DCT Industrial Trust Inc.

Second Quarter 2017 Earnings Call

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CORPORATE PARTICIPANTS

Phil Hawkins, *President and Chief Executive Officer*

Matt Murphy, *Chief Financial Officer*

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

Bud Pharris, *Managing Director, West Region*

PRESENTATION

Operator
Good day, and welcome to the DCT Industrial Second 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. After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star, then 1 on your telephone keypad. To withdraw your question, please press star, then 2. Please note this event is being recorded.

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

Melissa Sachs
Thanks, Nicole. Hello, everyone, and thank you for joining DCT Industrial Trust's Second 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 updates to our guidance. Additionally, Bud Pharris, Managing Director of DCT's West Region, will be available to answer questions about the market, developments 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 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 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 site, dctindustrial.com.

And now I will turn the call over to Phil.

Phil Hawkins
Hey, good morning, everyone, and thanks for joining our call today. The second quarter reflected continued momentum in our business, driven by healthy demand, low market vacancies, and rational levels of new supply. This translates into a better-than-expected rental rate and NOI growth than we projected at the start of the year. Our results to date, along with our confidence in market fundamentals, led us to increase our operating and FFO guidance for the year, which Matt will review in more detail shortly.

Owners and developers continue to display a high level of discipline and patience in leasing their space, staying much more focused on achieving or exceeding their desired rents in an occupancy and lease-up, and, similarly, tenants remain much more focused on finding the right building and location than on rents. That isn't to say, however, that they don't care about cost, but tenants and their brokers do understand the market, and after a fair amount of the usual negotiation, are prepared to pay a market rental rate for the building they want rather than switching to a lower cost alternative that doesn't meet their quality or location needs. With low market vacancy and continued active tenant demand, I expect this favorable leasing and rental rate environment to continue for quite some time.

Reflecting this strong market, leasing in our development projects continues to go very well, with our current pipeline now 42 percent leased, up from 31 percent last quarter. For comparison purposes, the same pool of development assets from last quarter is now 48 percent leased, up from 31 percent. We have several additional leases now in negotiation, with good proposal activity across all of our development projects, and while we have been fortunate in leasing up our projects faster than 12 months, we continue to believe that projecting a 12-month average lease-up going forward is prudent, given that we are more focused on rent and tenant quality than speed of lease-up.

The current development pipeline has a projected stabilized yield of 7.4 percent and an average estimated value creation margin of 45 percent, representing a very attractive, risk-adjusted return on capital and substantial value creation potential.

Lastly, a quick comment on dispositions. A combination of successful leasing at projects we have identified for sale, combined with a continued healthy sales market, led us to increase our disposition guidance for the year. While a relatively small dollar amount, we do expect to exit the Louisville market this quarter. We recently sold the three buildings in this market that we held in a joint venture and are now under contract, with the buyer’s deposit money non-refundable on the one building in Louisville that we own outright, with closing expected in the next few weeks. We continue to believe that this is an excellent time to sell our lower growth assets so we can redeploy that capital into development which offers higher growth and value creation potential over time.

With that, I’ll turn the call over to Matt.

Matt Murphy
Thanks, Phil, and good morning, everyone. Current market conditions of steady, healthy demand combined with historically low vacancy, continue to create an environment of positive surprises in rental rates and occupancy that are translating into very strong financial results at DCT. I will go through some of the details of our second quarter results and walk through our guidance for the remainder of the year.

Today’s positive market dynamic is very evident in our leasing statistics for the second quarter, where DCT’s rent growth of 40.2 percent on a straight-line basis and 17.8 percent on a cash basis, represents the best results in our company’s history. For the past four quarters, rent growth on new and renewed leases has averaged 26½ percent on a straight-line basis and 11.2 percent on a cash basis, both well ahead of our expectations. This prolonged improvement in market rents has and will continue to help drive excellent organic NOI growth in our portfolio. NOI growth for the second quarter in our annual same-store portfolio was 9.3 percent on a cash basis and 3.9 percent on a straight-line basis. While the cash number was enhanced by the decline of $2.8 million of free rent quarter over quarter, cash same-store NOI growth would have been approximately 5 percent without the free rent burn-off, driven primarily by rent bumps and positive releasing spreads. It’s worth noting that this growth was achieved with static average occupancy and despite a decline in miscellaneous income. It’s also worth noting that our definition of same-store properties only includes development and redevelopment assets that were fully stabilized throughout both periods reported.

