# DCT Industrial

## DCT Industrial First Quarter 2017 Earnings Call

## Friday, May 5, 2017, 11:00 A.M. Eastern

**CORPORATE PARTICIPANTS**

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

**Phil Hawkins** - *President and Chief Executive Officer*

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

**Neil Doyle** - *Managing Director, Central Region*

**PRESENTATION**

**Operator**
Good morning and welcome to the DCT Industrial First Quarter 2017 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. Please note, this event is being recorded.

I would now like to turn the conference over to Vice President of Corporate Communications and Investor Relations, Melissa Sachs. Please go ahead.

**Melissa Sachs**
Thank you. Hello, everyone, and thank you for joining DCT Industrial Trust's first quarter 2017 earnings call. Today's call will be led by Phil Hawkins, our President and Chief Executive Officer; and Matt Murphy, our Chief Financial Officer, who will provide details on the quarter's results and guidance. Additionally, Neil Doyle, our Managing Director of the Central Region, will be available to answer questions about the markets, developments, and other real estate activities.

Before I turn the call over to Phil, I'd 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 limitation, 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 on our supplemental, which can be found in the Investor Relations section of our website at dctindustrial.com, and now I will turn the call over to Phil.

**Phil Hawkins**
Hey, good morning and thanks for joining our call today. 2017 is off to an excellent start for DCT as our business continues to perform at a very high level. Market fundamentals remain as strong as ever with excellent tenant demand, declining market vacancies, and continued healthy rent growth and yet developers are responding to this environment by building more buildings, but in our view, these decisions remain rational and disciplined.

In every one of our markets, the amount of unleased space under construction is still well under trailing 12 month of net absorption. This absorption combined with historically low vacancy rates and rising development costs, leads us to remain bullish on future rent growth and equally important, since the capital behind virtually every one of these new projects is institutional equity, leasing decisions remain highly disciplined and long-term focused. Developers are not sacrificing targeted rental rates and long-term returns in favor of quicker lease-ups ~~[technical difficulty]~~. Reflecting this favorable market backdrop and the quality of our buildings in prime locations, our portfolio continues to perform very well. Rents on leases signed during the quarter increased 24.9% on a straight-line basis and 11.3% on a cash basis, while same-store NOI in the quarter increased 10.4% on a cash basis and 5.7% on a straight-line basis. These results, together with our continued optimistic view of market fundamentals, led us to increase our financial and operating guidance for the year.

The second quarter is off to a strong start, as well, with a little over 1.2 million square feet of leases signed so far in our operating and value-add properties with several significant leases out for signature. Development remains the best opportunity to create value in this environment. Our local market teams continue to prove time and again their ability to assemble and entitle well located sites at costs to provide very strong risk-adjusted returns. In addition to the predevelopment sites identified in our supplemental, we have under contract and are working through entitlements on a number of high-quality land parcels located in markets such as New Jersey, the Lehigh Valley, Southern and Northern California, and Seattle, which will provide future infill development opportunities at very attractive yields. Our current development pipeline totals 4.3 million square feet with a projected total cost of $368 million and a stabilized yield of 7.4%, more than 200 basis points over stabilized cap rate for these assets. The pipeline is 31% leased with strong activity on each of our projects including a number of leases currently in negotiation. Given this activity we're confident that actual lease up will average less than 12 months, we assume, in our financial projections for the project.

Before I turn the call over to Matt, I wanted to acknowledge Bruce Warwick, who decided to retire from our Board of Directors as of this week's Annual Meeting. Bruce joined our Board back in 2005 and has been a strong force behind DCT's transformation and growth. His extensive business, real estate, and development experience has been invaluable to all of us at DCT. He was our Lead Director at the time of great change and always helped the Board and management team keep a steady eye on where we wanted to go and maintain the patience and discipline to get there. I am grateful for his service and advice and look forward to benefiting from his continued counsel as a friend and ongoing supporter of DCT. With that, let me turn it over to Matt.

**Matt Murphy**
Thanks, Phil, and good morning, everyone. The first quarter was an excellent beginning to 2017 at DCT as the fundamentals of our business continue to reach new heights. Virtually all of our operating metrics were ahead of plan for the quarter and our outlook for the remainder of the year also improved, leading to the increases in guidance that Phil mentioned. I will dive into some of the results more deeply as well as outlining the specifics of guidance for the remainder of the year.

