

DCT Industrial Trust Inc.

DCT Industrial Trust Third Quarter 2015  
Earnings Call

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**CORPORATE PARTICIPANTS**

**Phil Hawkins**, - *Chief Executive Officer*

**Matt Murphy**, - *Chief Financial Officer*

**Mike Ruen** - *Managing Director of the East Region*

**Melissa Sachs** - *Vice President, Corporate Communications and Investor Relations*

## **PRESENTATION**

### **Operator**

Good morning and welcome to the DCT Industrial Trust third quarter 2015 earnings conference call. All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing the star (\*) key followed by zero (0). After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star (\*) then one (1) on your telephone keypad; to withdraw your question, please press star (\*) then two (2). We ask that you limit your questions to one, with a single follow-up. Please note this event is being recorded. I would now like to turn the conference over to Melissa Sachs, Vice President, Corporate Communications and Investor Relations. Please go ahead.

### **Melissa Sachs**

Thank you. Hello, everyone, and thank you for joining DCT Industrial Trust's third quarter 2015 earnings call. Today's call will be led by Phil Hawkins, our Chief Executive Officer and Matt Murphy, our Chief Financial Officer, who will provide details on the quarter's results and our updated guidance. Additionally, Mike Ruen, our Managing Director of the East Region will be available to answer questions about the markets, development and other real estate activities.

Before I turn the call over to Phil, I would like to remind everyone that management's remarks on today's call will include forward-looking statements within the meaning of federal securities laws. This includes, without limitations, statements regarding projections, plans or future expectations. Actual results may differ materially from those described in the forward-looking statements and will be affected by a variety of risks, including those set forth in our earnings release and in our Form 10-K filed with the SEC, as updated by our quarterly reports on Form 10-Q. Additionally, on this conference call, we may refer to certain non-GAAP financial measures. Reconciliations of these non-GAAP financial measures are available in our supplemental, which can be found in the Investor Relations section of our website at [dctindustrial.com](http://dctindustrial.com). And now, I will turn the call over to Phil.

### **Phil Hawkins**

Hey, thanks, Melissa, and good morning, everyone. Our business continues to perform at a high level, significantly exceeding the expectations we had going into this year, as well as this quarter. Development leasing is a clear highlight.

In addition to the development leasing we announced yesterday, last night we signed a full building lease at our 734,000 square foot River West development project in Atlanta with commencement scheduled for November 1. The tenant, a well-known Internet-based retailer, began installation of IT and materials handling equipment while the lease was being negotiated so they can be operational within two weeks, another indication of the strength of both our business and our customers' needs.

Leasing in our operating portfolio remains robust, as well, with an additional one million square feet signed in October, following a strong third quarter. The current environment is characterized by very healthy tenant demand across all sectors and sizes, low vacancy rates and supply that remains in check across all our markets. The result is a landlord oriented market where rental rate growth continues at a strong pace.

As a result of these favorable market dynamics, we are starting to see tenants competing against each other for space. We are also seeing shorter than normal cycle times, from initial inquiry to signed leases and occupancy, with the new River West lease serving as a good

example of that phenomenon. And on several occasions, we have had tenants that are more methodically going through lease negotiation, be supplanted by other more eager tenants who are able to finalize the lease in less than a week as well as offering better economics.

The market for selling assets remains strong as well. We have sales packages out for buildings in Houston, the Midwest and several other select markets. These marketing efforts are in advanced stages, ranging from negotiating first round offers to agreements reached and due diligence proceeding. In each case, the buyer pool has been deep with competitive pricing indicating that cap rates are flat to possibly even down a little from six months ago.

Reflecting continued strong pricing for assets, we expect acquisition volume to remain light. During the quarter, we bought two small assets totaling \$8 million. These buildings offer strong rent and NOI growth potential, are both in strong submarkets and are adjacent to other DCT assets. Our market teams continue to look for acquisition opportunities, but our focus remains on development and redevelopment, which we believe offer better returns and value creation potential.

Lastly, let me comment on our balance sheet strategy. With a strong asset sale market, as well as sooner and greater than expected cash flow generated by our development leasing, our balance sheet metrics will trend lower than our long-term targets. Given what I consider to be an environment that is more unpredictable than usual, we intend to keep our debt to EBITDA metric in the low sixes rather than our stated long-term target of mid sixes. I believe that having balance sheet capacity to further ensure our ability to fund profitable development or serve as dry powder to capitalize on any changes in the capital markets, asset pricing or even our own stock price, is prudent. A strong balance sheet is never a bad idea and in this environment, we have the good fortune of being able to strengthen it even further than initially planned while continuing to fund growth opportunities and generate favorable financial results.

So in summary, with a strong market, a portfolio and market mix that I consider now to be the best in our sector, and a talented team of people that are delivering outstanding results, it's a great time to be in our business and at DCT.

Let me now turn the call over to Matt, who can provide more detail on our quarterly results and updated guidance for the year. Matt?

**Matt Murphy**

Thanks, Phil. Good morning, everyone. The third quarter of 2015 continued a long trend of strong operating results at DCT, reflecting very positive market fundamentals and a team that is hitting on all cylinders. While our 2015 occupancy projections remain fairly constant from a quarter ago, we are raising both earnings in same-store guidance, primarily on the strength of rental rates, which continue to outperform expectations.

I will go through a few details from our third quarter results, walk-through changes in guidance for the remainder of the year, and touch on the financing transaction we announced with yesterday's earnings release.