Before I move on to guidance, I wanted to point out one other item in our same-store numbers that wouldn’t be readily apparent when looking at the financial statements or supplemental. In the second quarter, we received several final property tax bills related to prior years, whether because of appeals being finalized or because of certain jurisdictions that billed significantly in arrears. These bills were meaningfully lower than the accruals we had previously recorded for these buildings. As a result, we decreased property tax expense in the quarter by approximately $1.5 million and correspondingly decreased recovery revenue by about $1.4 million as the majority of this savings belongs to our tenants. While this obviously had very little impact on the bottom line, it did affect the year-over-year growth in each line item. Including this adjustment, our annual same-store portfolio shows a quarter-over-quarter decline in rental expenses at 2.5 percent. Excluding this true-up, expenses would have increased a more intuitive 4½ percent.

Turning to guidance, we are narrowing and increasing our 2017 FFO guidance as adjusted to $2.39 to $2.45 per share, an increase of 2 cents per share at the midpoint. This increase is predominantly related to operating performance for both our second quarter results and outlook for the remainder of the year, improved. The underlying elements and assumptions of our guidance are as follows.

We are narrowing and increasing our expectations for 2017 average operating occupancy to between 97 and 97¾ percent, an increase of 38 basis points at the midpoint. This increase is the result of both faster lease-up of vacant spaces as well as better tenant retention. The combination of higher-than-expected occupancy and higher rents has caused us to narrow and increase our same-store NOI projection for the year. We are now anticipating increases of between 7¼ and 8 percent on a cash basis and between 3¾ and 4½ percent on a straight-line basis., increases at the midpoint of 63 and 38 basis points, respectively, As always, our occupancy and same-store NOI guidance do not contemplate the potential impact of any future acquisitions or dispositions.

We are increasing and narrowing our guidance on development starts to between $275 [million] and $350 million, with the majority of the remaining starts expected to occur in the third quarter. We are also increasing and narrowing our guidance to between $50 [million] and $100 million — our acquisition guidance to between $50 [million] and $100 million as we have closed on or identified a few transactions in the past 90 days. While the amount is probably not significant, we believe each of the transactions will enhance our portfolio and cash flow growth potential.

Our disposition guidance is increasing to between $150 [million] and $250 million. The remaining expected dispositions for the year likely will be back-end weighted, with the bulk occurring in the fourth quarter, a bit later than our earlier projections.

In summary, the second quarter has continued the narrative of the past several years, where the fundamentals of our business remain very strong, and our execution continues to surpass expectations. As a result, our financial results and expectations continue to be very positive as well.

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

QUESTIONS AND ANSWERS

Operator
Thank you. We will now begin the question-and-answer session. In the interest of equal access to all participants, please limit yourself to one question and a single follow-up. To ask a question, you may press star, then 1 on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star, then 2.

Our first question comes from Manny Korchman of Citi. Please go ahead.

Manny Korchman
Hey, good morning, everyone. Phil, maybe one for you. Are you more surprised that you're able to keep retention as high as you can or that you're able to push rents as hard as you can?

Phil Hawkins
Boy, both high-class problems to talk about. I think they're both related. We're in an environment where the quality of the building and the location matters. Tenants are leaving, not because of rent, but because of the building no longer meets their needs. Most likely it's not big enough, or the space they're in isn't big enough, and that same environment allows us to push rents. As I said, it's not like tenants don't care about rent. That would be an injustice to the process and to the effort of our market teams, but it's clear that everyone is putting a lot more emphasis on function, whether that be a building function or a location function, or both, than they are on actual cost. They're totally related. So I think that the answer is the same, they both are reflective of the current environment we're in.

Manny Korchman
And then maybe just sticking to tenants' psychology for a second, how many of them, when you present them the bigger rent check or the new lease, start to think more about the way that they're doing their business, whether — is this space big enough, is it too big, do we need a location that has more people or less people, or do we need more truck bays, or what? How many of them are making that decision, and how many are just saying, "Our business is healthy. It's another three or four or five-year renewal. Let's just sign and move on, and we'll deal with this when we get there"?

Phil Hawkins
I think the reverse. The tenants we deal with primarily are in this business. It's not like an office building where a law firm deals with a lease once every five or ten years, and they're really not in the business of leasing space. Most of the tenants we deal with are professional tenants, and our buildings — and what we do is an integral part of what they do, and so they've been thinking this through in a very sophisticated way most often, way before they get to us. Clearly, we have a dialogue, hopefully it's ongoing and regular throughout the whole lease, but by the time they get to us, other than on, again, the normal posturing and negotiation which clearly goes on, they're not showing every card, nor are we, on the first formal meeting related to a lease, but I think that that is — to me, the tenants have already thought through what they need, and they've made a decision. More and more of those decisions, and have been for a while, are long term. They're not just kicking the can down the road, which is good for us, good for everybody. You get some of that, some on renewals, where it's easy to renew for a year or two or three, because you're already in the space, but, again, that's a pretty involved and thorough process.

