Vesta Industrial Real Estate

First Quarter 2021 Earnings Conference Call

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CONFERENCE CALL PARTICIPANTS

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Vanessa Quiroga, *Credit Suisse*

Juan Macedo, *GBM*

PRESENTATION

Operator

Welcome to the Vesta First Quarter 2021 Results conference call.

As a reminder, this conference is being recorded.

I will now turn the call over to your host, Ms. Maria Fernanda Bettinger, Vesta's Investor Relations Officer. Please go ahead.

Maria Fernanda Bettinger

Thank you. Thanks to everyone for joining our call to discuss Vesta's First Quarter 2021 Financial and Operating Results.

With us today from Vesta are Lorenzo Berho, Chief Executive Officer, and Juan Sottil, Chief Financial Officer.

Yesterday we issued our earnings press release after market closed. This release is also available via the Investor Relations section of Vesta's website.

Before turning the call over to Management, I would like to remind you that today's discussion could contain forward-looking statements of the Company's future business and financial performance. These are based on Management's current expectations and are subject to risks and uncertainties. Factors that could cause actual results to differ materially are included in our report we filed with the Mexican Stock Exchange. In particular there is significant uncertainty about the duration and contemplation of the impact of COVID-19 pandemic. This means that the results could change at any time, and the impact of COVID-19 on the company's business results and outlook is a best estimate based on information available as of today's date. Statements made on this conference call should be considered together with cautionary statements and other information contained within Vesta's earnings press release dated April 30, 2021, and within the most recent regulatory filings for discussion of these risks.

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

I will now turn the call over to Mr. Berho.

Lorenzo Dominique Berho

Thank you, Fernanda. Good day, everybody, and thanks for joining us. We certainly hope you and your families are safe and healthy.

On our call today, I'd like to briefly discuss what we are currently seeing in the market within the context of the exciting news we shared with you last week. As per usual, Juan will then follow me with more details on our financial performance during the quarter.

To begin, I'm pleased to note that last quarter's decidedly positive trend has strengthened at the start of the year and we're encouraged by what we are seeing, supported by economy's optimistic U.S. GDP growth forecast, the recently enacted USMCA, which should increase Mexico's manufacturing and distribution base as the most competitive trade block in the world, and a sense that Vesta's clients are on increasingly solid footing. The importance of Mexico's resilient supply chains has also been made abundantly clear in the current environment as competition with China exposes vulnerabilities to relying on out-of-continent supply chains.

Despite the COVID-19 pandemic, or perhaps because of it, e-commerce powered a banner year for warehouses and for the industrial real estate sector in 2020. Recent studies estimate that 10 years of change had been compressed into just one, as businesses and consumers have rapidly shifted buying patterns, a trend that continued in the first quarter 2021 and one we believe will remain.

As a result, we have seen an increased pipeline throughout different regions in the Mexican market. Industrial has therefore been one of Mexico's most resilient real estate sectors amid the COVID-19 crisis, buoyed by rising e-commerce demand, stoked by an ever growing consumer appetite for e-commerce and record demand for warehouses and other logistics infrastructure. Warehouse demand is expanding, resulting in storage space constraints. Transactions have also grown more common for facilities used for what's called safety stock, or extra inventory, with a goal of avoiding the supply chain disruptions many experienced in 2020.

As a reflection of these trends, Mercado Libre began its third expansion phase with Vesta for an additional 225,000 square feet during the first quarter. Demand therefore still outweighs supply for industrial real estate in Mexico, particularly challenged by logistic companies' unique requirements in a climate of scarce land availability in Mexico's key industrial hubs. We see exciting opportunities for Vesta in light of these dynamic shifts. We have a well established reputation for state-of-the-art facilities tailored to clients' unique needs. Further, our ability to swiftly pivot to today's environment was tested and validated during the pandemic, as demonstrated through our renewed strong relationship with Mercado Libre, the largest online commerce ecosystem in Latin America and in Mexico.