In addition to the phenomenal development leasing we achieved, I think the highlight of our third quarter results has to be our same store NOI growth, which was 5% higher on a GAAP basis and 8.4% higher on a cash basis than the third quarter of 2014. This latter number was primarily driven by a 6.6% increase in cash revenues. While some of this was the result of an increase in average occupancy of 1.1% and approximately \$400,000 in one-time items, the

remainder is the result of embedded rent increases in existing leases, as well as increasing market rental rates across our markets.

During the third quarter, re-leasing spreads averaged 18.8% on a GAAP basis and 2.2% on a cash basis; however, even these strong numbers don't tell the whole story as it relates to NOI growth. Two of the leases included in these statistics were signed on spaces that have been vacant for over two years and in both cases the adjacent tenant expanded to occupy all of what had been a challenging from a configuration standpoint. If you exclude these leases from the calculation, both of which are purely additive from a same store NOI perspective, the rent growth numbers would have been 20.3% on a GAAP basis and 5.5% on a cash basis. This constructive rental rate backdrop continues to drive our numbers. As a result of these factors, we are increasing and narrowing our guidance for same store NOI growth to between 5.25% and 6.25% on a GAAP basis and between 7.5% and 8.5% on a cash basis.

Turning to earnings guidance, we are raising and narrowing our 2015 funds from operations guidance to between \$1.94 and \$1.98 per share, an increase of \$0.02 at the midpoint. This increase is primarily a result of the same-store improvement noted above and the result of the anticipated interest savings associated with the financing transaction I will discuss in a moment. Other changes to guidance include raising and narrowing development starts to between \$275 million and \$335 million, lowering and narrowing acquisitions to between \$125 million and \$150 million and raising and narrowing dispositions to between \$275 million and \$350 million. While none of these changes will have a significant impact in 2015 financial results, I believe they accurately reflect the evolution of our capital allocation strategy towards development and the funding of that development, at least in the current environment, through dispositions.

Consistent with Phil's comments, as we revise our credit metric targets to include debt to EBITDA in the low sixes, our plan in the late summer to put more assets on the market that we strictly needed to maintain a mid-six ratio, should allow us to reach these lower levels by year end or early January.

With respect to capital markets activity, we have received commitments from a syndicate of banks for a seven-year \$200 million senior unsecured term loan that we expect to close in November. We intend to swap the facility to a fixed rate for the entire term of the notes, resulting in an expected all-in rate of between 3.35% and 3.5%. We are doing this in lieu of the public bond transaction I described on our last call. While the interest rate on this transaction will be somewhat lower than our expectations for a bond deal, the primary motivation of changing to a bank loan was not about price, but rather the certainty of execution. Consistent with our previous plan, we were in position to approach the bond market in mid-September; however, with volatility and diminished liquidity roiling the markets during that period, we began exploring other alternatives. Given the uncertainty of bond market conditions and the attractiveness of the bank deal, both in terms of execution and price, we determined that the bank deal was the better option. We strongly believe that under more normal circumstances, the public bond market is an ideal source of debt financing for DCT and this \$200 million transaction will put us in a position to be back in that market in mid-2016.

In summary, the third quarter of 2015 was a very important one for DCT. In addition to continuing our run of excellent operating results, our outstanding development leasing puts us in an ideal position heading into 2016 with a very positive cash flow trajectory and our balance sheet in great shape, affording us tremendous flexibility in executing our strategic plan.

Before I turn it over for questions, I would like to point out a couple of new additions to our

supplemental package this quarter. In response to some direct analyst and investor feedback, along with timely sell-side reports issued this quarter on REIT disclosure, we have added an Elements of NAV page to the deck and added some additional disclosure on debt covenants on the existing capitalization page. The next enhancement you'll see is a more fulsome guidance page in the supplemental, which will debut next quarter, along with 2016 guidance.

With that, I'll turn it back over to Denise for questions. Thank you.

## **QUESTIONS AND ANSWERS**

### **Operator**

Thank you. We will now begin the question and answer session. To ask a question, you may press star (\*) then one (1) on your telephone keypad. If you are using a speakerphone, please pick up your handset before pressing the keys. If your question has been addressed, you may withdraw from the queue by pressing star (\*) then two (2). Again, we ask that you limit your questions to one and one follow up. The first question will come from Eric Frankel of Green Street Advisors. Please go ahead.

### **Eric Frankel**

Thank you. I have a couple, but I'll just take, I have more than two actually, but I'll just take a couple and then jump back in the queue. So my first question is can you talk about just some of the vacancies you have left in the portfolio? I think you referenced last quarter you have a vacancy in Southern California that's located right near LAX and it looks like there are some other vacancies in Chicago and other parts of the Midwest. So I was just hoping you could talk about the leasing prospects for the rest of the portfolio.

### **Matt Murphy**

Yeah, hey, Eric, it's Matt. So we'll start with LAX. This is the space that, frankly, we talked about a couple of times where we had a tenant that was planning to move out March, hung around through June. There was optimism that they might stay longer. They did in fact move out in July. The good news is, and it's pretty high rent space, it's a really good location. The good news is we are on the one yard line, if you will, to signing a lease to take the entirety of that space in all likelihood this year at rental rates that, frankly, exceeded our expectations.

The other big vacancy that I think I'll talk about is, it's actually one of that did catch us by surprise. It was an early termination in Chicago, about 227,000 square feet, another excellent space that is, frankly, part of the reason for the decline in occupancy in the third quarter. Again, the good news there is we have one very, I think, likely prospect on that space. Not done yet, certainly not as far advanced as the space in Southern California is, but again, I think a really good possibility with a high quality tenant, which again I think will be ultimately good from a rental rate perspective, although that one's not certain and certainly unlikely to happen to anything in 2015.

