Vesta Industrial Real Estate

Third Quarter 2018 Earnings Conference Call

October 26, 2018

CORPORATE PARTICIPANTS

Christianne Ibañez, *Investor Relations Officer*

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Juan Sottil, *Chief Financial Officer*

CONFERENCE CALL PARTICIPANTS

Eugenio Saldaña, *GBM*

Victor Tapia, *Bradesco*

Pablo Ordóñez, *Itaú BBA*

Adrian Huerta, *JP Morgan*

PRESENTATION

Operator:

Good morning. My name is Doug (phon) and I'll be your conference Operator today. At this time, I would like to welcome everyone to Vesta's Third Quarter 2018 Earnings Conference Call. All participants are currently in a listen-only mode, and as a reminder, today's call is being recorded.

I would now like to turn the call over to your host, Ms. Christianne Ibañez, Vesta's Investor Relations Officer. Please go ahead.

Christianne Ibañez:

Thank you for joining our call to discuss our financial results for the third quarter of 2018. With us today from Vesta in Mexico City are Lorenzo Dominic Berhó, Chief Executive Officer, and Juan Sottil, Chief Financial Officer. Following their prepared remarks, there will be a question-and-answer session, during which time we will answer your questions.

Yesterday, we issued our earnings press release after market close. The release is also available within the Investor section of Vesta's IR website.

Before turning the call over to Management, I'd 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 October 25, 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.

Let me turn over to Mr. Berhó. Please go ahead.

Lorenzo Dominic Berhó:

Thank you, Christianne, and thank you, everyone, for joining our earnings call today. As you know, I've been leading Vesta for almost three months now, and have an extensive tenure at the Company in different operational roles. As I noted when I assumed the role of CEO, I'm committed to further strengthening Vesta's market position and achieving higher levels of growth. This won't be without its challenges, as we are operating in continually shifting political, economic, technological and social environments. However, as our performance over the last six years has demonstrated, we have more than doubled the size of our Company. Vesta has important competitive advantages.

We are the undisputed leader in industrial real estate in Mexico, with a portfolio of clients from a diverse range of countries and industries. What's more, our vertically-integrated management are considered to be locals, with offices in each geography in which we have a presence: a unique competitive advantage. Proximity to our clients enables us to maintain our close relationships, while gaining superior market intelligence and visibility that allow us to anticipate shifts in our markets and make the right investment decisions. I'm happy to report that we are confident about the growth opportunities we're seeing, even beyond 2020.

Moving forward, we plan to leverage our past success with a renewed focus on total shareholder returns, net asset value per share growth and some periodic dividends, guided by the Vesta mission 2020 strategic plan, the focus of which is developing and optimizing our growing property portfolio. We will remain closed to existing markets while assessing new markets with similar profit and return profiles.

Evidencing the effectiveness of our strategic plan, Vesta's NAV per share finished the third quarter at $2.09, a 7.7% increase over last year's comparable quarter. This also reflects our strong operating and financial performance.

Revenue grew just over 20% during the quarter, while net operating income increased nearly 21%. We now expect year-end revenue growth to exceed the upper range of our full year guidance of 20%. We also expect to exceed our 2018 margin guidance for NOI and EBITDA, which was 95% and 83% respectively, as we continue to leverage Vesta's scale.

Our strong performance was also a result of achieving a record 98% occupancy rate in Vesta's same-store portfolio during the quarter. Our newly appointed Chief Commercial and Portfolio Officers are successfully carrying out their new roles, securing new leases that have touched base, as well as efficiently managing our growing property portfolio, all while maintaining our characteristic discipline to emphasize accretive, long-term leases with high quality tenants.

During the quarter, we leased 1.1 million square feet, driving stabilized occupancy to nearly 97%, while also adding just over 400,000 square feet of GLA to our total portfolio of 180 high quality industrial properties with a combined GLA of nearly 29 million square feet, and with a balanced industry exposure that diversifies risk.

To share with you some insights on what we're currently seeing in the market, the conclusion of Mexico's elections and of the final chapters of the new trade agreement, USMCA, this past summer, have renewed confidence in Mexico and North American altogether as the world's premier manufacturing and logistics hub. This new visibility has resulted in increased demand with an even stronger pipeline as of today. We note strong demand by existing tenants who need to expand with increased interest by global producers who recognize Mexico's desirability as a manufacturing hub with the cost, location and engineering skill set to meet their exacting needs.