Without question, the bright spot of the quarter from an operational standpoint is once again the same-store NOI growth generated by our portfolio. The 10.4% growth in cash NOI and 5.7% growth on a straight-line basis exceeded our expectations and contributed to the increase in guidance that I'll talk about in a moment. The most encouraging aspect of our same-store NOI growth in my opinion is the source of that growth. $5.9 million, or 94% of our cash same-store NOI growth in the quarter, came from an increase in base rent. Half of that amount came from the contribution of embedded rent bumps and positive re-leasing spread taking effect. Said another way, an increase of just under 5% in NOI, year-over-year, is directly attributable to the increase in cash rental rates. It's exactly this type of organic NOI growth, combined with the positive trajectory of market fundamentals, which makes us so optimistic about DCT's future. It is also important to note that we achieved a 7.8% increase in cash revenues in the first quarter, despite a decline in miscellaneous income of over a $1 million. To put that in context, a million dollars equals 170 basis points of first quarter 2016 same-store cash NOI.

Turning to guidance, our excellent start combined with a positive outlook for the remainder of the year, has resulted in us raising and narrowing our guidance for 2017 fund from operations to between $2.36 and $2.44 per share. We are also increasing our guidance for same-store NOI growth to between 3.25% and 4.25% on a GAAP basis and between 6.5% and 7.5% on a cash basis. Similarly, we are raising our average occupancy guidance to between 96.5% to 97.5%. From a capital deployment perspective, we continue to be encouraged by our market team's ability to find and execute on attractive development opportunities and accordingly, we are raising our guidance for development starts for the year to between $250 million and $350 million, an increase of $25 million at the midpoint.

Before I turn it over for questions, I wanted to discuss the changes and clarifications that we made to the definitions of several operating metrics as reflected in our supplemental reporting package and press release. As all of you are aware, there has been a fair amount of investor and analyst confusion and maybe even some frustration about perceived and actual inconsistencies between how the various public industrial REITs calculate and/or describe some common operating metrics. In response to this, myself and a number of my counterparts from other industrial REITs began a series of conversations with the objective of creating a consistent methodology of calculating these metrics. I believe I can speak for the group well enough to say that we all felt strongly that it was in everyone's best interest to create a framework whereby investors, analysts, and companies could more confidently compare results on apples-to-apples basis. It became obvious early on that there were far more in common in our definitions than there were differences and the unanimous desire to achieve consistency made it easy to create a unified template that we could all adhere to. Given the fact that we are already in the process of refining and clarifying our own definitions, plus the fact that there were no significant differences between our existing definitions in the new template, we decided to adopt a revised definitions immediately. As you can see from our press release and supplemental, we have tried to be as clear and transparent as possible with respect to what changed and the impact of those changes. I hope you all find the enhanced disclosure clear and useful and, as always, I'm willing to listen to suggestions on how we can improve any aspect of our reporting. With that I will turn it over to the operator for questions. Thank you.

**QUESTIONS AND ANSWERS**

**Operator**
We will now begin the question and answer session. To ask a question, you may press star (*) then one (1) on your touchtone phone. If you're using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star (*) then two (2). For today's Q&A session, please limit your inquiries to one question and a single follow up for clarification.

Our first question comes from James Feldman with Bank of America. Please go ahead.

**James Feldman**
Thank you and good morning. I guess the increase in your development starts guidance, can you, and then tying that into, Phil, your helpful comments on supply in your markets, can you tell us where you're more confident starting more projects and if there are any markets where you do see that balance a little bit less favorable than others, if you could highlight that?

**Phil Hawkins**
I think in general, you'll find them, well, New Jersey, Lehigh Valley, Seattle, Northern California, and even Southern California I would, where they've smaller buildings, more infill, vary infill locations. I think we will continue to be biased towards this environment, small or medium-size buildings in supply constrained markets. There's one site, which we had worked on a couple years ago in Dallas, North Dallas that we're close to taking on, closing, if we get it through approvals, it was denied by the municipality, believe it or not, in Dallas a couple years ago.

We're back at it. We think there's a chance of getting approval, the first two to be built there were phenomenally successful because of the location and the size. So we'll go ahead with that, but I think you'll see bigger boxes in New Jersey with, actually, with a smaller building, as well, on each of the sites we've got under control. Southern California is smaller, Seattle, smaller in addition to what we have in the Port of Tacoma, where there'll be a fairly, a medium-size building. When I think about supply, clearly, everyone's talking about it, as they should. What I think about supply is it's been and tends to have been in bigger box and in further out locations. Inland Empire East is an example, South Dallas is an example, Jefferson County and Henry County in Atlanta, sites that don't compete with us in any way but certainly ones that influence the numbers.