In summary, for your whole question, there are not a lot of significant spaces today that don't either have leases that are being negotiated or very serious activity on them. Those are, honestly, the only two vacancies that we have, outside of the development portfolio, that are greater than 200,000 square feet.

### **Eric Frankel**

Great, appreciate the additional color. So with the development leasing you've done this quarter, you've created, I want to call it a high quality problem problem with the fact that you

don't have any additional space to lease up and so now it becomes a procuring additional development opportunity. So I was hoping maybe you guys can talk about the land market and how to fill this, actually to find new opportunities to refill the development bucket?

**Phil Hawkins**

Yes, I would love to. First, we've got, we're only 91% lease for development pipelines. We've got more opportunity there, let's not forget that. We've got a pretty good pipeline of land for '16 that'll bring us to our normal run rate. I think, clearly, '15 has been an extraordinary result that I would not plan on duplicating. I hope we can and it's certainly possible and we continue to look for land. We have some land that is under control, but not on balance sheet, under option agreement or under contract as we're going through the process to re-entitle, to rezone, to gain whatever relevant approvals that are required. And we continue to look for land in each of our core markets, though the land sites we look for, clearly, are more expensive than they were, but rents are higher. Margins will still be, in my view, 20% or better, or we won't do it. I think the other point to make here is financial discipline, as well as location and real estate discipline, are really key and to not lose sight of that internally or, not to lose sight of that at all. But we've got a number of projects that we're working on that I feel good about and that will position us to continue development as it makes sense for the next couple of years.

**Eric Frankel**

Okay, I'll save my others for later. Thank you.

**Phil Hawkins**

Thank you.

**Operator**

Our next question will come from Brendan Maiorana of Wells Fargo. Please go ahead.

**Brendan Maiorana**

Thanks. So, Matt, your, the spread between the cash and the GAAP rents is pretty wide. So what does that mean for kind of what you guys are doing on the annual bump side of things in leases? And where are you sort of in place in the portfolio and how does that compare to where recent deals are getting signed?

**Matt Murphy**

Well, so the spread between GAAP and cash, I think you really hit it right on the head. The big difference is, and we talked about this for several calls in a row, the continuing increase in what is a normal rent bump. I would say probably the most common rent bump we have in the portfolio today and the new leases being signed today is probably 2.5%. But I would say the second most common is 3% and I would have told you a year ago 3% with highly unusual. And we are seeing a lot of leases that are having long terms with significant bumps, 10-year leases with 3% rent bumps, and that, quite honestly, is the biggest single driving factor between the disparity or the gap, if you will, spread probably between GAAP and cash rents. I think your second question was really more of an overall mark-to-market and that's a tough thing to nail down. I'd tell you, 5% is probably a pretty realistic, if perhaps a little bit conservative, mark-to-market in the portfolio in general. You have got to get into, I hate to answer that question as a spot answer, but it is clearly increasing as market rents continue to increase.

**Brendan Maiorana**

Yeah, just as a follow-up related to that, the guidance in terms of NOI growth; you guys have had such strong NOI growth through the first three quarters of the year, kind of the implied

guidance for the fourth quarter, obviously, it implies a drop off. It's becoming harder in terms of the comps from an occupancy side of things. Is the fourth quarter sort of outlook a reasonable run rate to think as we head into '16? Or is it something where things could reaccelerate as you go into '16?

**Matt Murphy**

Well, I think, obviously, we'll get into a lot of detail in the '16 guidance for the next call, but I think from a sort of jumping off and run rate perspective, honestly, I think the fourth quarter is probably a little bit light. We had a really, really strong leasing quarter in the fourth quarter of 2014. Average occupancy in the same-store portfolio was 95.1 in the fourth quarter '14. We're going to be a little bit lower than that. Some of that has to do with asset recycling. Some of it has to do with those two move outs that I talked about, and what it's just like in the real estate business. The fourth quarter also tends to be a little bit, I don't know what the right word is, anomalous because there tends to be accounting adjustments that happen as you are truing up CAM recoveries. If you'll recall, we talked about that in the fourth quarter last year. So we did have a downward revision in CAM recoveries in the fourth quarter. It really isn't just a fourth quarter number. It's a current estimate of the whole year. So I do think the math is what it is on what the fourth quarter is, if you look at where we are through three quarters versus the projections for the full year, it is obviously lower than we are in the third quarter. I think it's lower than the run rate. I don't want to get into a whole lot of specifics on that until we get into '16. I think it's a starting point. The average bump in our, future bump in our portfolio, moving forward, is 3.63%. I think that's a number, all else being equal, that's what you look at, is what our bumps and then what our rental re-leasing spreads on spaces that are rolling over and I think that's as good a way to start from what's your estimate is going to be going forward.

**Brendan Maiorana**

Sure, okay, thank you.

**Matt Murphy**

Yep.

**Operator**

The next question will come from Craig Mailman of KeyBanc Capital Markets. Please go ahead.

**Craig Mailman**

Hey, guys. Matt, you guys obviously had a little bit smaller of a bond deal here this year. Could you just talk about what that could mean for the timing and kind of magnitude of what you may need to raise in '16 to fund your plans?

**Matt Murphy**

I mean I think I had called that out in my prepared remarks. I wouldn't call it a need to raise but I think what it really does is probably accelerate, in my own head, accelerate when we are likely to be evaluating what the next option is. Like I said, I really strongly believe and hope that it ends up being a bond market execution and like I said, I think at midyear. Before, we did 200 instead of 250; I would have told you probably more like third quarter, early fourth.