Investors approved our new financial plan presented at our annual shareholders meeting on March 23, trusting Vesta's ability of identifying new market opportunities and to deliver on them, which included raising $300 million in capital and increasing Vesta's debt limits to $1.25 billion from $850 million. This provided our Company with critical financial flexibility to continue our growth plans.

We successfully finalized our equity follow-on last week, on April 27, raising $230 million including the overallotment, which has been successfully executed. This transaction represents an infusion of funds needed to fully capitalize on the exciting new opportunities we're seeing in the Mexican market.

As presented in the shareholders meeting, and as part of the Company's financial plan, the Company is considering, subject to market and other conditions, the issuance of a new bond in order to refinance some of its existing debt and to extend the maturity profile of its debt portfolio.

We're excited to announce that during the quarter we acquired our second plot of land in the City of Monterrey, where we plan to develop a new Vesta Park targeting like manufacturing logistics and e-commerce opportunities in an excellent strategic location in the Apodaca submarket, a total investment of $70 million for 1.4 million square feet including land costs and infrastructure costs. We are officially in growth mode, executing in line with our level three strategy.

While Juan will discuss our results in detail, let me briefly touch upon some key highlights from the quarter.

We began the year on solid footing. This first quarter leasing activity reached 1.3 million square feet, favorably impacted by the 225,000 square feet for Mercados Libre's third expansion phase in Guadalajara, well ahead of plan, and 300,000 square feet in new contracts with companies, such as DB Schenker, Living Spaces, among others, with 750,000 square feet in lease renewals.

We reached a 90% total portfolio occupancy during the quarter. Further, less than 4.6% and 12.9% of our total portfolio will expire in 2021 and 2022, respectively. While the first quarter of the year has tended to be weak historically, I'd like to reiterate that we are seeing that tenants have reached a comfort level where they're starting to make decisions. We have also expanded our development pipeline with two new inventory buildings in Ciudad Juarez and resumed construction of Guadalajara's inventory building to reach a development portfolio of 1.3 million square feet for first quarter 2021.

First quarter EBITDA increased 6.3% to $33.44 million in the first quarter 2021, with reaching NOI and EBITDA margins of 97% and 87%, respectively. The margin increase reflects a continued proven approach to cost and administrative expenses, as well as improved collections which reduced the Company's capital accounts reserve.

In closing, we're very encouraged by the initial optimism we're seeing in the market and by the considerable opportunities we're now empowered to capitalize on. We expect the strong tailwinds we're seeing will come to fruition in the first quarters ahead.

That concludes my remarks for now. Juan, over to you.

Juan Sottil

Thank you, Lorenzo, and good day, everyone.

Starting with a review of our P&L, first quarter revenue increased nearly 2% to $38.4 million, mainly due to rental revenue coming from new leases and inflation adjustments to rented properties made during the quarter. This was partially offset by expiring leases that were not renewed in the first quarter 2021, and to a lesser extent by an FX conversion impact on our peso-denominated rental income and lower rental rates on certain leases that were renewed during the period. On the first quarter revenue, 84.5% was denominated in U.S. dollars, 1 percentage point above last year's comparable period.

Moving on to our cost structure. We saw a significant reduction in total operating cost this quarter at occupied properties, declining almost 43% to $1.5 million compared to $2.4 million in first quarter 2020. The decrease was primarily due to lower allowances for doubtful accounts from improved collections during the quarter.

As a result of higher rental revenues and lower cost, net operating income increased 5% to $37.22 million with a margin expanding 298 basis points to 96.9%. Our prudent approach to costs and administrative expenses, coupled with a higher gross profit, allowed us to achieve almost 370 basis points in EBITDA margin expansion, with EBITDA reaching $33.4 million this quarter.