Manny Korchman
Thanks, Phil.

Operator
Our next question comes from John Guinee at Stifel. Please go ahead.

John Guinee
High-class problem, guys. Question — in the last 12 months, if you think about development costs or replacement costs in your various markets, primarily a land or land to get at fully entitled and then also generic hard costs, how have they moved, and can you give us a little bit of insight on that?

Phil Hawkins
Yeah, I think basic costs probably up 5 percent, comprised of materials costs and maybe up a little bit less than that; labor costs, more than that; and then contractor margins, more than that. Contractors are now prioritizing and being more selective and most are pushing those own prices — don't blame them. And there's also some capacity challenges. For example, in Chicago, pre-cast, where you're not tilting and pouring in place and tilting, you're bringing in pre-cast, there's a 9- to 12-month backlog.

And then the other thing that's gone up and is also taking longer is entitlement and approval process. Off-site fees are going up, entitlement costs are going up, and then just the time it takes to get them done, which has a cost because the time value of money has also gone up. I think it all rounds off to probably about 5 percent higher today than it was a year ago, excluding land, and that was a key part of your question, and that's probably unfortunately more market specific and harder to be generic, but I will tell you land costs are up at least that much, on average, across the country, some probably closer to 10 percent, and many in the 4 to 5, 6 percent range.

John Guinee
Okay. And then a second question, in terms of turnover cost per square foot, it looks like you've been holding pretty steady at $2.00 to $2.50 per lease year. What's your thought on providing turnkey TI dollars for these tenants, or are they putting money into the space? We've noticed in the retail world and the office world, that more and more of the landlords are essentially financing these businesses, but how does that work in your business?

Phil Hawkins
It's a combination. Clearly, the tenants are doing more to their space than they were ten years ago or even five years ago, so the total costs are up. We continue to remain willing to fund what I would describe as generic improvements, typical improvements. The cost of those, just like construction costs, are up a little bit, and then tenants are then investing more money into their space than that. We also are willing, though, for the right credit, to fund but amortize over the term of that lease, some of those costs, and that , usually the rate we're getting in return is a 7 to 10 percent interest rate on top of full amortization of the principal.

But I view it as a negotiation, and if it's more important to them than to us — and capital is something we care about, but we feel if we're getting the right return on it, happy to provide it as long as the return we're getting back is attractive, and then we push what's important to us, which is rental rate and rent bumps. I'd much rather deal with rent bumps and rental rate and then be less difficult when it comes to a discussion on improvements.

Matt Murphy
The only thing I'll add to that, John, is that the way I heard your question, anyway, you were talking about maintaining a line of between $2.00 and $3.00, but you said per year of term. That's a total of $2.00 per square foot on the leases that are signed as opposed to a per-year term.

John Guinee
Oh, yeah, I'm sorry. Thank you for correcting that. Last question, you've got a big package out there in the market. Are you allowed to talk about that?

Phil Hawkins
We're allowed, but I don't want to jinx the situation. We are out with a couple different packages. One is a large one, it's an Eastern, Southeast type of package that we hope will be as well

received as we think it will be — high quality, Class A assets with long-duration leases in place with credit and tenants. We'll find out. We're price sensitive. We've got some other packages on the market. The one you're talking about is, you know, frankly our — we weren't intending to do that originally in terms of a package, but the belief is there may be the potential for a portfolio premium, and if we can get that, we'll be thrilled and sell it as one package, but we'll also be willing to break it up if execution and pricing make sense to do it that way.

John Guinee
Thank you. Thank you.

Operator
Our next question comes from Jamie Feldman of Bank of America Merrill Lynch. Please go ahead.

Jamie Feldman
Thank you and good morning. So it sounds like you were surprised to the upside on rent growth this quarter. Any readthrough for what it means for leasing spreads as you look ahead to 2018 and your mark-to-market?

Matt Murphy
Yeah, Jamie, I think the answer is I don't know for sure. What I will say is that I've talked for probably a year, maybe more, about trough leases and knowing that our comparisons, the leases that we're comparing against, were, in many cases right now, done in the lowest — what I call trough, which is 2009 through 2011. And clearly this quarter's numbers have been enhanced by that. I think to me, what's encouraging about this is that the ones that are after the trough, if you will, still had 20-plus percent rental rate growth on a straight-line basis and was just under 10 percent on a cash basis, which, to me, is more indicative.

