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# Gramercy Property Trust's (GPT) CEO Gordon DuGan on Q4 2017 Results - Earnings Call Transcript

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## Q4: 02-25-18 Earnings Summary

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EPS of \$0.52 | Revenue of \$122.48M (+ 28.2% Y/Y) beats by \$1.91M

Gramercy Property Trust, Inc (NYSE:GPT) Q4 2017 Earnings Conference Call March 1, 2018 11:00 AM ET

## Executives

Gordon DuGan – Chief Executive Officer

Ben Harris – President

Nick Pell – Chief Information Officer

Jon Clark – Chief Financial Officer

## Analysts

Ki Bin Kim – SunTrust

Karin Ford – MUFG Securities

Craig Bibb – CJS Securities

Mitch Germain – JMP Securities

John Massocca – Ladenburg Thalmann

## Operator

Thank you everybody for joining us and welcome to Gramercy Property Trust Third Quarter 2017 Financial Results Conference Call. As a reminder, a supplemental for the call is posted on the company's website at [gptreit.com](http://gptreit.com), in the Investor Relations section, under Events and Presentations. [Operator Instructions] Please note, this conference is being recorded.

The company would like to remind listeners that during the call, management may make forward-looking statements, actual results may differ from the predictions that management may make today. Additional information regarding the factors that could cause such differences appear in the MD&A section of the company's Form 10-Q and other reports filed with the Securities and Exchange Commission.

Also during today's conference call, the company may discuss non-GAAP financial measures as defined by the SEC Regulation G. The GAAP financial measure most directly comparable to each non-GAAP financial measure discussed and reconciliation of differences between each non-GAAP financial measure and the comparable GAAP financial measure can be found in the company's press release announcing third quarter earnings, a copy of which can be found on the company's website.

Before turning the call over to Gordon DuGan, Chief Executive Officer, of Gramercy Property Trust [Operator Instructions] Thank you, and please go ahead, Gordon.

### **Gordon DuGan**

Thank you very much. For anybody worry that they're living through ground haul data movie this is our fourth quarter earnings call, not our third quarter earnings call. Good morning thanks for joining us. With me as usual Ben Harris, Nick Pell and Jon Clark. I'm going to try to keep my comment snappy and turn it over to Ben. And keep them relatively high level and give you a sense for our perspective on the market today.

Going back to our Q3 earnings call. **We started to pull back on our external growth expectations.** And that was before the significant REIT selloff that we've seen this year. And there are a couple of factors playing into that that continued into this year, and that's reflected in our guidance that we put out this morning of AFFO per share of \$1.90 to \$1.95. We also to know, **I think most of you saw did also guide to positive industrial same-store sales growth as well as positive office and specialty same-store sales growth.** And that's reflective of how we see the business going into this year.

The other thing I'd point out is in the fourth quarter. We were successful at a number of asset sales. We sold five buildings for roughly \$156 million this was to offering our leverage down. We brought our leverage down by the end of Q4 and we continue to sell non-core assets into 2018. One thing, I think that's interesting you'll see in the supplemental and in the press release. **We sold office buildings in one of our lifetime fitness centers, the overall blended cash cap rate on that was just over 6.5%. So we've continued to get good execution on selling our non-core assets.** But clearly the business

has gone from a shift from portfolio repositioning now to looking for ways to generate better internal growth. Ben will speak more to the leasing stats and some of these other issues a little bit later.

Today clearly our cost to capital that's not allow us to be competitive buyer of large amounts of stabilized industrial assets. Our plan is to recycle capital increase the quality of the portfolio as we go through the year, but I wanted to just pause for a piece of perspective on that. If you go back to the merger with CSG in December 2015. And some of you've heard me say this, if you could have gotten in a time machine and gone to the future in December 2015 and looked around the world today and then gone back to December of 2015 you would have done exactly what we did and that is we sold roughly \$1.8 billion of assets almost all of them assets to assets over that period of time. And we've invested in \$2.7 billion of high quality industrial assets over that time. This portfolio repositioning has created tremendous NAV accretion. They clearly has not reflected in our stock price today and today we stand with an industrial portfolio that's 85% of the value of Gramercy's overall real estate holdings.