Total other expenses were $9.9 million compared to $4.4 million in the first quarter of 2020. This increase was mainly due to lower revaluation gains and higher interest expenses and was partially offset by a positive variance in the FX line as well as gains resulting from properties sold in the quarter. That leads us to pretax income of nearly $22 million, which declined 15%, while pretax FFO increased 1% to $22 million, an almost 2% on a per share basis.

Now moving on to our Capex and portfolio composition.

We invested $25.6 million in the quarter, mainly in the construction of new buildings in the Northern, Bajío and Central regions. At the end of the first quarter, the total value of the Company portfolio was $2.2 billion, comprised of 189 high-quality industrial assets with a total GLA of 31 million square feet and with an 84.5 of total income denominated in U.S. dollars.

Year-over-year, our stabilized portfolio grew 5.4% to 31.2 million square feet with occupancy up 90.6%, down from 93.6% in the first quarter of 2020. We ended the first quarter '21 with a land bank of 41.6 million square feet, up 5.5 sequentially, due to the acquisition of additional land in Monterrey for the development of a Vesta Park of approximately 1.4 million square feet.

Turning to our balance sheet. Our total debt remained stable at $840 million at the end of the quarter, and our cash position stood at $99 million. Net debt to EBITDA was 5.8 times, and our loan to value ratio was 37%.

In line with our commitment to deliver shareholder value through a prudent capital allocation, subsequent to quarter end, in the Company's annual general shareholders meeting, Vesta shareholders agreed to pay $55.78 million dividend to be paid in quarterly installments. On April 15 we paid a cash dividend for the first quarter of 2021 equivalent to Ps. 0.48612 per ordinary share.

Finally, as Lorenzo highlighted, we are pleased with the successful completion of our equity offering, which, together with the approval we obtained to increase the Company's debt limits, will allow us to strategically access the equity and debt capital markets to finance potential growth opportunities. Having financial flexibility is key in our path to achieve our level three strategy.

With that, we conclude our first quarter review. Operator, could you please open the call for questions?

Operator

Thank you. Our first question comes from the line of Gordon Lee with BTG. Please proceed with your question.

Gordon Lee

Hi, good morning, everybody. Thank you very much for the call. Two quick questions. First, I was wondering, on the operating front, if you could comment on what happened in the quarter in the Central region. I see that part of the occupancy slippage during the quarter was concentrated there and I was wondering whether there was any particular property or if there was more of a market issue.

The second question, a more general question, but I was wondering if you could tell us, with the equity raise from a couple of weeks ago, plus the potential debt raise that you discussed, I was wondering whether maybe you could give us a little bit more color on how this allows you to bring forward or increase, or both, your investment plans going forward. Thank you.

Lorenzo Dominique Berho

Thank you. Gordon, great to have you on the call. Regarding your question on the operating results, yes, we had a couple of buildings in the Central region, particularly in the State of Mexico, in Paluca, that terminated the lease. Therefore, we took over the buildings and are now in marketing mode. This was a good company that moved to another facility and it actually reduces their space but completed its full lease agreement. We see that there's an opportunity to re-lease this particular building to another tenant and probably at higher rents, because the market dynamics are pretty solid in Paluca.

This is normal in the—it's part of the cycle. However, some of the empty buildings that we had last year, we were not able to conclude part of the leases throughout the quarter, but we are very positive in the region and we're positive in the upcoming quarters to have an accelerated leasing activity for the Central region particularly.

Yes. Look, talking about the plans. We have a very active pipeline, with larger investments for this year and actually for the upcoming year. Therefore, we believe that the equity offering was a great way to finance the growth prospects for this year and next year. Clearly, we're going to have major development activity in many of the markets that we are currently operating in as well as the new markets we entered recently. Therefore, it is important to consider that it's not only about the equity offering that we recently had, but we will also be issuing debt soon to refinance existing debt and kick out maturities and we will also be able to raise some additional debt and that will help us to finance the growth prospects that we might have for this year and the upcoming year.