Further on demand, I look at demand under construction, half of our markets under construction went down, half when up. The overall increase in our construction over the last quarter is about 5% or 6% in our markets, but the majority of that increase was in one market and that was the Inland Empire, one where, certainly, we were going to watch closely. A lot added in the East in lesser supply constrained locations, but it all relates to each other. I suspect that a lot of what's going on in Inland Empire will, hopefully, landlords and developers will react to that like they have in other markets where you've see it come down, markets where construction went down, Houston, Chicago, Dallas, glad to see it.

So, to me, when I think about supply, the real question, rather than equilibrium, which the word that we would like to use, to me, the real question is, do you see a place where developers and owners are likely to change their behavior with respect to rental rate discipline and even start discipline over the next year or two? And I'm optimistic that that's not the case. That they will continue to, there's enough out there, there's a strong demand, costs are going up, long-term perspective of capital, but as a result, I'm still optimistic that for the reason we've been talking about for years, that those factors will lead to continued discipline and good results in our business, but certainly something I know all investors and analysts and all of us on the management side will keep watching.

**James Feldman**
Okay and you mentioned municipalities and getting approvals, like how has that changed this cycle and how much of an impact you think that's having?

**Phil Hawkins**
The change has been dramatic and it's been over the last couple years. Two things. One, municipalities are under-staffed. They laid off a bunch of people in '08, '09 and they've not replaced them. So it just takes time. Most of our projects, frankly, while they lease up quicker, they start later and as we try to bake that into our planning, we still won't get it right. We're still too optimistic about starting. And then it remains difficult, even where zoning is applicable, to get approvals. Eventually you get it through but it just adds to the time factor. Like I said, even in Dallas, who would've thought that we would be two or three years into a project and hoping we get approval of a building that in a location that clearly would be very well suited for a distribution building.

**James Feldman**
Okay, that's really helpful. Thank you.

**Operator**
The next question comes from Emmanuel Korchman from Citi. Please go ahead.

**Emmanuel Korchman**
Good morning, guys. Matt, if we just think about your same-store NOI guidance, can we just talk about the trends for the year and if there's anything unusual driving it up in 1Q or if there's a good quarter that's going to get just lower through the year of whatever items?

**Matt Murphy**
Yeah, I think from a trend perspective, I think it looks excellent throughout the year. I think there's no question that the first quarter was more significantly impacted by the burn off of free rent than the remainder of the year will be. We have approximately $2.5 million of free rent, comparatively lower free rent in the first quarter. Beyond that, both occupancy, the continuation of rent bumps, the continuation of the impact of re-leasing spreads, remains relatively constant. So I think first quarter is probably a little bit atypical in a good way, the remainder of it remains, from where I look today, it looks reasonably constant.

**Emmanuel Korchman**
All right, thanks and then, Phil, on the increased development starts, just if we sort of think about the way that you approach starts, how much of it is each of the projects that you're comfortable with, how much is it that you don't want that dollar figure to get too big? How much is it you pushing your guys to do more? Sort of what's the flavor of how you increase the number of starts and how you sort of cap that?

**Phil Hawkins**
I think all the above. We certainly start with the market itself, the individual markets, not just the national markets, and then really get down the project very quickly and who it's competing against and what it's competing against. We have, our balancing risk management, we have turned down more projects in the last few months than we probably had in the first three years of the cycle and we've turned them down for a variety of reasons, one might be location wasn't quite as stellar as we want. Second, returns didn't quite work as well for us, investment community, as it might have in the eyes of the market leader. And then third, we are able because we've got more opportunities coming in, we are able to be more selective and so sort of like we sell the bottom portion of our portfolio every year, well, the same is true to triage out some of the development projects. To me, the biggest criteria right now is are we leasing, are we leasing in that market and are our competitors leasing?