So now we're talking about what the algebra looks like sort of after the recession kind of muddied up the waters, so I think there is a readthrough. I'm always reluctant to extrapolate rent growth numbers, because they are so dynamic. That's why we've never given out short-term guidance on them, but I think the basic fundamentals of that are remarkably encouraging.

Jamie Feldman
Okay. Thank you. And then just one more. Some of your peers have talked about an improved outlook for the supply risk across their markets. Would you say in the last quarter or so, things have changed in your mind also?

Phil Hawkins
No. I had a more balanced perspective last quarter than some. I'm still where I am. There's plenty of capital out there. It's all equity, very little non-recourse debt for speculative construction. Developers have been disciplined for a long time for a variety of different reasons that are structural and not just based on net long-term memory, which we know they don't have. There's plenty of supply in all of our markets, some a little more than you'd like, but it's all in an environment with low current vacancy rates and where the quality of the building matters a lot. And, as a result, I think we're in the same environment we were in last quarter.

Jamie Feldman
Okay. Great. Thank you.

Operator
Our next question comes from Craig Mailman of KeyBanc Capital Markets. Please go ahead.

Craig Mailman
Hey, guys. Matt, maybe starting with you, just looking at same-store guidance, it continues to be strong and move higher here, but it's probably at a level that maybe isn't sustainable into '18, and I thought it was interesting you gave the 5 percent growth stat without free rent. If you have the number on hand, maybe a a good baseline comparison as we head into next year. What would that number be on the full year guidance, and maybe even if you have it on '16 to get a trend of where that core cash same-store would be X some of the non-cash noise.

Matt Murphy
Ah, the ever present desire to get '18 guidance. Yeah, well, one, you bring up in your question, the primary point that I would make, which is that absent, so for the last two quarters, we've effectively been flat on an occupancy perspective, and I've tried to be real clear on stripping out the impact of the burn-off of free rent, and it's the year-over-year burn-off of free rent, the comparison. And in each of the last two quarters, the answer has been right about 5 percent. I think I've talked a number of times about how our average bumps in the portfolio are about 3 percent. The actual mathematical — the factual answer to that is our average next bump is more than 3 percent. That's built up of some factors that are — they're not really teaser rates any more. Sometimes it's staggered lease-ups, sometimes it's leases that don't actually bump every year. So it's becoming far more prevalent that bumps are 3 percent, and so if you assume static occupancy, then it becomes an analysis of both where releasing spreads will be and the other sort of beneficial impact that I've also talked about in the past of just being in a prolonged landlord-friendly market, you win more throws in terms of negotiation your ability to recover expenses and all that sort of thing.

So I probably answered longer than I needed to, because I don't really want to try and set the bar for 2018 right now, but I think what I've talked about is that we are now four quarters in a row sitting around 5 percent without the benefits of any of these extraneous items, if you will. And I think, to me, the most significant part about that is that, I think generally people — I've seen models, I read reports — I think people have the nearer-term numbers pretty accurate. There are some that are higher than others, there are some that are lower than others. And when I say higher and lower, I really mean than me, but I think what's maybe missing is the acknowledgement or belief, if you will, that we have experienced a paradigm shift, and the longer-term growth rates for industrial — this isn't your father's industrial financial environment, that I think the longer-term rates, because of all the factors we're talking about, are maybe more positive than, I think, some people perhaps are giving credit to as they think through what the future looks like. It's not a guarantee. We don't know that the economic environment is going to remain as it is. Who knows? But I think the assumption's inherent in many people's reports and models, is that it will be, because how do you predict otherwise? And yet I think the growth may be — I think it's — I feel like I'm biased for sure, but I feel like the basic fundamentals are different.

Craig Mailman
No. That's helpful. I wasn't fishing for '18 guidance. I was just trying to —

Matt Murphy
Yes, it was. You're doing your job, I'm doing mine.

Craig Mailman
No, I was just trying to set the stage of reading through the optics of going from high 7's to something lower next year and kind of making — buffering the concern of deceleration.

Matt Murphy
And I'm just pulling your leg, as you know.

Craig Mailman
Separately, maybe for Phil, we're all talking about infill and the demand there and the growth there, and I guess maybe this is a two-parter, but just curious across some coastal markets and some non-coastal, where you're more infill, one, are you seeing the ring of infill migrate out to where some of your, what you would consider non-infill assets, now become infill, as you guys just can't get in there? And, two, if you're not seeing that and the demand continues to chase the same small subset of assets, I know we all talk about rent growth going up, but, I mean, a lot of this is e-commerce-driven, do you see that net gap narrow between what retail rents are at strips and maybe some malls versus what you guys have the ability to charge for industrial?