We're excited with the pipeline that we are seeing. We're excited with the inflection point that we seem to be getting from the pandemic. A strong economic recovery from the U.S. is leading tenants and potential tenants to reconsider their projects in Mexico throughout the different markets, throughout different sectors that we mentioned in the call. We're excited about the upcoming quarters and even upcoming years in our sector, Gordon. Thank you.

Gordon Lee

Thank you. That's very clear. Thanks very much.

Operator

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

Adrian Huerta

Hi. Thank you. Hi, Loren and Juan. Just going back to Gordon's question on vacancies, it seems like from your Satellites portfolio, the vacancies. If you can just talk a little bit how quickly we can see these Satellites portfolio getting back to the 95% level that you had two years ago.

The second question is also with the growth. You had plans for land sales and also potentially doing a JV or selling a minority stake in the portfolio, etc., to finance growth. How does this change now that you have done the equity offering? Are you still pursuing some land sales and doing JVs, etc.?

Lorenzo Dominique Berho

Perfect. Thank you, Adrian. Thank you very much for being on the call. Sure, let me talk about the vacancies first. I think that everybody is well aware that 2020 was a very tough year in terms of leasing. Exactly a year ago when we were reporting the first quarter results, I remember saying that things were put on complete pause, every project in every type of—in every market in all transactions. However, and that also repeated in the upcoming quarters. We're coming out of a very tough 2020 when there was really no major leasing activity. However, we believe that things might be changing soon. We think that companies are resuming their plans now with very exciting economic trends in Mexico and even in the U.S., and I think that's going to be—we're going to see a change pretty soon.

I think that the occupancy levels, which we believe are lower than they were a year ago, will probably change in the next quarters. I think that we feel that the number where we're at in terms of occupancy is very manageable. However, we see that this could be increasing in terms of occupancy now that the companies are considering expansions, considering stock inventories because of the disruption of supply chains, because of the disruption in certain sectors that are just demanding more space like the other sector. I'm glad to hear good announcements of new investments like the one from General Motors, which was done last Friday, announcing a billion dollar investment in the electric vehicle sector for their plant in the Northern part of Mexico.

I'm very happy that the trends are changing and they're changing very quickly. I'm sure that leasing activity is going to be picking up in an important way now that certain projects are also taking place again.

Regarding your question on other strategic transactions, there are a couple of land sales that we have been doing at high margins. However, I think that importantly is that we are continuing with our asset recycling plan. We did put it on pause last year. There's some plans to dispose of some assets and we will hopefully be doing some asset sales soon. However, we do not see us for the moment any joint ventures or any other strategic transactions besides the asset recycling plan of certain assets, which was already part of the level three strategy.

On that regard, I think that we're pretty much executing on the level three strategy as presented a couple of years ago.

Adrian Huerta

Great. Thank you.

Lorenzo Dominique Berho

Thank you, Adrian.

Operator

Our next question comes from the line of Francisco Suarez with Scotia Bank. Please proceed with your question.

Francisco Suarez

Hi, good morning. Thanks for the call. Two questions, one on liability management. You have a lot of secured debt compared to your peers. To what extent that gets in the way of enhancing further your overall maturity profile and cutting down on the cost now that you have already a well capitalized company with the follow-on?

My second question is on Monterrey. You mentioned in your press release that you're making a huge investment in land in Monterrey. Can you give us a little bit of color on what are the overall prospects to start building and do you have the building permits already and how fast you can actually go in the market? Any color you can share? Thank you very much.

Lorenzo Dominique Berho

Gracias, Francisco. Thank you very much for being on the call. I will answer your second question on the market. We're very excited that we were able to conclude the acquisition of a land plot in Monterrey. This is the second project that we did. The first one was a smaller project, which we executed well in terms of not only the land acquisition, but the development and the leasing. We were able to lease to an e-commerce company, which was fantastic, in the Guadalupe submarket. This new land is also in the neighborhood. This is a 29 hectare project.