We are seeing dynamic activity across most regions, and I would like to give you a recent example of our success of capitalizing on it. There are strong market conditions in Tijuana currently, where we recently developed over 500,000 of spec building, of which over 50% was leased before delivery, demonstrating our ability to anticipate market activity.

Before I turn the call over to Juan to discuss the details of our third quarter results, I will also like to point out that Fitch renewed our BBB- with a stable outlook. In addition to the cash that our business generates, our credit rating allows us to inexpensively fund accretive investments as we continue selectively building out Vesta's property portfolio and adding to our land bank to capitalize on opportunities that we see over the next two years and beyond, in current market and new geographies.

When we do not find the right opportunities in which to invest capital, we will continue to return it to Vesta's shareholders via dividends as well as stock buybacks, as we did in the recent quarter when we repurchased 26.8 million shares. We will also undertake buybacks when the discount to NAV falls too low.

Lastly on this subject, Vesta's Board has approved the cancellation of 25.3 million Treasury shares, which is a clear signal on our focus to create value for shareholders. Needless to say, we're optimistic about what we're seeing in the market and with Vesta's prospects.

Let me now turn the call to Juan, who will discuss our quarterly financial results in more detail. Over to you, Juan.

Juan Sottil:

Thank you, Lorenzo. Good morning and thank you, all. With the increase in third quarter revenue and an expanded net operating income margin, EBITDA grew 21.4% year-over-year, representing a 90-basis-point expansion in EBITDA margins. Thanks also to our share repurchase, EBITDA per share increased nearly 25%. In addition to the robust leasing activity that Lorenzo highlighted, revenue also rose as our average price per square foot increased slightly. Also, lease renewals dropped 2018 and 2019 maturities to 1.2% and 6% respectively.

Operating cost increased 3.4%, with a 5.7% increase in cost related to investment properties, generating rental income. For the quarter, net operating income increased nearly 21% year-over-year. Moving further down the income statement, our administrative expenses rose nearly 19% as we added employees and invested in marketing to support Vesta's growth efforts. The increase was also due to increased long-term employee incentives.

Also noteworthy, on the expense side was the 15.3% increase in interest expense, which reflects a higher level of debt, stemming from the issuance of debt last May to help fund our development pipeline. The relatively low cost of funding that Lorenzo referenced is due to Vesta's optimal level of leverage, approximately 35%, and a debt maturity that averaged seven years. Moreover, the interest rate on all our debt is fixed. This funding, combined with Vesta's strong cash flows, are another significant scale advantage that we have in our industry.

As regards entering new markets, we will only make investments that generate at least the same level of profitability and returns that we earn in our current market.

Funds from operations declined just over 73%, due to higher taxes stemming from an appreciation of the peso during the quarter, as well as an increase in the financial results. The current tax on Vesta operations was $15.1 million, of which the exchange-related portion was $5.5 million. As a reminder, approximately 87% of Vesta rental income is denominated in U.S. dollars. On a per-share basis, the decline in FFO was partially offset by the share repurchase during the year.

Compared to last year's quarter, our cap ex increased 26% to nearly $30 million. These investments are related to the construction of new inventory and built-to-suit buildings in ciudad Juarez, Tijuana, Aguascalientes, San Miguel de Allende, Silao and San Luis Potosí. In total, we are currently developing approximately 1.9 million square feet of new GLA, representing nearly $80 million in investment.

During the third quarter, we added two buildings for two new BTS buildings for Smurfit Kappa and RSB Transmissions, which are expanding their operations. We also added two inventory buildings to our development portfolio, for which the weighted average expected return on cost was just over 11% for the quarter. Although we are expanding Vesta's pipeline, we want to emphasize, we are not losing sight of optimizing our existing portfolio.

Vesta's stabilized portfolio expanded approximately 17%, with occupancy increasing 60 basis points to 96.4%, while our same-store portfolio grew 16% and occupancy increased 100 basis points year-over-year to a historical high of 98%, as Lorenzo highlighted.