Phil Hawkins
I can't answer the last question, because I have no idea what rents are in strip malls, either a year ago or today. I've not been in a mall, or I've not been shopping for a long time, so I'm the wrong guy to ask that question to. I think Regency's got their call right now if you want to jump over there.

It's too simple to simply bifurcate the world in infill and non-infill, so I think, to me, I would rather own as an operator and developer more infill sites and sites that are more infill than not infill, period. But you're also seeing in some of the non-coastal markets and particularly — actually, even in coastal markets — Inland Empire East is a good example, where, while we talk a lot about the importance of infill, and that's where the demand is, there are obviously tenants that are going further out, for whatever reason. It could be that location could be better, it could be that they are more rent sensitive in their business model than others, and in this environment, a rising tide is lifting all the boats. I think some boats are going a little faster than others, and I hope we're one of those boats because of our strategy, but only time will tell.

I think the real key for me about infill is I think it's a more sustainable business model as an investor, operator, and developer than it is just simply meeting demand. When the tides starts going out, I'd much rather own a building whose location makes it a lot more durable and there's a value creation in demand depth than when I'm further out, South Dallas or Inland Empire East, or Central Pennsylvania, or whatever — South or Far West Chicago. Every major market has their examples. I'd rather stay away from that.

Craig Mailman
All right. Thanks.

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

Eric Frankel
Thank you. I certainly appreciate that occupancy can't move much higher, but I wanted to address Chicago again from the last call. I think you knocked out a lot of your lease maturities that looked pretty high last quarter, but there's not that much this quarter, but the occupancy for that quarter,

the market occupancy still looks somewhat lowish. Maybe you could talk about some of the space you need to fill there.

Matt Murphy
Yeah, Eric, I think it is. It's the nature of the beast sometimes that expirations clump, and that's clearly what happened in 2016 — or in '17, really more early '17. I think we've done a lot of shorter-term leasing in Chicago that has — so, in other words, you get expirations more frequently. I think what I continue to see in Chicago is there is very good leasing velocity, and we have for an 18-month period, both leased a lot of space and had a lot of space vacate and therefore have kept our occupancy more or less where it is. We still have a couple of spaces. We have a couple hundred thousand square feet that has — it's both in our expirations as of June for the remainder of the year. We've now signed it through the end of the year, so we've both leased it and still have to lease it again. Now, it may be that that tenant turns into a long-term answer; it may not be.

So, we're treading water. We're doing a lot of leasing. There's actually been pretty good rent growth. One of the best rent growth stories we had in our second quarter numbers was a space that we had in Chicago. In that case, it was both a representation of the market getting better and it was, frankly, a pretty tough lease that we had to sign. That one was in 2009. So there's work to do there. The good news is there's a lot of demand and a lot of activity, but obviously, it's a big market, whose average is below the portfolio average. I think a lot of that is, as I mentioned off the top, just a function that we had a lot that expired at the same time, probably not in our best buildings, which I'd love to say that all of our buildings are our best buildings — that's obviously impossible — and so we keep making progress.

Eric Frankel
Okay. I'll probably just jump back in the queue, but, Phil, maybe just a broader question. Do you think your development guidance this year — how sustainable is that, do you think, in the next few years? Do you think it can actually ramp up higher, given your platform and your personnel in place, or is it just really tough to increase it much more based on the current competitive landscape?

Phil Hawkins
Well, tell me what the market's like and tell me how our approval process is going through the city. Could we ramp it up a little bit more? Probably. Is it likely? Probably not. It just takes — for two reasons. One is we need a lease, and it takes time to lease, and you've got to build it and lease it, and we're not going to get too far ahead of ourselves in terms of unleased capacity. We track very closely the unleased percent of our development — the value of our unleased development as a percent of total assets and don't want to exceed 10 percent, which means we can move it a little bit higher but not a lot. And then, second, we are only focused on sites that we like really long term, more infill, more difficult to develop, problems as a result need to be solved.

And I'll give you an example real quickly, or hopefully quickly. We're working on a project on the East Coast zoned from day one correctly, and we are now 18 months into the approval process and with trying to convince neighbors and whatnot to sign off. We'll get there, we think, but it's not — even when it was zoned right, it's taken us 18 months to get it through the process, and we won't have the final hearing — hopefully the final hearing — until September — mid-September, so it's just — it's not getting any easier, and therefore it's not getting any quicker.

Eric Frankel
Okay. Thanks.

Operator
Our next question comes from Rob Simone of Evercore ISI. Please go ahead

Rob Simone
Hey, guys, thanks. Matt, I'm going to ask another version of an earlier question, so go easy on me, but —

Matt Murphy
I will if you will.