This is exactly the type of Vesta Park that we know well, that we think that there would be a lot of value creation through development. We see Monterrey as being a very dynamic market, clients looking for high-quality projects and high-quality buildings, and I think Vesta is therefore able to deliver those types of projects. We try to differentiate through great quality, great locations and I think that this will be another second very successful project in Monterrey where we think we'll be able to differentiate ourselves.

Juan Sottil

Regarding the debt, let me tell you, as we said on our shareholder meeting, we asked for an increase from $850 million of our then current debt limit of $1.25 billion. What we are looking for, as we explained in the meeting, is optionality to have the best balance sheet in the market, to have a very robust balance sheet. We will be very cautious on any future debt issuance. I am of the opinion that given the state of the 10-year treasury bond and the compression on these spreads that at some point in time, in the near future we will be launching global bonds to take advantage of that.

We're watching the markets. I think that there's opportunities right now. We will be keen on issuing something. Any of that issuance, as you might imagine, is going to go to some repayment of debt. I want to clear out my revolver line. Revolvers should be used for emergencies, that's why we pulled it last year. I want to pay all that so that I have it as an emergency line, as it should be. There's some opportunities on repayment of certain loans that we had with MetLife that are guaranteed by properties that will further strengthen our balance sheet.

Yes, we're watching the markets and are keen on taking advantage of those markets ASAP. But we'll think about it.

Francisco Suarez

In other words, Juan, if the potential repayment fees and the like are not an issue to cost of the debt, I understand.

Juan Sottil

The way I look at my debt portfolio is it has to make sense on an IRR point of view. It's not only the issue cost of the debt but it's the coupon that the market could offer us. I also take into account prepayment fees. If it makes sense for the Company and it will lower our costs, and increases our average life of liabilities, we will do the issue. Today, we have an average life of around five years. Well, if you imagine the minimum size of a bond on a 10-year maturity, I will increase my average life to around eight years plus, which is what I argued on our ordinary meetings materials.

Yes, with today's market level, including prepayment fees, I think there's good opportunities.

Francisco Suarez

Fantastic. Very well answered. Thank you.

Operator

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

Vanessa Quiroga

Hi, good morning. Thanks for taking my question, and congrats for the successful follow-on issuance. The first question is regarding the investment in Monterrey to buy land. Can you disclose the amount invested for this land?

The second question would be if you have a rough guidance of how much of the follow-on proceeds will be used for land and how much for infrastructure and buildings?

The third one, regarding the comment that you made on the changes in revenue that we saw in the quarter and that's something you have done on lower rents. I believe it's probably the second quarter that you have this comment in the press release. I'm wondering if you can share with us what you are seeing in terms of trends, if there's any pattern or specific type of tenant that you are having to give this rent management? Thank you.

Juan Sottil

Let me get into the revenues question, Vanessa. Last year, as part of our dealing with the pandemia in our books—besides, by the way, I think it was particularly successful. All of our clients performed as we expected. In some cases what we did is for those clients that had maturities in the next, let's call it 30 months, what we did is we rolled over those maturities for five or seven years, and we lowered the rent in order to achieve those long-term rollovers. Every transaction was analyzed so that it was NPV neutral, if not slightly positive for us. Now, once we execute those anticipated rollovers, which manage our risk on rollovers for the next 30 months, that's very good. As the new rent kicks in, that's where you see a slight lowering of our missing revenue due to the rollovers.

Now I have to say that of the maturing contracts that we have during the first quarter of this year and even on the fourth quarter of last year, all of the rollovers had a positive lease spread. We're not lowering rents. We don't think that we need to lower rents. I think that the markets are very tight and we certainly price our available space at market conditions.

That would be my comment on lowering our rents per square foot.

Also, please take into account that a lot of my large build-to-suits were delivered to us on the last couple of days of the fourth quarter and on the last couple of days of the third quarter. They increase our GLA, but I have no revenues to show up. You have to adjust for that matter, no?

