Vesta. Let me maybe start by the second question that you raised, according to the new government. In our case, what we believe is that the elections took place and the democratic institutions of Mexico show their maturity and our population show the level of civil commitment that we have, voting more than 60%, which is very high. Now, on that regard, the results were respected, and the new government was very well accepted not only internally but also internationally. The fact that they have been started working since day one with a lot of collaboration from the current government shows a lot of maturity in the way they are handle things. The fact that yesterday one representative of the new government is already in Washington talking and being part of the negotiating team about NAFTA, shows how strong commitment there is between the two governments.

In that regard, we're pretty confident. And related to permits, remember that permits will be issued by either municipal and state governments; these are the ones that issue these permits. With that, we are really working very close, we're very close in promoting companies and investment to each one of these states. We don't see any change; on the contrary, we are following very closely all the proposed changes, especially at the Northern part of the country; if that happens that will probably maybe accelerate more investment to those regions. But we will be close to that.

Related with the sources of funding, I'm going to ask Juan to go to that question.

Juan Sottil:

Vanessa, thank you for the question. As we have said before, in the future, funding of CAPEX is something that is very close to us. We're reaching 36% LTB as of this quarter. Certainly, in the future, funding of CAPEX has a lot to do with recycling of properties, selling our properties that we will recycle, with a clear strategy and a clear message, and as part of that strategy, a possible disposition of a portfolio to a Fibra as part of Vesta would be a good idea, it would be analyzed accordingly. Just remember that hiking, we still have a substantial potential of leveraging. Our stated objective is 40%, as we grow the portfolio at 40% is a dynamic number; we believe that, at least in my model, we can continue to develop at this pace for some future still. Yes, at some point in time, that would be an option. But that's about it, then.

Lorenzo Berho:

Finally, regarding some of the questions related with market deceleration, we have not seen that in the markets where we operate, Vanessa.

Vanessa Quiroga:

Okay, that's great. Thank you for all the answers.

Lorenzo Berho:

No, thank you, Vanessa, for your questions.

Operator:

The next question is from the line of Francisco Suárez with Scotiabank. Please proceed with your question.

Francisco Suárez:

Hi guys. You really have lots of things to celebrate, congrats. The questions that I have relates a lot with the potential disruptions across the supply chain, generally speaking. I'm not talking about the trade risk that we might or might not have in effect in Mexico. Clearly you have great asset quality; nevertheless, the risk of reshoring technological change, and so for that might affect the supply chains from the production side of view. How do you see your overall portfolio suited for those potential shocks that might emerge eventually? Thank you.

Lorenzo Dominique Berho:

Thank you very much, Francisco, for your question, and this goes right on what we talk yesterday in our event. But let me tell you, the disruption that we are much more worried is the increase of investment into Mexico's regions. What we believe is that Mexico has gained competitiveness and in these last 25 years there has been more than $500 billion invested in the supply chains; so Mexico's competitiveness is here to stay. This is also helping U.S. competitiveness, even as the renegotiations taking place as part of the dynamics of what is happening today. We are convinced that Mexico has industrial potential, has a very strong base, and it's going to keep growing at a good pace. That will be what we will be supporting, and that's why we want to position our Company, anticipating those trends related with the positive disruption that we see.

On the other hand, I will tell you, what we have also seen is that the U.S. has been growing faster with a 4.1% since 2014. This is something that is pulling very much on Mexico's dynamics.

Francisco Suárez:

But you don't see the risk of actually capital reshoring, for instance, because the technological changes and of course what has happened from the consumer's point of view, that potentially may affect the auto industry in general, diverting some of the production elsewhere. Does that might be a risk? I mean, I fully buy your argument on Mexico's competitiveness, but I have more doubts in general related with the potential shocks affecting or creating incentives to reshoring production, like Mexico.

Lorenzo Berho:

Again, thank you for your question but on the contrary, not at all. We see the potential of Mexico—we see we are a country that we know how to adapt to changes, from—and you're talking about the auto industry, if the auto industry keeps changing to more electrical cars and the way they produce, Mexico is taking the lead, and will be playing a very important role in the future. We are convinced of that, and the disruption that we are worried, the positive disruption that can increase the investment into the regions in which we operate.

Francisco Suárez:

Great. Okay. Thank you so much. Makes sense.

Lorenzo Berho:

Gracias, Francisco.

Operator:

The next question is from the line of Alejandro Lavin with Citi. Please proceed with your question.

Alejandro Lavin:

Hi, good morning, everyone. Thanks for the call and congrats on everything. I have a couple of questions. The first one would be on the build-to-suit follow-up. I noted that returns or expected returns of the build-to-suit projects seem to be lower than the inventory projects recently, right? A couple of years ago that was probably the other way around. My question is, what have changed here, and is this also part of your preference for inventory projects in the short term?