**Craig Mailman**

Okay, that's helpful. Then, so congrats on all the development leasing you guys have had. It's come quick here. Could you just give us a sense of where kind of rents are coming in relative to pro forma on those deals? And I guess kind of bigger picture; the fundamentals remain good,

new supply remains relatively in check. Do you guys think you're pushing rents on sort of the operating portfolio as hard as you could? Or you think there's kind of more of a tailwind there as we head into '16?

**Phil Hawkins**

Great questions. First, each development lease that I can think of, Matt correct me if I'm wrong, is higher, comfortably higher than our pro forma rate. In addition, obviously, lease-up was much quicker, as we typically assume 12 months of lease-up. I can't think of a single exception to that. Matt's agreeing with me.

**Matt Murphy**

Yeah.

**Phil Hawkins**

The second question is a more important question. And my honest answer is, well, I think our teams are doing a great job and I think our teams and our company is focused on it as well as we probably could be. But in this environment, it's impossible to answer your question affirmatively with a yes. Every time, I mentioned a couple of situations where tenants came in and trumped the one that was negotiating leases. And those leases were going on, lease negotiations for maybe a month, month-and-a-half, which is not unusual. And in each case, the tenant before, the tenant after paid significantly more than the tenant that they kicked to the curb. So I think it's hard. None of us, and I've been in this business for 35 years, none of us have been in this kind of environment. And I don't want to overplay our hand with tenants, I really don't. On the other hand, we're here to represent the shareholders and the value of our company. And so I think it's something we talk about all the time. We have an employee call right after this one. I can tell you we'll talk about it then. But we're still learning like everybody else on how to deal with a market that is more friendly to landlords than one I've never experienced before.

**Craig Mailman**

Great, thank you.

**Operator**

The next question will come from John Guinee of Stifel. Please go ahead.

**John Guinee**

Really wonderful quarter. Is Jeff on the call?

**Phil Hawkins**

No, he's not. Mike Ruen is the guest.

**Mike Ruen**

I drew the short straw this quarter. We rotate.

**John Guinee**

Well, tell Jeff he's been right for the last year and a half and I congratulate him. Question for you and I might have my numbers wrong on this, Matt, so correct me. But on one hand, like a lot of your peers, you're talking about self funding in this environment. It appears to me you've got \$155 million that will close in the next 90 days of asset sales and it looks to me like you're on the book development spend remains about \$240 million. So that's one point. And then when I look at your equity raises, it looks to me and, again, correct me if I am wrong on these



numbers, it looks to me in 2013 you raised about \$350 million at maybe \$29, plus or minus; in 2014 you raised \$262 million of common at \$32, and it seems to me that raising common net \$37 in 2015 wouldn't be a bad idea at all. So any thoughts on that, Phil?

### **Phil Hawkins**

I'll let Matt, actually [multiple voices] I will follow follow-up.

### **Matt Murphy**

Yeah, your math all made sense. I don't know that you are exactly right on the equity raises, historically, but you're certainly in the neighborhood. And so I'll start the answer, I'm sure Phil will either cut me off or add to it. I think it's all about relative to your alternatives. Where we are right now, obviously, we like the stock price today better than we did a couple of months ago, but you are still looking at that as a cost to capital relative to your alternatives and right now selling assets has both the double benefit of being a cheaper cost of capital in our view, when you realize what the cash flows are for the buildings we're selling, and also has heretofore, at least, provided an upgrade to the portfolio. So I think we are continually — the way this business works from my chair, if you will, is we determine what deployment we think we can do on an accretive basis for assets that we really like from a locational and functionality perspective. And then it's my job, obviously in concert with a lot of other people, to determine what the best type of capital is that can fund that and then go out and get it in as cheap a fashion as I can. And I think what you've seen us do is pull the lever that we think makes the most sense at the time we're pulling it.

### **Phil Hawkins**

Let me answer the other part of the question, which is the development spend that is short of what you see as the fourth quarter fundraising. And to me, we are match funding, we continue to match fund. And the development spend you're looking at is well out into the middle and later part of '16. We think we've funded well into the first quarter, if not past that. One of the reasons we have lower than normal target for debt to EBITDA is to create capacity if for some reason the sales market goes away. We have assets we're putting on the market now and actually for the last month to so that won't close in the fourth quarter or early in the first week or two of the first quarter next year, but, well into the maybe middle or later part of first quarter. So we've got the sequencing staged and we're, obviously, highly confident we can do it.

Equity, it's funny, you can look back and say, why'd you raise equity at those numbers? And at the time, our NAV and our ability to deploy capital was in a different world. Cap rates were higher. I think today, given our strength of our balance sheet, I continue to have a bias towards asset sales because I think we can sell them at prices at or above what you all and our investors ascribe to NAV, while at the same time funding our development activities. But clearly, equity also is a more powerful tool to strengthen the balance sheet and it certainly, it would nice to have that option available to us and hope it remains so. But at this point, our bias remains dispositions over equity, even though our stock price today is higher than it was two weeks ago. Today, we may be talking about, the question has come about, you issue equity, last quarter was do you do buybacks. Clearly, we're in a volatile time, which is a darn good reason to have a good balance sheet and be able to have much more discretion of your timing than being forced to react quickly to market changes.

### **John Guinee**

Just to be clear, your sources and uses are obviously very well lined up through '16 and I don't think anybody is criticizing a \$29 equity raise in '13 or a \$32 equity raise in '14, but given your conservative mindset on the balance sheet, you can put a lot of fears to bed for the long-term at

\$37 a share and not lose any sleep. Anyhow, thanks a lot and a happy weekend.