I'm just taking a look at our lease spreads—lease durations. Look, we have good rollovers and at positive spreads over the quarters. That would show up eventually in our revenues. We have very little maturities during the year, around 4% for the rest of the year. We're quite satisfied on that, actually.

Lorenzo Dominique Berho

Thank you, Juan. Regarding the question on the development pipeline and land versus buildings, I think that the overall investments for Monterrey is going to be in the $70 million area for the next four years. However, land and the infrastructure on land that we will be commencing very soon to the groundwork for the improved land will be in the neighborhood of $22 million to $25 million out of the $70 million that will be done over time.

Regarding the pipeline, we believe that the Company will keep on investing on buildings for build-to-suits and spec buildings, inventory buildings in the current existing land reserves that we own. However, we did acquire Monterrey, which was part of the plan. We will be doing more acquisitions in other markets, but the idea is to keep a good balance between the land reserves that the Company owns and the vis-à-vis total income producing assets, and we're going to keep that same discipline, understanding that it's important to own the land in advance, put the infrastructure in place, have the availability of energy, of utilities, services, security. In the end, we believe that this is going to be very important in order to have an edge and a competitive advantage to many of our peers. We, I would say anticipate the potential demand that we are currently seeing.

Vanessa Quiroga

That's very clear. Thank you, Juan and Loren.

Lorenzo Dominique Berho

Muchas gracias, Vanessa.

Operator

Our next question comes from the line of Juan Macedo with GBM. Please proceed with your question.

Juan Macedo

Hi. Thanks for the call. My question is regarding the cost efficiencies obtained during the pandemic. Do you expect them to remain at similar levels, or have a slight increase in the coming quarters?

Juan Sottil

Can you repeat the question? There was a glitch on the line, on our line.

Juan Macedo

Yes. It's regarding the cost efficiencies that you obtained during the pandemic. Do you expect them to be the same, at similar levels, or have a slight increase?

Juan Sottil

We are keen on keeping our discipline on controlling SG&A. In fact, if you take out the long-term incentive and impact on SG&A, I think that we have been on top of expenses of SG&A expenses, and we also have seen improvements on the property expenses as well.

We're going to be on top of that. Now we have to realize that as the Company resumes normal operations and as we are expanding into new geographies, that will make us—we need to hire more people eventually. We will be doing that carefully. Entering the Monterrey market being managed by Ciudad Juarez. As long as we can leverage our presence there as much as possible, that will be great. Entering Guadalajara, we're leveraging our Bajio region personnel. As long as we do that and we will continue to do so. Entering Mexico City, we will be using our Central region asset manager and sales force. As long as we can do that, we're going to do that. In time, we will see what we can adjust.

Lorenzo Dominique Berho

Probably, Juan, compared to the pandemic, I think the most important element was that first of all we have been able to collect pretty much all the rents from the rent deferrals. This is a signal that the market is—the tenants are doing well. We have eliminated part of the reserves, no, collection on doubtful accounts reserves, and that has an improvement—that shows an improvement on margins and improvements on costs, particularly on NOI.

Juan Sottil

Exactly.

Juan Macedo

Great. Thanks for the answer.

Lorenzo Dominique Berho

Thank you.

Juan Sottil

Thank you.

Operator

Thank you. There are no further questions at this time. I'd now like to turn the call back over to Mr. Berho for concluding remarks. Please go ahead, sir.

Lorenzo Dominique Berho

Thank you. Well, thank you very much, Operator, and thank you, everyone, for joining the call.

In light of the current environment that I described, we're very optimistic about the opportunities we see ahead based on the strength of our level three strategy. Vesta is therefore well positioned to aggressively capitalize on exciting opportunities, with benefit of a strengthened balance sheet and considerable resources to drive our Company's future growth in today's dynamic market environment. We remain vigilant regarding the near-term threats that the pandemic and its aftershocks still present, which we will continue with discipline and strong execution. For that, we look forward to providing further updates on our second quarter call in July. Thank you very much, and have a great day.

Operator

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