And so again I think for perspective, the progress that we've made and the NAV accretion that's been created by doing so has been very, very significant. Today the industrial market and the market that that we focus on is buying primarily stabilized assets in major markets, in that marketplace cap rates in 2017 compressed across all assets in all of these major markets. And there are a number of very good reasons for that. There was good rental growth, you have low vacancies, strong absorption and a supply and demand dynamic that's in balanced, thoughtful and disciplined. And so there's a reason why investors in the private markets are focused on industrial assets today.

And within the net lease sector, I would say that in that – as I look at other earnings reports and write-ups on those earnings report, it prompted me to point out that industrials quite different within the net lease sector. You actually have real rental growth in industrial assets that you don't have in net lease retail assets. Net lease retail assets are through fixed income type instruments. There's no real rental growth in the leases, and you don't get to mark those rent those assets to market ever if there is real rental growth.

And so the difference between industrial single tenant assets, and retail single tenant assets that you have the opportunity for real rental growth. And we designed our portfolio from day one to take advantage of that many of you heard us say that we by basically good assets that happen to be single tenant and that's been historically what we thought,

we've also bought some very high quality portfolios of more multi tenant industrial as well. But that's been the primary focus and in our portfolio should be able to take advantage of higher growth.

The other advantage to our investment strategy in industrial as we have a much better credit profile across our portfolio. We have very little exposure to any variety of retailer. We have tremendous industry diversification. Please look at the page in supplemental that breaks that out. There's always one or two companies that are paying later, we have a very large tenant base companies that may file for bankruptcy. But because we own high quality industrial assets for the most part those are easy to re-tenant if we do lose the tenant relatively, but the credit profile of our portfolio is not being recognized in the marketplace today, and that's been one of the benefits of the portfolio that that we put together.

The other thing, I wanted to point out is the industrial investment sales marketplace, isn't really impacted by the public REIT market and will not be terribly impacted in my view by the public REIT market. Sell-off, because industrial REITs are not – have not been significant buyers of industrial properties over the last few years. Other than Duke taking the medical office building proceeds and investing them, they have been almost exclusively developers, they're not buyers, the private market is led by core funds, private equity funds, et cetera and the marketplace continues to be very robust and again industrial REITs aren't really major buyers of assets in the private markets.

And again just for perspective, all of the publicly traded REITs put together in the industrial sector are about a billion square feet of space the U.S. institutional quality industrial markets 15 billion square feet. So not only are they not major buyers at all, but the private marketplace is far larger than the public marketplace for industrial REITs.

So the reason I point that out, I don't think in my view that the fall in public REIT prices is going to mean, cap rates are going up in the industrial sector. And, I would point to in or I would say that our expectation – my expectation is that you're going to have flattish cap rates in the industrial sector in 2018.

Last comment on external growth. I've been in this business for 30 years. At this point in the cycle it is not the time to reach for yield. There are assets we can buy that would produce 7%, 7.5%, 8% yields, if you're buying industrial assets with those types of yields. You're buying assets, you have very low credit quality or assets that physical attributes of those assets are very low quality. We are focused on higher quality assets in major markets, just as we've always been and if anything over the past two years, we've gone

higher on the quality scale in terms of our acquisitions, our expansion of our portfolio in Atlanta is a very good example of that we now have a significant Atlanta industrial portfolio and that's an example of where we've gone up in quality. And we've been willing to make that trade-off even though it makes external growth very difficult. We think it's the right trade-off especially at this point in the cycle.

That doesn't mean we don't have other strategies, as we've mentioned in the past we have a couple of asset like strategies and in our E-Commerce JV with the large Sovereign Wealth Partners we just closed in Q1 our first acquisitions in that JV. Our own portfolio, we expect to track pretty close to market rent growth on an overall basis, and we've also added some value added assets that you may have seen in the Q4 release that have the ability for higher internal growth.

Last thing, I'll say is, as we look around the market today, we don't have a cost to capital that allows us to continue external growth. My own personal belief is, there's been an overreaction in the marketplace and indiscriminate selling across the REIT sector and there's not a look through the asset quality of the underlying REITs and but that is the current landscape and we've adjusted for it.