**Phil Hawkins**

No, John, first, I didn't take your comment as criticism, I sort of hear those numbers and I think, it's self criticism. Hindsight is perfect and I don't have the same foresight as I have hindsight. I think, as long as we're confident in the sales market, our bias, we do want to be able to sleep well at night and that's our approach to the balance sheet and will be for a long time. Good question, thank you.

**John Guinee**

[multiple voices] All right, thanks.

**Operator**

Our next question will come from Gabriel Hilmoe of Evercore ISI. Please go ahead.

**Gabriel Hilmoe**

Thanks. So I apologize if I misheard this, but I think you referenced 750,000 square feet leased in Atlanta. Is that on top of the 1.4 that you referenced in the press release?

**Phil Hawkins**

Gabe, you got to sign in early, you missed the big start. Yes, 734,000 foot lease at River West, signed last night after the press release went out, puts that, it's in addition to what you saw in the earnings release and on the supplemental.

**Gabriel Hilmoe**

So as far as the pre-lease rate on the development pipeline, what does that go to, taking that lease into account?

**Matt Murphy**

91.1%.

**Phil Hawkins**

Yes, I think that gets you 91%.

**Gabriel Hilmoe**

Okay, perfect. Thank you so much.

**Operator**

Our next question will come from George Auerbach of Credit Suisse. Please go ahead.

**George Auerbach**

Great, thanks, good morning. Still on the \$135 million or so of sales program for the fourth quarter, any color on how far along the sales process is, where the assets are that you are selling, and what kind of cap rate we should expect?

**Phil Hawkins**

As I said, I think in my remarks, I don't want to be too redundant, they're fairly far along. Everything that we have guided for the fourth quarter or I mean — and by the way for tax reasons we may push some of them into the first week of the New Year — but is, at least, at first round offer stages where we're negotiating and culling and clarifying offers, to advanced where we have contracts signed and due to diligence proceeding. Cap rates, no comment on

that. Obviously, the combined mix is going to depend on what we actually sell, but I will say that they are very consistent with our expectations going in and I would describe the pools as deep and pricing competitive.

**George Auerbach**

Would you say that the pricing has been, I guess, more competitive than you would have thought? You wouldn't think these would be 6.5% assets and they could have traded at 6% and 6.25% or the pricing is sort of as expected?

**Phil Hawkins**

I am a nervous guy, so I'd say more, better than I feared, not better or not too much different than we expected. We put more on the market and I think those of who I met with at BAML — and maybe Matt'll have other comments — is I talked about putting more on the market than we actually needed because of the time in early September, it's really right after Labor Day, the world, particularly the debt markets, were a little more skittish and we put it on so we could remain price selective and we've been pleasantly surprised, which is why, again, I think proceeds are higher than we planned for but not higher than we hoped for and we now have I think a good problem of a little bit more capital a little sooner than we wanted, but frankly that's offset by, more than offset, by better than expected financial results. So we're in a good situation, I think.

**George Auerbach**

Sure and I guess just lastly on development volumes, going forward. Obviously, this was a great year for development volumes in part because the pre-leasing, but how are you thinking about, one, development volumes for DCT on a kind of a run rate basis, given that the Company is much bigger now and in more markets than you've been in in the past. But I guess we're also in year seven of an economic cycle. Are you, you mentioned a 20% margin on the new developments, is that sort of the new target, just given that we're later in the cycle? Or is the target lower but the leasing and sales market is just more complicit?

**Phil Hawkins**

I think I look at both spread relative to underlying cap rates, stabilized cap rates, as well as what fits in our margin. And with so low cap rates, it's easy to have higher margins than, say, back in '07. So I think to have that kind of spread where you have perhaps the risk of stabilized cap rates coming up, you have risks of leasing falling short, although clearly, we haven't had to experience that. So I think that to me, financial discipline and a margin for error is important. I'd say the run rate hasn't changed, in my view. We were very fortunate this year. We could be fortunate next year. But I think \$150 to \$200 million in starts when you have a good market, like we have and I think that'll continue next year, is a prudent estimate. As leasing goes better, we can do better. Whether you approve these projects you wouldn't have otherwise started or you pre-lease or your lease your pipeline that's under construction or develop faster, that all gives you more capacity. But the same financial and risk management discipline, the governors that we've had in place since the recovery began, remain in place. And in fact, I think we're more serious than ever about them, given where we are the cycle. I don't know if seven years into recovery means anything, but it's certainly something to think about and I see nothing on the horizon that would indicate our business is slowing or is facing the risk of contraction, nor even facing the risk overbuilding; we've got plenty under construction, but we've got healthy demand and everything is in balance. But you know what, you don't bet on that forever and that's another reason to maintain your risk management discipline.

**Operator**

Our next question will come from Juan Sanabria of Bank of America Merrill Lynch. Please go ahead.

**Juan Sanabria**

Hi, thanks for taking the time to answer my questions. Just as we look forward over the next two quarters or into '16, is there any known vacancies that you guys have out there on the horizon?

**Matt Murphy**

Juan, this is Matt. I think the only one, we have like 400,000 square feet in Atlanta that is extending into sort of mid or I guess early second quarter next year that we know will move out. They're having a building built for them. I can't think of another significant, I am sure I am missing some, I can't think of another significant building or space that we're, in quotes, giving up on.

**Juan Sanabria**

Okay and then you obviously had very bullish general commentary about market demand and just the business in general, but has there been any signs at all, maybe in some of your more manufacturing heavy geographies, that the slowdown we have seen in the macro numbers in the fall have impacted the business at all? And any sort of more cautious commentary from any of the leasing brokers or what have you?