Rob Simone
Yeah. So if you think about the pretty wide spread between GAAP and cash, like everyone knows that, obviously, they should converge over time, but if I think about where your average rents are today and kind of those 3 percent bumps, what's the lead time to those numbers eventually converging? And then I guess my follow-up is if you guys have had four quarters of, call it, plus or minus 5 percent same-store cash NOI without the one-time effects, why hasn't the GAAP number come up to that?

Matt Murphy
Well, those are good questions. I think if you think about it — so I first — where my mind goes when I start this, is it's a five-year business, right? So it's — all else being equal, you would think — so what's really happened is you've seen occupancy increase overall. Occupancy increases are always associated with and connected with free rent periods. That's just the way our business works, and bumps have improved over time, so if you assume a change happened all at once, you would think those numbers would converge after five years, because they're five-year businesses, and it's — I'm sorry, it's a five-year lease business. What's happening is obviously the past stays static, and the new leases continue to be dynamic, so what happens is it's not like we went from 1 percent bumps to 3 percent bumps over time. What's happened, it's become more and more prevalent, so if you assume that it was a three-year process, you know, you work your way through to it. So I think the fact of the matter is rents are getting better at an increasing pace, and bumps are getting better at an increasing pace.

So you're right, over time, by definition, GAAP and cash will — they are equal, because you're talking about the same revenue stream. And what makes it hard to answer that question in the real dynamic world is that things are moving — both the comparisons have moved over their five-year period, and the new leases are moving over their five-year period. I think the biggest thing is we're now to the point where occupancy is static, and therefore free rent is more likely to be static. And so I think you see those numbers really start to converge, really starting now. I've said this before, the back half — and I think I was answering your question before — the back half of he year free rent differential is effectively zip. And so that element will go away on a quarterly basis almost effective immediately. On an annual basis, it will really start to manifest itself in '18, but I hope in a rising tide, cash will always continue to outpace it in the short term because of all the things that I mentioned — bumps are getting better, rents are getting better, and the past remains static. So you have to stop the music for them to actually converge, and hopefully the music doesn't stop.

Rob Simone
Right. Right. And then the second part, just the GAAP number or the straight-line numbers that you guys provide, that's short of the plus or minus 5 percent level. Is that the same effect just on the opposite side, or how does that work? Why hasn't that come up to 5 percent?

Matt Murphy
I do think it's the same thing. I haven't really thought about it that way, and I'm reluctant to just fire form the hip, but I think that's right. I don't know why it would be any different. It's just a matter of timing.

Rob Simone
Got it.

Matt Murphy
And those increases get impacted sooner and therefore less pronounced, but ultimately you end up in the same place.

Rob Simone
Right. Okay. All right. Thanks, Matt, appreciate it.

Operator
Our next question comes from Bill Crow of Raymond James. Please go ahead.

Bill Crow
Good morning, guys. This probably goes in the category of looking for problems when none exist, but any tenants that might be slow in their decision-making process because of global exposure, NAFTA, prospective changes, anything like that?

Phil Hawkins
I don't think we have that kind of insight. I'd say the answer to your question is no. I would say for development properties, tenant decision-making, if it was — speed was white hot six months ago — it's simply hot today, meaning it takes a little bit longer to get them to the lease approval process. They're signing leases, but they're methodical. The approval process, it seems to be taking a few weeks longer. I don't think that's related to any global events. I think it's the fact that they're getting ahead of their business, they're talking about development properties. They've got time. We've got time, and it's being used to some extent in the negotiation process.

Bill Crow
Okay, and my second question is you talked about the approval process from the cities and getting permitting. Any markets that are just they're at their breaking point from an industrial development perspective?

Phil Hawkins
I think — well, breaking point from the staffing, most are. Most are understaffed. From a willingness perspective, I think that nothing's changed. If it's already zoned, we're in pretty good shape. If it's not zoned, we're — we've got a long — we got a problem. They'd rather not have our business, you know, not in my backyard, kind of in that category. That's not to say that we're not trying some cases, but I'd say it remains a capacity challenge, and then if any of it requires public discussion and approvals, which therefore involves homeowners and residents and voters, it's a pretty steep uphill climb.

Bill Crow
All right. Thank you. Appreciate the time.

Operator
Again, if you have a question, please press star, then 1. Our next question comes from Rich Anderson of Mizuho. Please go ahead.

Rich Anderson
Thanks. Good morning. Great quarter. So a couple of weeks ago, Duke reported and said that the business is operating in a state of equilibrium, which isn't a bad thing considering the high level of occupancy. I'm just trying to — like I knew this — pick through the things that you said today. Do you agree with that statement in your markets, or do you still feel it's not quite at equilibrium, you're undersupplied still, given your comments?