We see a deal probably three times at least from the time we first tie it up and approve due diligence money and pursuit dollars to then buy the land after due diligence is done and final cost estimates are there and then, lastly, when we go vertical. So we get to see the competitive set at my level at least three times and then, of course, we're out there touring projects and stuff on our own, as well. And seeing what's going on in the market and the changes that have happened, had they been faster or slower than expected in the first memo, for example, that's a key consideration. We're paying attention. While we're optimistic about the environment, very optimistic, that doesn't mean we are complacent and take it for granted and so we're challenging and debating and scrutinizing every day.

**Emmanuel Korchman**
Thanks very much.

**Operator**
The next question comes from John Guinee from Stifel. Please go ahead.

**John Guinee**
Great, thank you very much.  Phil, no secret land costs have gone up significantly in the last year, hard costs have gone up, can you talk to what magnitude they've gone up in different markets and then also how you've been able to maintain a GAAP yield on costs north of 7%?

**Phil Hawkins**
I'm going to first hand off to Neil, who can talk a little closer to it than me and then I'll come back to kind of yields and where I think they're going.  Neil?

**Neil Doyle**
Okay, sure, good morning, John.  John, what we're seeing sort of across the board in the Central region is land prices are flat to up in a measurable way, but maybe 5%.  It's really, depending on the market, depending on where you're looking, certain places, take Cincinnati, which has been on an absolute tear, land prices are up significantly.  Chicago, they're pretty stable.  Dallas, they're pretty stable.  Houston, they're stable to down and really just I think a result of the industry sort of confirmation bias on what's happened in Houston.  More importantly than land right now, from what I'm seeing, is labor costs, material costs, etc., and where you've got, for example in Houston, major petrochemical projects, labor is still an issue.  Dallas is expanding roads, bridges, on top of a huge real estate boom, labor is an issue.  Chicago, which has more than 50 high-rises under construction, 50 at the moment, labor is an issue and that's driven up some of our cost.  So let's say land is 0% to 10%, construction costs are 4% to 6%, that's averaging to a building of maybe 5% to 6% more expensive than a year or two ago.

[multiple voices]

**John Guinee**
Would you make that same sort of, thank you Neil wonderful job, would you, Phil, make that same sort of numbers if you looked at the East Coast or California and the West Coast?

**Phil Hawkins**
Yeah, I think land is probably going up, is slow.  I think land is slowing in appreciation.  Cap rates have sort of bottomed for the most part, you can still find evidence if you keep going down, but certainly the trajectory has slowed of decline and cap rates.  Yields really start coming down a year or more ago and I'll get that part of the question.  You're seeing some developers, 100 basis point spreads over current cap rates, buying land and so that, I think that land is slowing, which is a good thing, but probably going up in the 3% to 5% range and maybe you can find acceptance of that, probably a little more than that in Seattle and, but is slowing.  From a yield perspective, I think there's two reasons our yields have held up pretty well and they're related. The first is we are pursuing projects that we're adding value to the land process.  Almost every one of the projects we're on, we are looking at, working on, we spend a considerable amount of time solving a problem, assembling the site, trying to get approval through wetlands or other environmental issues solved and the second thing is because of that time, time passes and if land was going up 5% to 10% a year, maybe a little more in some of these markets, and we've had it on a contract for two years, there is a benefit right there from a passage of time where on the sellers nickel, we're not, we've got some deposit money down and we're spending our own time and money, but for the most part, we tied up and add value and then closed, that's also helped our yield hold up.

I got to tell you, yields are, you're looking at now are low to mid-sixes in many markets. California, while we've not been a, Southern California, we've not been a significant player, low fives, you can see, you hear examples of some developers going ahead with kind of high four.

So yields are definitely in general down significantly over what you're seeing in our supplemental.

**John Guinee**
Great, thank you.

**Operator**
The next question comes from Eric Frankel from Green Street Advisors. Please go ahead.

**Eric Frankel**
Thank you. Phil, could you, I think there's been a lot of press and attention kind of on ecommerce and how that's impacting supply chains. I think you're seeing that a little bit into how there's a little bit more infill leasing or leasing for last mile purposes. Can you discuss the trends and whether buildings in a lot of your markets are actually suitable to take advantage of this trend? Or if it's really much of a trend at all?