Vesta's total property portfolio grew nearly 1.5% during the quarter, while our vacancy rate remained unchanged at 8.1%, supported by leases totaling 1.1 million square feet. We also continued to add to Vesta land bank, which grew 4.6% sequentially to 33.6 million square feet of gross land area.

I finish here with guidance for 2019. We expect to increase rental revenue between 12% and 14%, with a 96% NOI margin and an 85% EBITDA margin.

That concludes our prepared remarks. Operator, let's open the call for questions.

Operator:

Thank you. We'll now be conducting a question-and-answer session. If you'd like to ask a question, you may press star, one on your telephone keypad. 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 using speaker equipment, it may be necessary to pick up your handset before pressing the star key.

Our first question comes from the line of Eugenio Saldaña with GBM. Please proceed with your question.

Eugenio Saldaña:

Hi, guys, good morning, congrats on your results. I have three questions for you; the first one is, do you think that this positive perspective that you were mentioning, after trade agreements and all that, could alter the mix of development in terms of built-to-suit and speculative going forward for you? That's the first one.

The second one, if I recall, Loren, you mentioned during the Vesta anniversary that you might expand your footprint to new regions in Mexico. At this point, what is the advance on this matter?

The third one, besides the financial signaling benefit of cancelling the stock, does that decision have to do with taking a tax benefit, I mean, for holding the share for more than a year and preventing from paying any taxes, or something? Thank you very much.

Lorenzo Dominic Berhó:

Perfecto. Hola, Eugenio, buenos dias, thank you very much for being on the call and thank you for the questions. I will answer the first two questions and I will ask Juan to answer the third one.

Definitely, we have seen that since there's more clarity regarding the new trade agreement, the pipeline has slightly picked up, which is a very good signal that some companies that had some projects on hold are now returning to the markets to analyze some of the projects that they were previously analyzing. Therefore, we believe that there could be more leasing activity.

Regarding your emphasis on built-to-suit and spec buildings, as you know, we have a strong—today we have a very strong preference towards our strategy on spec buildings. Since we have been able to have more market intelligence to anticipate to demand and even at controlling the standard type of the construction of the buildings. Having standard buildings with multi-tenant buildings has enabled us to accommodate all sorts of tenants: logistic tenants, light manufacturing tenants. We think that that has been a very well received strategy and was a very accretive strategy from Vesta because we're having pretty high returns, over 11% on the spec buildings.

Of course, the built-to-suit projects, we're still very close to them. We have a couple of them on our pipeline. We think that some of them will materialize also in the next quarters.

Just to give you an idea on the pipeline that we are seeing, in average, let's say some years ago, quarters ago, we had an average between 35 to 40 pricings per month, which is a very good number and as you know, the leasing activity in the past was very good. That particular pricing activity increased to between 60 to 75 pricings per month just in the last couple months. Yes, last couple of months. This is a very good signal; we are very active. I think this also is time that many of potential clients are analyzing some of the spec buildings we did in the past, so that's also a result of having made the right decisions in the right moment.

In terms of the new geographies that I mentioned, definitely, Vesta is always open to analyze new opportunities. Nevertheless, we are very cautious on really entering those markets where we believe we can maintain the same type of profitability that we have been able to find in the markets where we are leaders. Just to give you an example, the type of builds that we do in Tijuana and Bajío central region are with return on cost of 11% U.S. dollar, long-term leases, high quality tenants. I just want to be very cautious that if we enter other markets, we also want to maintain high profitability. We wouldn't like to enter just because. Therefore, we're analyzing some opportunities in some of the main markets of Mexico, particularly Mexico City and its surroundings, Guadalajara and Monterrey.

Juan Sottil:

Regarding the shares question that you had, Eugenio, look, as I've been saying over the past quarters, the tax implication of Treasury shares really happens once you have the shares for more than one year. Then you have to pay taxes as if you had paid a dividend, roughly speaking. Most of our share repurchase, most of the balance of our share repurchases has already more than one year. There's only a smaller portion, around 10 million shares or something to that effect, eight million shares, that have been purchased, that have almost a year but not quite a year.

Most of the shares have already paid as taxes. The cancellation of the shares is really our—as Loren pointed out, is our willingness to really underline that share buybacks are really accretive to the shareholders. We perceive that there was an interpretation in the market that those shares had other uses. We wanted to maintain the flexibility, but at the end of the day, we want to underline to the shareholders that the sole purposes of share repurchase, from now on, is to increase shareholder value directly.