**Phil Hawkins**

None. I tell you I was, two things and I have been traveling a lot since Labor Day when everybody else was back from vacation and, as my team will tell you, probably the first question I ask any broker I meet with, two question really, how do you think the widening of credit spreads will affect investor demand for real estate and cap rates? The answer to that is, haven't seen it and in fact, if anything, demand has accelerated. And the second question I ask is, do you see any weakness anywhere? And the answer I get there is, no. And I know, both the manufacturing numbers and also I follow some of the trucking and transportation analysts, as well, and there the commentary is much more neutral to, frankly, a little more cautious and pessimistic, somewhat related to capacity as opposed to demand, but it's, and we don't see that. And I think, in part, we're seeing e-commerce driven demand go further into the infill locations that we run, own and we don't have, and there's still good consumer demand, which is still driving flow-through through our buildings. So I haven't seen it. Now, the wrong people to ask to get a long-term perspective are brokers. No offense to brokers on the phone, but they're focused on the immediate near-term, immediate term and if life is good, life is good and if it's not, it's not, but they're not going to transport forward.

But I, again, if we look at our leasing numbers, you look at our lease under negotiation and proposal activity, you look at comments from our own team, there's a lot of things to feel good about it and a few things on the near horizon to not feel good about.

**Juan Sanabria**

Thanks, guys.

**Operator**

Our next question will come from Ki Bin Kim of SunTrust. Please go ahead.

**Ki Bin Kim**

Thanks. This isn't really meant to be a lay-up question, but just curious to know, is there something that you guys think you are doing differently in terms of leasing, especially in your development pipeline, that's allowed you to be pretty much 80% leased, which is at least double your peers with similar or bigger development pipelines?

**Phil Hawkins**

Well, we're the same people who had 7% two quarters ago. So honestly, the answer is I think our strategy combined with the market is working. Our strategy is a focus on infill sites in closing locations. In Inland Empire West, we are in close to O'Hare airport or the city of Chicago. We are closer in Atlanta. Dallas, we are near the airport or near North with smaller buildings rather than competing in the South with big buildings. I think we're infill type developer and I think the market's come our way. I don't know, it's hard to differentiate between good fortune and good strategy. I suspect we have both. I think all of our peers are doing well with development. And from what I can tell and I do follow them and as I drive around the markets, I think everyone's got a good program in place and making sound decisions. We're just, we've had a good couple of quarters, but like I said, we're same team that you all were worried about two quarters ago.

**Ki Bin Kim**

I wasn't worried.

**Phil Hawkins**

Okay, there's one, the only one.

**Ki Bin Kim**

And just as a follow-up to that, one thing that is different with your company is that you haven't had a large land bank, historically. So a lot of the stuff you're building on today, I'm assuming, is more recently purchased land, which would make an impact to the yields you would achieve, right? Because you don't have a low basis and I know you said maybe the margins will come down 20% but it still seems like it's pretty high at almost 8%. So just curious, what is going on there that it's allowing you to get those higher yields? And where does that go down to maybe, going forward?

**Phil Hawkins**

Well, first of all, I think development yield going forward, I would say are closer to 7 than 8, and cap rates are kind of 5.5% to below 5.5%. We saw the Southern California cap rates are 4.5%. In fact, there's deals that are sub-4. Miami, where we're going to be developing, cap rates are mid-fours. So keep that in mind. We've got market teams that are able and willing to assemble land, essentially develop land, not just acquire land. And there is value in the current world from that skill as opposed to buying other sites that someone else had or, frankly, buying with forward commits or whatever. And we've done some JVs, we've done some forward commits and the economics are, frankly, far better when we do the heavy lifting on the land work. The real value is created at the land assemblage and acquisition. There's some value, obviously, in taking the risk and succeeding when you lease and design the building. But I think we have a great team of people out in the markets that spend time thinking about how do I create the next land site, how do I tear down a building. What we are doing in the stockyards will start in the fourth quarter. What Neil and his team have been able to do, it's a building that was on that site that was built at the turn of the 20th century and going through that thing was quite an experience, as we got close to Halloween, but we're going to tear that building down. What we deal with for the build-to-suit, was now build-to-suit at Central Avenue in Chicago, again, we're tearing down

a bunch of buildings. We are, we've assembled land. Like I said, we, some of the land we're building on today, we've been working on for three years. There's a site we're working on in a coastal market that, if we are successful with final approvals in November, we'll start in early next year, we've been going through that process for two years. It is not easy and it's not quick. I think another thing that I think people don't fully appreciate about development these days in industrial. We're not, what the tenants want and where the opportunities are not going out to the next cornfield at the next interchange and buying land for \$2 a foot that's fully entitled and ready to go. That's not what customers want. And that's not where the opportunity is. It is hard to build industrial. It isn't Manhattan and I am not trying to make it be overdramatic, but it is much harder to build a building today than it was 10 years ago. And that is also a factor contributing to, I think, the much longer and somewhat feared market runway we've experienced with respect to supply remaining in balance with demand.

**Ki Bin Kim**

Thanks, great color, thank you.

**Operator**

The next question will come from Mitch Germain of JMP Securities. Please go ahead.

**Mitch Germain**

Good morning, guys. Phil, in your comments, you referenced that you were seeing either flat to down cap rates. So curious, is it market specific? Is it kind of broad-based? I'd love to get some commentary on that, please.