Lorenzo Dominique Berho:

Hola Alejandro, this is Lorenzo Berho, Chief Operating Officer again. Thank you very much for your question. You're right, we believe that build-to-suit projects have pretty much maintained stable in terms of returns, having returns in the roughly 10% to 10.5% return on cost or cap rate. Nevertheless, if the inventory buildings and the spec buildings where we have seen an increase in returns above 11%, and sometimes even closer to 12%—that's why this has been an important change towards our investment strategy, and we're taking advantage of that particular situation. We're still having high returns on the inventory buildings, therefore since early last year we saw that there was an opportunity, and that's why we put the gas pedal down in inventory buildings, and we have been very successful, and we have created a lot of value for our shareholders by investing in inventory buildings.

Nevertheless, as you know, build-to-suit projects are commitments in advance before building the projects. We still believe that they are very attractive in terms of our risk-adjusted returns. We're still going to see the same—a good balance between build-to-suits and inventory buildings. We're very close to the markets. We're trying to identify what are the real estate fundamentals for each of the markets and whenever we see a good opportunity we are going to keep on developing inventory buildings, in advance and ahead of our competitors. That's what we're been taking advantage of.

Alejandro Lavin:

Okay, that's very clear, thanks, and if I may add one final question, just a quick one on dividends, so you're obviously generating good cash flows, you're also getting buy-backs. I mean, considering the trade-off between investing in growth and paying out dividends, right, so you could lower your pay-out ratio, you could lower—I mean, you're paying a very generous dividend as of today, right? You could lower your pay-out ratio and still manage to keep growing your dividends per share, right? Would you consider that?

Lorenzo Dominique Berho:

Look, the dividend question is a key question for any Board and any Management. We will be cautious. As you recall, our policy is based on actual cash flow generated by the portfolio, not on a particular dividend yield. We will analyze the alternatives, we will certainly look at the potential growth opportunities of the Company and will make a rational decision. We're eager to demonstrate that the Company has a lot of growth potential, and we're eager to demonstrate that the Company can distribute, when needed, the excess cash that we generate. We will be cautious taking that decision in the future, and you will see that as you have seen it over the last six years, now.

not relevant

Lorenzo Dominique Berho:

Please remember that the Board and Management only recommend to the general assembly for the decision, you know? We will be conscious of the needs of the decision, the rationality of it.

Alejandro Lavin:

Okay, thank you.

Operator:

The next question is from the line of Roberto Waissmann with Bradesco BBI. Please proceed with your question.

Roberto Waissmann:

Hello, guys. Thanks a lot for the call. My question is regarding the leasing spread. We have lately seen your top line growing an average of 20% year over year, but this is mainly due to new development and inflation adjustment. My question is, should we expect to see leasing spread stronger in the upcoming quarters, or if this behavior of growth should continue? Thanks.

Lorenzo Dominique Berho:

Thank you, Roberto. This is Lorenzo Berho again. There have definitely been some larger bumps in terms of leasing spreads. Normally these large leasing spread differentials are in some markets that have were effective ten years ago, eight years ago, and some of the leases are what we call vintage leases that were way below market, and at some point we'll have to recover to market. Nevertheless, the portfolio of Vesta does not represent many of these type of leases, actually very little. In the markets that we were operating compared to our peers, are very solid markets where we had leases in U.S. dollars, and which we in total in our portfolio, we believe that we have been a leading market rate setter in most of the markets, and therefore we're very close to market rent, sometimes even a little bit higher, and we have seen that the leasing spreads throughout the years, in the long run, if you analyze the long run, normally they increase roughly a little bit above inflation, over the years, in U.S. dollar terms. That's what we have seen in the past, and looking into the future we honestly think that this will hold up pretty much the same as long as we don't have leases below market.

Now, bear in mind that our business is more about the quality of earnings and the predictability of income into the future, and long-term commitments with our clients, and most of our leases are adjusted to the U.S. inflation. Looking forward, we think that that should be the analysis that has to be done if the markets in the long run could increase somewhat above inflation, that's something that we could be considering looking into the future.

Roberto Waissmann:

Okay, very clear, thank you.

Operator:

As a reminder, to ask a question, you may press star, one.

Thank you. I'll turn the floor back to Management for closing remarks.

Lorenzo Berho:

Okay, well, thank you for joining us today, for your continued and commitment to Vesta, as together we have embarked on a new and exciting chapter on our Company's growth path. The team looks forward to speaking to you and seeing many of you over the next couple of weeks and months during the upcoming road shows and conferences. If in the meantime, please do not hesitate to reach out to us; as you know, we will always be happy to assist. Thank you again for your confidence, and congratulations again to celebrate with us our 20th anniversary. Have a wonderful weekend.

Operator:

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