**Phil Hawkins**
Well, it's a trend. It's not the only positive out there, but it's certainly a very positive trend and, in my opinion, ecommerce last mile location is important, but also functionality is important and I think I saw one of our peers and in a joking way, but a serious way and an accurate way, mentioned that every brokerage package, the worst the building, the more frequently you'll see last mile on it and it's not a band-aid for a lousy building. Ecommerce requires efficiency of movement and access and I think that's our focus on quality ultimately will pay off over the long-term in all uses, I think, but particularly or certainly including ecommerce, whether it's a 50,000 foot building, and 200,000 foot building or a million square foot building, access, location, parking, clear height, to a reasonable extent, lack of columns, all that matters and, to me, that's exactly where we've been moving our portfolio over the last 10 years.

**Eric Frankel**
Okay, somewhat related question, I think related to that, you've probably, I think, mark participants stated that the pricing for B quality assets has not declined much in the last year or so or the cap rate spread between, call it, Bs and As has maybe compressed a little bit. Any thoughts in terms of how much of your lower quality assets of your portfolio you're willing to sell in the next year or two?

**Phil Hawkins**
Well, first, B is in the eyes of the beholder and I would, and if you are a seller, it's a B plus, if you are a buyer, it might be a B minus. I would say that, I want to be a little more precise on your statement or other statements. Our opinion, in our experience, higher quality functional B might be 24 foot clear, might be 20 years old but functional, good decent parking, those are selling quite well in significant good locations, not commodity locations. Those are selling very well. On the other hand, quote, B that is not as functional, there's a much thinner buyer pool, deals have not happened to the extent that you would think. Cap rates have probably gone up some for those. So I think that's the environment we're in. We absolutely have a desire to sell. We are selling, not necessarily just based on quality, but on economics. We may be exiting a market or two that we, where leasing has gone very well recently. We'd like to see that happen for sure, and what we're selling right now, we had a couple I would say lower quality assets under contract where cap rates are probably in the mid-sevens. We also have the opportunity to sell assets, high-quality well leased assets in markets that aren't best for us but others may like in the kind of mid five to mid-six cap rate. So I think our sell process will remain focused to commit one-off assets and not necessarily just quality or just markets.

**Eric Frankel**
Okay, thanks.

**Operator**
The next question comes from Craig Mailman from KeyBanc Cap Markets. Please go ahead.

**Craig Mailman**
Hey, guys. Just curious where on the rent side you and peers are pushing spreads pretty nicely here, I'm just curious, are you guys seeing any kind of push back, maybe by size or kind of non-proximate to infill, kind of any trends you're seeing on the ability to push rents either or also whether it's ecommerce, 3pl, or just kind of a more traditional industrial use?

**Phil Hawkins**
I think, Craig, one advantage of having local people is that really becomes a local building-by-building, space by space, market by market decision. The better the building, the better location, the lower the neighboring vacancy, obviously, the more likely you are to push. In general, tenants are less price sensitive than I would've expected, given how far rents have moved. But they're smart and in many cases, almost most cases of the tenants we deal with, are professional, they do a lot of this and, as a result, they're savvy but, also, they need the space, they need to make a decision. They get to an answer they think is fair and you're done. Not as simple, it's easy for me to say that, maybe a little more difficult for our market leaders, but I think it really depends on all the above, how good of a position you're in and do you know it and do you play your hand well or do you overplay it or underplay it. Hopefully, we've got, I think, a great team of people out there and I hope they're playing their hand just right and maybe bluffing once in a while to the positive.

**Craig Mailman**
No, that's helpful and then just secondly, anything you're seeing on just the velocity of demand as you guys look to either absorb the minimum empty space you have or backfill renewals, is anything on the competition side for space?

**Phil Hawkins**
Neil, you want to take that one?

**Neil Doyle**
Sure. Craig, I believe obviously ecommerce is still pushing the envelope and is pushing the envelope in different locations in different ways. In Chicago, Amazon absorbed over 6 million square feet in 2016. I can't believe that will happen again in 2017, especially as they move away from fulfillment in sortation centers down to, as they are called, the last mile facilities. But you go to Houston and I think we're in the infancy of ecommerce and I can't tell you why, there are six million people there, why the ecommerce movement is a bit behind. My guess it's because of a bit of a lack of density of the population. But ecommerce is well advanced in a city like Chicago, in its infancy in Houston. So we'll see demand taper in one and pick up in the other.

The other big trends I'm seeing are the typical consumer goods, food and beverage is as hot as ever, transportation, logistics, otherwise known as a 3pl, continues to be one of our most active client base and one that requires a lot of work because they're trying to be as efficient as possible, moving different accounts in the same buildings and it's a real opportunity for us to actually partner with a client.