**Phil Hawkins**

I'd say some market specific. I'll give you some color commentary I think that, one, the coastal markets remain in hot demand, major markets remain in hot demand, and that's, frankly, where we're selling right now. Houston, where I said we've got a package out, I'd say cap rates there are flat, maybe up a touch, but I'm not sure, I'd say flat. I think the person, Teresa Corral, who runs all that would tell me right now and has told that they're flat and when you look at what we're selling, it will be a good result, I hope, but very competitive demand for Houston. It was a pretty broad group of well-known names, institutional names that were spending serious time on that package, which we very much appreciate, and we're hopeful that execution there will be successful. I'd say the other comment I'd make is that we're not, is that the spread between B assets and I mean not fully functional, so B assets, not A minus or B plus assets, B assets in kind of core quality, institutional quality assets, is as wide as it's ever been. And that is reflecting, I think, a continued strength in the institutional side of our business and further away from the more entrepreneurial local buyer who doesn't have the same access to cheap capital. So I think that's the one weakness in the market that I see and hear about is B asset pricing just doesn't make sense yet, relative to A asset pricing, but across all markets, secondary and primary, A asset pricing is strong, hot.

**Mitch Germain**

Thank you.

**Operator**

Our next question will come from Tom Lesnick of Capital One. Please go ahead.

**Tom Lesnick**

Hi, guys, thanks for taking my questions. Just one brief question. Obviously, you guys have made significant leasing strides on your stuff in Inland Empire West this quarter with leases at

Jurupa Ranch and Rialto, but as you look out to Inland Empire East, are you concerned at all with the amount of spec development that's going on out there? And really, are you comfortable at this point in the cycle with kind of your valuation of risk exposure? What I mean by that is not really risk exposure on the revenue side, but perhaps with the strong dollar impacting trade and whatnot, cap rate sensitivity in the overall Inland Empire markets could potentially be at risk.

**Phil Hawkins**

Well, the strong dollar is at least 12 months old news and we've seen accelerating demand in the Inland Empire. We're on pace for a record year for net absorption. I would rather be in the West where we are with our owned assets and the development and our land, but the East seems to me to be in pretty good shape, as well. We've got in the Inland Empire West buildings over the 500,000 feet; there is less than 2% vacancy. It's hard not to be really bullish about that situation when you're seeing the demand and the new product, the new requirements from tenants in the market today. The lease we've signed for the Jurupa Ranch happened in a week and they were signed in a few weeks. It was the pace of movement that tenants have a sense of urgency is to me very notable and remarkable. I don't want to over dramatize it because it's not all leases that way, but I tell you, I've never seen it before and we're very fortunate to be in the situation we are in and I put the Inland Empire West, Inland Empire, in general and Southern California in general, at the very top of the list right now. Seattle, again a market that benefits some from port activity, never been hotter; demand had never been stronger. And again the strong dollar, yes, it's continued to strengthen, I guess, but that's old news and anything helps imports and we're an import business. We're not an export business. We're an import business.

**Tom Lesnick**

Makes sense. Thanks, guys, appreciate it.

**Operator**

The next question will come from Paul Roantree of JPMorgan. And as a reminder, you may press star (\*) one (1) if you would like to ask a question. Mr. Roantree, please go ahead with your question.

**Mike Muller**

Oh, hey, it's actually Mike Muller and I apologize in advance, I got on the call late, so if this was asked, I'll get it from the transcript, but on the development pipeline, two quick ones. Thinking about the bigger size that is right now, is there some sort of an annual investment volume that you think of, not volume but spend, that you think of as a base case in this environment? And then what does the crystal ball tell you if you look forward over the next year or two about the mix of pre-lease starts versus spec?

**Phil Hawkins**

Mike, I'll answer it quickly, because I did answer it about halfway through the Q&A. I said good run rate to think about because of our risk management parameters we described on many calls in the past is probably \$150 million to maybe \$200 million of starts. If we do more pre-leasing, we'll do more and, obviously, if we do less, we do less. We remain focused on buying land in submarkets that we can put into production today and we would rather not wait, buy land and put it on our balance sheet and wait for a build-to-suit. I think that the risk is lower that way. Clearly, you have some if you take on the construction risk in the market we know today, but also, if have land in your balance sheet, you may own a few cycles. And what I hope will continue to happen is that land will prove to be so well located that we either end up with a build-to-suit or two, the large build-to-suit we did in Chicago with an unnamed tenant, and our

Central Avenue site is a great example. And then the pre-leasing you've seen recently is another good example of where you buy good land sites that are ready to go, you build the building you want and you get the rent you want, not some rent constant calculation, and you're, I think, in better shape. So I don't think you're going to see us focus on build-to-suits. I do hope the market remains strong so that we get some pre-leasing before we start construction and then some leasing during construction. But I can tell you, we continue to underwrite with 12 month lease-up. So don't be surprised if we end up with some buildings that take longer than a few days to lease after the completion of construction. That's just not normal. And the same thing I said two quarters ago is the same thing I'll say today, we're the same team, the same strategy and we just happen to be in a really good market right now.

**Mike Muller**

Got it, okay, thank you.

**Phil Hawkins**

Thanks for the questions.

**Operator**

And the next question will be a follow-up from Eric Frankel of Green Street Advisors. Please go ahead.

**Eric Frankel**

Thank you, so I am back as promised. Mike, I was hoping you can answer my Panama Canal question. So, obviously, the Panama Canal is set to open next year. It looks like a lot of East Coast ports really aren't ready to accept the really large ships. There's a big labor slow down at the earlier part this year in the West Coast that already diverted a lot of traffic. Do you have any sense of how that's going to impact industrial demand when the Panama Canal opens in the near and long-term?

**Mike Ruen**

My comment would be that the impact is going to be dominantly felt by the carriers as opposed to the ports and we do expect some increase in containers, but for the most part your major markets, New Jersey, for example, Port of Elizabeth or Savannah, those markets should see an increase in TEU traffic, but really, it's more a boon to the carrier and we don't expect to see a dramatic shift in our business.