Eugenio Saldaña:

Thank you. Just a follow-up, Loren, on those pricings, I mean, what's the historical fixed rate on those pricings?

Lorenzo Dominic Berhó:

Oh, that's a good question. Gee, I mean, just thinking—without having the right number, but just thinking about the result that we have had in the past, we have been leasing, making third quarter probably over 12 leases, between 10 and 15 leases, with the number of pricings that I just mentioned. Probably a good fixed ratio would be, yes, somewhere like 20% to 30%, probably.

Eugenio Saldaña:

Okay, thank you very much. Good day.

Lorenzo Dominic Berhó:

Bye. Good questions, thank you.

Operator:

Our next question comes from the line of Victor Tapia with Bradesco. Please proceed with your question.

Victor Tapia:

Hi, good morning. We are seeing, like you're saying, this increase in leasing activity, which is—should remain—with the pipeline, should remain very good given the trade agreement with the U.S.

But looking to this side of the competition, how are you guys seeing these increases in leasing activity? Are you guys seeing some new entrance in the market, or some vacancy or pressure on rent costs going forward?

Lorenzo Dominic Berhó:

Great, thank you, Victor, for your question. Well, I think that one of the good decisions that Vesta took in the past couple recent years is to really be close to the markets and really identify important investment opportunities. In the last couple years, we have identified that Vesta has maintained its leading position and has taken a step forward towards developing, towards acquiring land, and anticipate to potential demand. I don't think that other competitors were in the same track. I think that many of them were lagging in terms of investing, and I think that this, for some of them, it's still going to take them a while until they identify the opportunities, acquire land, put the infrastructure in place, start developing spec buildings. I think that that particular rise is going to be an opportunity, a good opportunity for Vesta as long as we maintain our leading position, and even that there could be some small competitors, realty fundamentals are stronger than ever.

I mentioned the case of Tijuana. Tijuana has a vacancy rate of 2%, and that's why we decided to make an over $30 million investment on the spec buildings that I recently mentioned because we know that realty fundamentals are the ones that are driving the profitability and the returns of the project. In Tijuana for example, rents are increasing, in dollar terms at a very attractive pace. That's why we have been able to do accretive investments in the region while maintaining construction costs down, and also being very disciplined on the type of tenants that we have. That characteristic is one that we want to hold in most of the markets where we're at; being very cautious on how competition is doing, and as long as competitors are, let's say at some point disciplined, I think that Vesta's going to take advantage on that.

Victor Tapia:

Okay, so just to make clear, you guys believe that competition should increase, but you believe that Vesta is better positioned to deal with new competitors. Is that correct?

Lorenzo Dominic Berhó:

Absolutely, and probably, just to give a part in, I think that it's also a matter of how well-capitalized the companies could be, and I think that Vesta has a solid balance sheet—Vesta is well-capitalized and not necessarily our peers are in a similar situation. They are shrinking, and that's why they have limited access to capital right now, and that could be another potential advantage.

Victor Tapia:

Okay. Thanks very much.

Operator:

Our next question comes from the line of Pablo Ordóñez with Itaú BBA. Please proceed with your question.

Pablo Ordóñez:

Hi, good morning, Lorenzo, Juan, Christianne, congratulations on the results. Can you, for the guidance, provide us for next year; can you give us some color on what you expect for development and cap ex next year with all this very active pricing and requests for proposal activities? Also, what are your plans to form this cap ex? Also related to this, should we read the decision to cancel the shares that you've had in Treasury as you are more confident that you can fund your future growth with internal capital? Thank you.

Juan Sottil:

Look, regarding the cap ex, we typically invest around $125 million per year. That includes buildings as well as some replenishments of land. I expect the next couple of years to have a similar cap ex level. Last year, we had a bigger investment in capital, I believe, that was an extraordinary year, so $125 million is a good number to have on the back of our mind. Not all of it goes to buildings, I underlined, around $100 million goes to buildings, $90 million goes to buildings, the balance goes to land, plus infrastructure.