And finally, what I'll note that, and mainly in Cincinnati, in Chicago, and a bit in Dallas, is a noticeable uptick in manufacturing uses. There was 0.5 million square feet taken down for manufacturing in the first quarter in Chicago and, in fact, in Cincinnati, we just leased a 120,000 square feet to a 3pl work in a GM account. So manufacturing has been a noticeable uptick, more noticeable than other quarters and I hope that trend continues to complement the other basic four, which continue to move along at the pace they've shown us for the last couple of years.

[multiple voices]

**Phil Hawkins**
It's smaller in volume but not into of number of leases, a lot of housing related deals that I'm familiar with related to people furnishing their houses, building houses, building apartments, building hotels, furnishing hotels, there are a number of those going on in pretty much every market of the country.

**Craig Mailman**
If I could sneak a third one in, are you guys, what are you guys seeing on the utilization side as you monitor tenant spaces?

**Phil Hawkins**
Neil, do you have any thoughts on that?

**Neil Doyle**
Craig, do you mean relative to utilization of the clear height of the facility?

**Craig Mailman**
Just are people warehousing warehouse space or are they kind of busting at the seams?

**Neil Doyle**
I would say you're starting to see busting at the seams probably drop a bit as tenants have gotten smarter and as tenants have found confidence in the recovery, they're making longer-term more intelligent decisions on their facilities and so I feel as though we're getting better term deals with better utilization to facilities, to date, than we were five years ago and I believe that's just a confidence in the economy, a confidence in their business, the willingness of banks to lend their business. But all of that has caused more utilization the way you define it.

**Craig Mailman**
Great, thanks, guys.

**Operator**
The next question comes from Tom Lesnick from Cap One. Please go ahead.

**Tom Lesnick**
Good morning, guys. Most of my questions have been answered at this point, but I just wanted to circle back on the retail environment generally. Obviously, retail has kind of taken it on the chin here as of late. Obviously, ecommerce trends are positive for industrial real estate, but as you look at the overall retail picture and the prospect of a softening consumer environment, how do you see that playing out for industrial demand, generally, and what kind of lag historically have you seen between a weakness in the consumer and that flow through into physical real

estate?

**Phil Hawkins**
That's a great question, one we spent a fair amount of time talking about at our Board meeting a few days ago from a variety of different perspectives and I'll let Matt go in a little bit detail on the rolling portfolio, but typically, we don't have a lot of direct business with retailers and we certainly have no exposure as far as I know of at any of the ones that are the news, but that doesn't mean who's next. I think we're in the 3% because of our total exposure to retailers. You also have exposure to 3pls and some of their business is clearly retailers-driven, but we've seen from them they've been able to shift accounts around, they've been able to move into the ecommerce world. But, so, it's a fairly small exposure and I think, my guess is that's reflective of the overall markets we're in, as well. So you don't just worry about your own portfolio or about your neighbors' and I think that's fairly representative and as long as demand elsewhere, housing, food and beverage, ecommerce, remains as hot as it is, I think it's less of an issue. But it's certainly one that's becoming more and more front and center because it's something to think about and follow, both at the Board level as well as the operating level here at DCT.

Matt, do you have anything you want to add?

**Matt Murphy**
No, I mean, you talked about a lot of it. It's interesting, this the question, as you can imagine, comes up quite a bit and what is a retailer, there's not, certainly not a monolithic answer to what is a retailer. I think Phil put the number that I think as inclusive as I think you can make it realistically, we are at a little under 3%. We haven't had any exposure to the names that you've read in the news either that have gone down or are perhaps teetering, with the one exception, we talked about on the last call, I talked about on the last call, a known 250,000 square foot move out in Chicago, that was hhgregg. They actually made it till the end of their lease term and left so we obviously have no more exposure to them.

**Phil Hawkins**
And that was a mutual decision wasn't it, and Neil can explain it to you, but the fact is we did, while they were current, we had no desire to go further unless certain terms were met and for whatever reason, they, we mutually parted ways and gives us a head start on leasing that space.

**Tom Lesnick**
Got it. That's really helpful, guys, appreciate it.

**Operator**
The next question comes from Ki Bin Kim from SunTrust. Please go ahead.

**Ki Bin Kim**
Hey, good morning, everyone. So can you give us your internal rent forecast for industrial or at least the assets that you're end markets that you're operating in for maybe this year and maybe a little too early for next year, but maybe can take a guess.