**Eric Frankel**

Okay, appreciate the color. I think my follow-up questions are just on Atlanta. You're obviously very active with the recent lease you guys completed last night, so kudos on that. It does appear you have some fourth quarter leasing yet to do with some expirations in the fourth quarter and, obviously, the deconsolidation of that land site in the Northeast part of [technical difficulty]. So hope you can talk about market conditions there. Obviously, there's also some supply that's obviously peaked up over the last year or two.

**Mike Ruen**

Sure, sure, well, I'll say, in general, we haven't seen an operating environment as strong and balanced as we've seen today in this recovery, certainly in Atlanta, relatively early in this recovery. It's over the last couple years that we've really seen Atlanta spark. If you look at what's in motion today, roughly 19 million feet, 85% of that's bulk. We haven't even reached the ceiling on replacement cost rents for multitenant, which I think is a very positive aspect for Atlanta. I think it shows run way and there's an opportunity to grow the smaller regional tenants.



All in all, though, the market is very healthy. That 19 million in play, it's coming online as we speak. A little over 5 million of it will be online by the end of the fourth quarter and 50% of it's pre-leased. So again, and of course, as Phil mentioned earlier, we bifurcate our development to the infill markets. So much of the activity that you see and much of the planning that you see in Atlanta are regional, super-regional locations in the Northeast and South Metro, which we do not participate in. So I would say Atlanta is healthy and from our perspective and our focus, even healthier.

**Eric Frankel**

Very much appreciate the color. Final question, Matt, maybe you could touch upon, this might be related to Ki Bin's question about the development yields. Maybe you could touch upon just the cost basis, some of the deal that you've executed pre-leasing on. So for example, the Downs Park development, looking on the cost base around \$170 per square foot and the O'Hare project is roughly \$115 per square foot that seems a little bit higher than what I would expect for a spec development. So many you could just comment on whether there is lease amortizations affecting that or whether that's just a function of construction prices or land prices? Thank you.

**Matt Murphy**

Yeah, I think it is, particularly as it relates to Dulles Downs, and I'll let Mike jump in, it's his deal. But yes, it is, the cost basis is a result of the lease, as well as, so it wasn't, we didn't do the spec building with that level of cost, we are being paid to put some above standard improvements and we're being, not only repaid for those, but being paid in return on that capital — similar situation in Chicago. So you are seeing, Chicago maybe more, it's a little bit different building, I'm not sure which one you're talking about. You are seeing, we're having some, we are in a market today, you get to be a little bit more selective with your tenants. If we have a good quality tenant that is willing to pay for some above-standard improvements, and that's an interesting phrase, too, it's, above-standard doesn't mean the next guy won't use it, it means you can't count on the next guy using it. In some ways, that ends up really being a boon where you get somebody to pay for improvements that the next guy needs, as well, or it allows you to have sort of better negotiating leverage with that same tenant as they renew, because they can either pay for it again to you or they can pay for it again with somebody else. So, clearly, there is an interrelationship between some of the improvements and some of the rents. I would say the vast majority of our buildings we are building very generic buildings with the cost basis that's kind of right down the middle and in the cases where we are increasing that, it is for good financial returns, as well as with a thorough investigation of the credit underlying the people that are going to pay us back for those financial returns.

**Phil Hawkins**

I would say, the O'Hare building that you are talking about, is not reflective of de-leasing. It's reflective of the cost of land in close proximity to the O'Hare airport. That's a new world.

**Matt Murphy**

Yeah, maybe, which building are you talking about? [multiple voices]

**Eric Frankel**

The O'Hare one, the \$115 per square foot cost [multiple voices].

**Phil Hawkins**

North Avenue is a build-to-suit. It was a true build-to-suit but we acquired. We demolished buildings. In fact, we're still the demolition phase of that project. We're demolishing. When

you're doing infill locations and you're demolishing buildings, your costs are clearly higher than if you have a site scraped, pad ready and ready to go.

**Eric Frankel**

Okay, that's it for me. Thank you.

**Phil Hawkins**

Mike, why don't you have a little more color the Dulles Downs, since we are the last question anyway.

**Mike Ruen**

Yeah, well, Eric, the only additional color I would share with you is to keep in mind that when you look at these two buildings in Dulles, there are 30 clear distribution shells with all the typical design that we would include for a distribution building and the specialty items are dominantly driven by the tenant and their use and there is a meaningful retrofit obligation at the end of the term.

**Eric Frankel**

Okay, good to know. I think that's terrific color, appreciate it.

**Phil Hawkins**

Thanks, Eric.

**Operator**

And at this time, we will conclude the question and answer session. I would like to hand the conference back over to Phil Hawkins for his closing remarks.

**CONCLUSION**

**Phil Hawkins**

Thanks. Before ending the call, I wanted acknowledge the extraordinary career of David Hoster of EastGroup. His successful track record of consistent performance, candor and transparency combined with a great sense of humor have and will continue to set the standard for all of us in the REIT world to follow. He's always the first to call me after our earnings call to point out any long-winded or less than articulate answers to questions that I may have provided and I hope that he continues to monitor DCT and keeping me on my toes well into the future. He's certainly going to have a field day with this call. But with that, let me thank each of you for joining our call today and listening to it in the future. Your interest in and support of DCT is much appreciated and we look forward to seeing many of you in a few weeks at NAREIT. Thanks.

**Operator**

Ladies and gentlemen, the conference has now concluded. We thank you for attending today's presentation. You may now disconnect your lines.