At the same time we have a lot of flexibility with our business we have tremendous asset quality and we feel very good about where we are today. I guess that's on a relative basis, but we do feel very good about the amount of flexibility we have given high asset quality, and good positioning in major markets.

With that I'll turn it over to Ben Harris.

### Ben Harris

Thank you, Gordon. Let me start with the balance sheet. We ended the quarter with net debt to EBITDA of 6.0 times or 6.1 times adjusted to include the full impact of acquisition disposition activity during the quarter. Last quarter we early adopted the new NAREIT definition of the EBITDA, unfortunately this cause significant confusion among our investors. So we've decided to switch back to our old covenant definition, which we've been using in the past, and we'll continue to use after the time being until NAREIT definition is more broadly adopting [ph]. For the quarter the NAREIT definition would have been approximately 0.1 times higher. So there isn't a significant delta for consistency sake. We've gone back to the covenant definition.

We provide further detail on our leverage and capitalization on Slide 11 of our supplemental. At the end of the year, we entered into an interest rate hedge for a planned 10 year bond offering in 2018, this hedge locked in a 2.23% rate for 10-year on a notional amount of \$250 million. We currently expect to complete the bond offering during the first half of this year and our earnings guidance incorporates this bond offering and one additional bond offering in 2018 as we continue to ladder out our balance sheet. We closed the quarter with total liquidity of \$523 million and have an additional \$123 million in dispositions that have either closed or under contract since quarter end.

Next, I want to touch on leasing stats. For the quarter we executed 3.1 million square feet. Brining total leasing for the year of more than 6 million feet. Q4 leasing spread was minus 3.8% and the straight line leasing spread was 6.3% for the year cash leasing spread was 2.9% and the straight-line leasing was 13.4%. The largest drivers in Q4 leasing spread, were three large industrial leases that we proactively signed during the quarter on Class A bulk warehouses we signed these leases with large multinational tenants where we believe the term in credited of these renewals create significant value and we may look to monetize those assets during 2018. We continue to see strong tenant demand for industrial space across all types of industrial assets. And have made significant progress on renewing or releasing our 2018 expirations highlighted on 24 supplemental.

Next, let me touch on same-store sales. For the quarter the portfolio generated the same-store sales NOI increase of 0.6% and industrial sub-portfolio generated the same-store sales NOI increased at 0.8%. This same-store sales cohort includes approximately 67% of our total portfolio and 61% of our industrial portfolio. So I caution people to read too much into this because we have been growing it still doesn't represent our portfolio.

For the full year, the portfolio generated at same-store sales NOI increase of 0.3% largely driven by activity during the first half of 2017 that we talked about on the past calls. And the industrial sub portfolio generated to same-store sales NOI decrease of 0.8%. The full year cohort includes approximately 55% of our full portfolio and 47% of our industrial portfolio. We include a couple of additional slides in the supplemental that we believe give some additional color on our portfolio performance.

On Slide 28, we broke out year-over-year same store NOI in the two components a stabilized portfolio, which includes 234 buildings and account for 96.7% of our portfolio and if they can see a leasing portfolio, which includes nine buildings and account for 3.3% of the portfolio. That vacancy a leasing portfolio are essentially the assets where there's a moving part, it's a piece of the portfolio that I would expect significant volatility as they goes wage and or it's leased up for the quarter to stabilize industrial portfolio generated

3.2% same-store sales NOI increases and the vacancy in leasing portfolio with a negative 63.1%. And the negative was largely driven by an increase in vacancy across those nine buildings. As those buildings leased up you'll see a reversal of that, but again what we try to do is isolate the highly variable piece.

On Slide 29, we included a sequential quarter-over-quarter same-store NOI for our industrial portfolio. This metric is an attempt to capture a much larger share of our portfolio and includes our newer acquisitions. We build our measure gives a better real time performance of the overall portfolio for the quarter that the industrial portfolio generated a 0.8% quarter-over-quarter same-store sales growth, which equates to a 3.2% annualized figure. We think that this is a good way to keep track of sort of a stock valuation of that portfolio

I'm going to hand it over to Nick to talk about the acquisition environment.