**Phil Hawkins**
Well, our crystal ball is probably more cloudy than some other of our peers who appear to have very clear crystal balls. I think, and Matt can, we don't roll it up. It's a space by space, building by building analysis in our forecasting and budgeting process. My guess is the only numbers are based on, what, 3% to 5%, maybe a little more in some markets and I think that that, we've

proven to be conservative, not by intent but by result over the last couple years. It's appearing to be the case this year again and I'm happy to accept that fact of being wrong and I believe, given what's going on with low vacancy, healthy demand across sectors and sizes and markets, I think the psychology of brokers and tenants is what'll lead us to be pretty bullish about rents next year. I'd probably, this early in the stage say 3% to 5%, and I hope I'm as wrong next year as I have been the last couple.

**Ki Bin Kim**
Okay and what is your kind of current philosophy on not A versus B, but maybe secondary markets? Do you think, so the Kansas or South Carolina, or the number of markets that you're not in, do you think those have been almost two beneficially treated well by the uprising industrial demand or do you think those are markets where you would be little more careful about deploying capital?

**Phil Hawkins**
Well, first, we make decisions on which market to be in based clearly on a view of the market, but also on the recognition that we have to focus our resources. We aren't a company with unlimited resources and so we're going to be focused and so we've exited markets. A few that I'd say, I like that market, I just don't think we can afford to be there and if not going to be there in a meaningful way with people and invested capital, why be there at all? So to me, that's where it starts. My personal view and it's self-serving, is that I think the market, the REIT market overvalues lower quality assets and lower quality markets relative to the market, the private market, but that's a self-serving comment given the direction we've been heading.

**Ki Bin Kim**
That's all right. I always view you as a pretty straightforward guy, so alright, thank you.

**Operator**
Again, if you have a question, please press star (*) then one (1).

Our next question comes from Eric Frankel from Green Street Advisors. Please go ahead.

**Eric Frankel**
Thank you. Two quick follow-ups, one, Phil, do you see a possibility down the road, obviously you've consistently stated that supply has been backed by institutional capital, any thoughts of DCT recapitalizing some of those projects if for whatever reason institutional capital wants to flee for whatever reason? Obviously, everyone seems to be interested in industrial right now but may not happen forever. So any thought in terms of recapitalizing some of the newer supply that's coming online?

**Phil Hawkins**
Well, it's one of those situations I don't hope for because it would reflect a period of stress and illiquidity. But clearly, one of the reasons we maintain a low leverage balance sheet and continue to de-lever where we can, is to be ready to go on offense if that was ever the case. We're always looking for opportunities that create value and make money and if the cycle moves in a way that this illiquidity that we can solve in a way that we feel is the right decision long-term and profitable, heck, yeah, we'll jump into it. I don't think that's going to happen. These are deep-pocketed investors, smart, experienced industrial investors, the pension funds that are in this business, non-traded REIT or two that are in this business. Obviously, the public REITs, they are well capitalized. They've been in this business a long time. Most of them, not all them, most have been funding development or in the development part of the business for a

long time. As a result, I just don't think you're going to see a very quick or sudden panic if you even have a view that the environment may get that way in the near future, which, obviously, I don't yet, but if it happens, well, we'll be ready

**Eric Frankel**
Okay, and question I guess for you Neil, I noticed your remaining lease expiration, Chicago represents a pretty disproportionate number of that. Could you comment on what's rolling your confidence in leasing that space?

**Neil Doyle**
Absolutely, so we are running about, Eric, about 8 million square feet in Chicago on a consolidated basis. We're a little over 92% occupied. The roll is severe in '17, well, maybe severe is too strong of a word. It's significant, as it was in '15 and '16. We're currently looking at about a million feet of current vacancies among seven buildings and we are in the final stages of negotiations, in my opinion, on about 350,000 square feet of that. So we've got one space that is new to the vacancy list, that's the hhgregg space that Phil mentioned, or I'm sorry, Matt mentioned, that's another 250,000 of that. It's an 88, it's got highway visibility, it's got great access, and it is Class A. So feeling pretty confident, but it is a challenge and as far as my region goes, every city has a challenge every year. The roll in Chicago is a challenge for the region this year, remain very confident. Absorption has been great. We're seeing just an absolute differential of users across the board. Everything seems to be on track. We came out roaring in the first quarter. I expect it to continue and hopefully by the second or third, this will no longer be the challenge that it is today.