Phil Hawkins
Well, for the last several quarters, maybe the last year or two, a number of people on the sell side as well as the buy side as well as management teams somehow are infatuated with this concept of equilibrium. We've proven that we don't know how to predict it, but I also don't believe it's all that relevant. I think it's not a two variable equation — supply and demand. You've got to throw in the current vacancy rates, and then you've got to throw in a fourth subjective variable — motivation of developers and owners. And the motivation is, as I said in my opening remarks, long term, vacancy rates are low in every market, and then supply has ramped up appropriately so. We certainly are doing it. How can we fault others for doing what we're trying to do? And then demand remains broad and deep across markets and across industry verticals.

To me, all four of those things need to be discussed at the same time and not just simplifying it and do, "Are we in equilibrium or not?" In our markets, we think of development supply, not yet — not pre-leased supply compared to trailing 12 months of demand. Theoretically, our theory is is there 12 months or less of supply coming or not? And in every single one of our markets, the answer is below 12 months. So does that mean we're in equilibrium? No, I think we're short of it, but, again, I think it's an almost — it's not the right, complete concept to think about. I know others disagree, and that's fine, but my view is it's a more complicated discussion to get at the real objective, which is — or the real question, how are landlords doing with rents? That's what we all want to know, and the answer is we're doing just fine.

Rich Anderson
Okay. The other thing that could screw up the story, and, again, I'm kind of pulling from Bill's page and trying to find something that's not wrong. Is Amazon taking over the world? Is there any — you know, it's not a big part of your business, but it is the largest part of your business, I'm just curious if there's any reluctance at all to doing another deal with them, you know, not to turn myself into an Amazon analyst but, a relatively thin margin business. Do you have any concern about the next five yeas with them?

Phil Hawkins
Well, first, we're not in the build-to-suit business with them. We have been leasing to them second generation existing space as well as a number of — several — actually, maybe more than — first generation development projects that we started specs, so, frankly, they're high margin, the margins are not any different than they are for any other tenant we deal with. I would hesitate to say — privately or publicly draw lines in the sand, or as they say in Washington, D.C., some red line. There's no red line in my mind about Amazon or any other tenant. I think we'll evaluate each situation based on the merits of the opportunity and make the decisions at that time. It's a

high class problem to even talk about like we have a choice. I think Amazon is a phenomenal company, a phenomenal business model that is some — a business model that I would like to stay in touch with and closer — get closer to, even, and if we can do more business with them, assuming everything else makes sense — the economics and terms and all that — we're happy to do more business.

Rich Anderson
Okay. And then just a modeling question for Matt. So I know we traded emails on this earlier, but this three-line rent number came down strangely first to second quarter. I'm just curious what that is and how we should be thinking about the ramp of straight-line going for the rest of the year.

Matt Murphy
Well, as I said a minute ago, I wouldn't say it came down strangely. I think it came down totally predictably as for all the reasons I just said. We are burring through some of — really, that's development free rent that's burned off — is the short answer to that, and it's — so I do think in a static occupancy, without predicting future development, because that's the wild card that could make this change, which is why I tend to talk about free rent on a same-store basis, because there will — as we lease up our development portfolio, and we've talked about we've got a number of starts coming, there will be free rent associated with that. I think, honestly — well, whether it will be more or less than it was in the past, I don't know. The total development volume is probably a little higher, but I think what you'll see in the operating portfolio is at static occupancy, free rent — there's virtually no free rent on renewals today. There are exceptions to that, but it is really, really small. You're basically down to a third of a month per year of term on operating portfolio free rent, which is the lowest it's ever been, so I don't know where the new free rent comes from other than development, and so the fact that it's dwindling doesn't surprise me a bit. In fact, I had hoped to foreshadow that as we talked about the numbers in the past.

Rich Anderson
Okay. So the entirety or most of the straight-line rent adjustment is free rent-based as opposed to just straight-lining fixed escalators over the course of the lease. Is that the right way to think about it, and what should we —

Matt Murphy
Yeah, the way that it works is the more free rent it is, the sooner it goes from a positive number to negative, because the total straight-line adjustment is the combination of the two, right? It's both free rent when you're recognizing revenue when they're not paying you any cash and also contemplating the bumps in the future. So, yeah, you will always have a free rent component as long as there's bumps. The smaller the portion of that adjustment that is represented by free rent, the less volatile it becomes, and therefore the less noticeable it becomes.

Rich Anderson
Okay. So going forward, should we think that the second quarter, putting aside the development free rent, is a reasonable run rate?

Matt Murphy
I never parsed it like that, so I'm reluctant to answer. I think theoretically the answer's got to be yes, but I haven't — I didn't really — I haven't split it into its two components.