Regarding the decision to cancel the shares; yes, indeed. We always wanted to keep the shares—to have the optionality during the rest the mission of 2020. However, I believe that with the cap ex levels that

I am underlining and the increase on leverage that we could do over the next two years on very pointed… I mean, on a smaller scale, and the retained earnings which play a very important role on funding the Company, I believe that we made the right decision, the Board made the right decision, to basically underline to shareholders that the objective of the share repurchase is really value creation, and we wanted to be very clear on underlining that to our shareholder base.

Pablo Ordóñez:

Okay, understood. Another question; regarding the growth outlook, Lorenzo, Juan, are you seeing opportunities in the logistics segments, and are these type of business segments—does it meet your business profile, the maturity of the lease terms, the quality of the tenants, so on and so forth?

Lorenzo Dominic Berhó:

Yes, definitely. As you know, roughly 30% of our portfolio is logistics, so we have been very close to the logistics sector. One out of every three leases that we sign is related to logistics. Nevertheless, we are very cautious on maintaining the same lease profile that we have in our portfolio. As long as the logistics client is an investment-grade client, is a dollar-denominated lease and it has a lease term of approximately 5.8 years, which is our average, we feel comfortable. What we don't like is short-term leases with low credit rating companies in pesos. We think that, in the long run, that really impacts the value for our shareholders, and we are very disciplined on trying to achieve good value creation for shareholders. That's why we are also very cautious on what type of logistics tenants we take.

Pablo Ordóñez:

Okay, thank you. Very clear.

Lorenzo Dominic Berhó:

Gracias.

Operator:

As a reminder, it is star, one to ask a question.

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

Adrian Huerta:

Thank you, good morning, Loren and Juan, and thank you for taking my questions. Two questions; one is, your views on asset recycling. The second one is, if you can just tell us, from which type of clients are the ones that are pushing demand higher in the last few months? Are these U.S., European, Asian clients, and which type of sectors? Thanks.

Lorenzo Dominic Berhó:

Sure, hola, Adrian, and thank you very much for being on the call. Yes, I think—well, as you know, Vesta has—always has flexibility on pulling different strings in order to find the best alternatives to capitalize the Company. We did it when we raised equity back in the years, we did it when we raised debt and financed the Company at competitive terms. I think that asset recycling could be also an alternative looking into the future, if the prices are right.

I think that having that flexibility is good for the Company, and if there could be opportunities in the future to recycle capital, we could do so. As you know, having over 30 million square feet, having some sales of a smaller portion of our portfolio would not really impact our revenue base, and I think could send us a good signal. In the end, we're making decisions in order to create value for shareholders, not nationally because we want to get—we wanted to get real assets.

Secondly, regarding your question on the type of tenants, we are seeing still demand from the same regions as we have been seeing in the last years. Asia, it's the U.S., it's Europe; I think that it really has not changed that much. A couple leases that we signed in Tijuana recently were with American companies. I think that in the end, American companies want to be competitive, American companies want to be profitable, and in order for them to be profitable, they need to keep expanding their operations in Mexico. That's why we are still seeing that they're growing their footprint in the country.

As you know, the Asian companies in the automotive industry have expanded in a very important way, as well as European companies which are considering Mexico as an important logistics and manufacturing platform.

Operator:

As a reminder, ladies and gentlemen, it is star, one to ask a question.

There are no further questions in the queue. I'd like to hand the call back to Management for closing comments.

Lorenzo Dominic Berhó:

Thank you very much, Doug, and thank you, everyone, for being on the call. As I stated at the beginning of the call, we are really focused on driving NAV higher and will do so in a disciplined manner, leveraging our leading market position, scale, powerful market intelligence and strong balance sheet and funding capabilities to capitalize on opportunities in current markets and in new ones over the next two years and beyond 2020.

As Juan stated, we will remain focused on optimizing Vesta's current property portfolio, and we will only invest in new geographies when we can achieve the same level of profitability and returns that we generate in current ones. As I noted earlier, we will return capital when we are unable to effectively deploy it, or when Vesta's stock trades too far below NAV.

Thank you for the trust that you've continued to place in me, the rest of the Executive Team and the many other employees who are behind the success of our Company.

Operator:

Ladies and gentlemen, this does conclude today's teleconference. Thank you for your participation. You may disconnect your lines at this time, and have a wonderful day.