**Eric Frankel**
Okay, thank you.

**Operator**
Our next question comes from Rich Anderson from Mizuho Securities. Please go ahead.

**Rich Anderson**
Hey, thanks for sticking around. So part of the problem with 10.4% same-store cash NOI growth is you need 11 next year for everyone to stay happy and I'm being tongue-in-cheek of course, it's a great number. But I'm curious, not to ask for 2018 guidance, but is there an element of the same-store that is not necessarily repeatable, whether it's burn off of free rent or whatever that may be should be communicated now to prepare people for a more sustainable number in the future.

**Matt Murphy**
Yeah, Rich. Clearly, I'd hoped I'd been doing that already. Like I said one of the things I was really, really encouraged by, saw it coming to some degree, but it was even better than I thought and I'll repeat this from my prepared remarks, just about 5% growth of our NOI was about rental rates, increases, and rent bumps. That obviously doesn't take into account we had a 90-basis point increase in average occupancy that contributed to the 10.5%, 10.4% cash growth. We had burn off of $2.5 million of free rent, which is unlikely to be repeated anytime soon because honestly, in some ways that's the byproduct of the increase in occupancy that happened in that portfolio, really ultimately in late 2015, which manifested itself in free rent in early 2016. So yes, I don't think it's probably a new flash to assume that we can't extrapolate 10% cash growth, or revenue growth, but 5% revenue growth that is just about rental rates, which is what we just experienced, that is and as I mentioned to Manny's question, that's pretty well represented through the back half of the year. I'm not going to get into '18, that's pretty darn healthy growth

and that's based, not on one timers or aberrations, that's based on the harvesting of what's been going on in the markets over the last several years.

**Rich Anderson**
And for the record, I think you have done a good job communicating. I was trying to get to the bottom line sort of opportunity with some sustainability and if that number is kind of five, then that's the number, but I'm just wondering if there's any more moving parts beyond that.

**Matt Murphy**
Yeah, I don't think so. It's pretty simple business. We have the vast majority of our expenses pass through to our tenants. It's not perfect, but it's pretty close and have your own views about occupancy. Obviously, we're in pretty rarefied air from an occupancy perspective. However, given what happening in the market today, I don't see the force that's going to change that dramatically. It'll move quarter-to-quarter. So really what you have is rents and as I've mentioned, rent comps get a little harder with respect to we're basically in the last year of rolling it against kind of trough, a significant portion of trough rents. So that's obviously not just sort of algebraically helpful, but the flipside of that is what's been going on since then has been pretty dramatic market rental rate growth that has continued to fuel the re-leasing spreads that we've talked about.

**Rich Anderson**
And then just a quick follow-up, unrelated, I guess, but on the development pipeline, 31% leased. I know you're targeting a fairly rapid lease up profile, but I'm just curious if you can get, is 31% kind of what you would view as the floor to the preleased number for your development pipeline or would you be willing to let it drift lower with future earnings reports because of the confidence you have in leasing up quickly?

**Phil Hawkins**
It's not a floor. It's project by project. We are, given the lack of land banking and in fact, we love our land sites. We want to put them in production quickly. We're not a big build-to-suit company. We'll do a couple a year, but we're not a big build-a-suit company. We've had good fortune that we've had that number in the 25% to 50% range for quite a while. But if we lease up a bunch now and then start another one that I've talked about in my prepared remarks all at once, that can go from 30 to 50 to 20. That would not be, on itself, concerning to me. When, and I look at our current pipeline where a lot of it is still under construction, much of that's not in, and then 12 month of lease up beyond that, I'm fine with 31. I was fine last quarter with 25. I'd rather have it higher, trust me. On the other hand, what we want to do is, if we have confidence in the projects that we've been thankfully able to deliver over the last five years, if we're confident in the project, we will start and hope that our convictions are well proven.

**Rich Anderson**
Fair enough, thanks very much.

**Operator**
This concludes our question and answer session. I would like to turn the conference back over to Phil Hawkins for any closing remarks.

**CONCLUSION**

**Phil Hawkins**
Thanks, everyone, for joining our call today and your interest in DCT. 2017 is certainly off to a

good start and we look forward to seeing many of you at NAREIT.  Take care.

**Operator**
The conference has now concluded.  Thank you for attending today's presentation.  You may now disconnect.