Rich Anderson
Okay. All right. No biggie. We can talk about it offline if we have to. Thanks. I appreciate it.

Matt Murphy
Yeah.

Phil Hawkins
Thanks, Rich.

Operator
Our next question is a follow-up from Eric Frankel of Green Street Advisors. Please go ahead.

Eric Frankel
Thank you. Yes, one quick follow-up. Given that it is difficult to find good land locations that you like, can you tell me about maybe some recent experiences or your strategy going forward and maybe re-entitling non-industrial sites for industrial use, whether they're dead balls or suburban office buildings or the like?

Phil Hawkins
We've had conversations with a few people from the retail world, very high level, theoretical, and, frankly, what we confirmed is that it's going to be a needle in a haystack, a haystack full of opportunities and maybe one needle in there, nothing that's moved on along enough to say that it's possible or get a personal feel for how hard it is. I think it's going to be very hard, so it's hard to — we're still focused on land that comes from a manufacturing or industrial use for the most part or it's already zoned distribution or industrial, whatever that might be. Bud, is there anything — you're missing — maybe you've not gotten a chance to talk. Anything you would add to that question?

Bud Pharris
Yeah, great point, Phil. In the Inland Empire as an example, Eric, there is a Southwest Industrial Plan, which is a fairly new master planned area for industrial, so they're taking a little bit more of a blighted area and creating more of an overlay. So we've had some good successes in finding a couple of owners that are contiguous, tying them up, knowing that in time, this general plan is going to affect this area. So we've had some successes, again, in that Fontana Swift Area, and so that's one of the things. I've also noticed that there are some situations where you've had — where you have an opportunity to acquire a piece of land and bring it through the entitlement process. Phil mentioned earlier the challenges maybe of some of the neighborhoods of contiguous uses, and it's a struggle, but I know our market team certainly on the West Coast, we've experienced that gone to city council meetings and fought the fight with some pretty decent success. So I'm encouraged that it's one-off deals, just fighting away to find the right deal to develop in the future.

Eric Frankel
Interesting. If not, you or maybe one of your competitors, you know, I think the only thought I have is that with — you know, especially with dying malls, you can buy them at relatively high yields and perhaps the land base is even — you don't know exactly what it's going to be in five or ten years time, looks reasonable enough, so I'm not sure if you or your competitors are considering buying some of those sites and then hoping in five or ten years, it works out that industrial [unintelligible].

Phil Hawkins
I have a tough time — I probably shouldn't comment on a hypothetical topic, but I'll do it anyway. From my perspective, I'd have a tough time supporting a deal that is not zoned for our business and believing that we could make money even if it doesn't go our way on industrial. Maybe we

can, maybe others would do better, and maybe others have a business plan or a business model or a mandate from their investors that allows them to do a more broader — take a more broader perspective with investing. I wouldn't, without knowing the circumstances to compel me otherwise. I'd be very tough — a tough sell on why we should take on a retail land that doesn't have an industrial use or not a strong probability of an industrial use. That's not our business. There's plenty of ways to make money in our world and many ways to make money in real estate. What's served us well at DCT is focusing and focusing on our strengths, keeping — sticking to our knitting, and we've got to keep doing that, even if we look to our side or behind or in front of us with envy to somebody who had a broader mandate or more confidence or whatever, that did something that we didn't do. I'd rather stick to our knitting. We're doing just fine doing that.

Eric Frankel
Thanks. I don't want to take up a lot of time, but if there's no more questions in the queue, I think my one last question is just that given that industrial REITs seems to be trading at pretty good value with low implied cap rates, [unintelligible] premiums, whatever have you, I understand you're trying to sell lower growth assets, but do you have any thoughts in terms of being a little bit more aggressive in buying assets in markets and submarkets that you really like right now?

Phil Hawkins
We are trying. I'd say we are a little more aggressive today than we were six months ago, but so is everybody else, so our relative position doesn't seem to have changed. We've prevailed on a few that Matt mentioned in his remarks. I'd like to buy more if we could, if we love the real estate building and location, tolerate the initial return and like the growth, whether it be rent bumps in place and/or below market leases that roll over in the relatively near term, yeah, we'd like to buy more if we could. It's just not easy, which is why we're not the only ones that like our business. A lot of people want to invest in industrial right now.

Eric Frankel
Okay. Thank you.

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
Hey, thanks, everyone, for joining our call today and your interest in DCT. We had another good quarter and remain intensely focused on executing our business plan and capitalizing on the opportunities in our markets to deliver results and create value. We'll keep doing that. In the meantime, enjoy the rest of your summer, and we'll talk soon. Bye.

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