### Nick Pell

Sure. Thanks, Dan. We acquired three stabilized industrial properties for \$106.4 million in the fourth quarter that had carried over from our previously announced nine property industrial portfolio. These assets were located in Chicago, Boston and Reno. Initial cap rate of these assets was 6.4%. Two of the assets are long lease single tenant assets in the Reno building as a multi tenant fleet lease warehouse with significant excess trailer storage tanks at the airport. We also acquired two value added Class A industrial assets for \$38.6 million in Miami and Atlanta and we expect both of these assets to stabilize to approximately 6% initial cap rates when leased. We also commenced a \$46.4 million build-to-suit project for a million square foot warehouse in Memphis. On a ten year lease that we yield a 6.4% initial NOI when completed.

For the year we acquired \$1.3 billion of stabilized industrial real estate at initial cap rate of 6.3% an average price for square foot of \$67. We also added \$77 million of value added short-term or vacant Class A real estate into the portfolio.

In general, I would characterize these acquisitions as geared towards improving the overall quality and composition of our real estate portfolio. Our focus is on the acquisition side continues to be increasing the NAV of our real estate portfolio. The asset quality of some of our more recent acquisitions is already evident and some of the shorter term leases we assume as we continue to see favorable industrial fundamentals across our markets with rents outperforming our underwriting in many cases.



The industrial marketplace continues to reflect these strong leasing fundamentals and relative attractiveness of the real estate asset classes. Buyer pools remain deep in diverse for high quality assets in primary and secondary markets in cap rates remain a historic lows in a compression largely in many markets in the second half of 2017. CBRE just published at 2017 cap rate survey and reported that Class A, and Class B cap rates compressed 12 to 23 basis points in Tier 1 and Tier 2 markets in the second half of the year. The biggest impression being on Class B assets in Tier 1 markets. On average CBRE Tier 1 market cap rates were 4.6% on Class A assets and 5.6% on Class B assets. And Class A cap rates in Tier 2 market were 5.5% and Tier 3 market a 6.2% cap rate.

As I look at our investment activity in 2017 acquiring mostly Class A and B assets in Tier 1 and Tier 2 markets, which are pretty good about the investments and pricing we achieve despite the intense competition and continued cap rate pressure. So to offer just a little flavor of what other principals in the industrial marketplace we're talking about, I would say conversations are not send it around rates were depressed prices of REIT stock as Gordon alluded to, but really not deploying private equity funds that have already been raised placing to the margin allocations of core and core plus funds into the market. Capitalizing on favorable development spreads which are 100 basis points to 200 basis points in many markets across the country finding good land sites in primary and secondary markets and then underwriting the impact of rising construction costs for new buildings. And so that's really the marketplace that we're dealing with out there and continues to be very strong and we're happy to own \$76 million feet of industrial products.

So with that, turn it over to Jon.

### **Jon Clark**

Thanks, Nick. I'm just going to highlight some of the per share figures quickly and then to touch on a few things on our financial statements. We recorded nearly FFO for the quarter of \$0.51. This compares to \$0.48 in the prior quarter. Our Core FFO was \$0.52. This compares to \$0.53 in the prior quarter and for the year, our Core FFO was \$2.05. AFFO for the quarter was \$0.49, compares to \$0.51 in the prior quarter. Our AFFO for the year was \$1.90.

Just as a reminder last quarter our FFO, Core and AFFO was positively impacted from the promote revenue that we aren't in connection with the sale of the assets in Gramercy Europe. That are contributed about \$0.06 in the prior quarter with no corresponding contribution in the fourth quarter after the sale.



On a GAAP basis, we recorded net income of about \$0.10 a share that compares to \$0.03 in the same quarter the prior year and net income of \$0.32 in the prior quarter. For the year, GAAP net income was \$0.52. Again, our GAAP net income was significantly higher than prior quarter from this promote revenue from Europe and also the substantial gain on sale that we recorded in the third quarter.

The properties we acquired during the quarter that Nick had mentioned added \$0.06 to NOI. This was partially offset by a higher dilutive share count, most of which was related to ATM issuances part of the way through the third quarter. So we had a full quarter impact in fourth quarter. And to a lesser extent, we issued \$1.3 million OP units in the quarter and connection with the acquisition of the three industrial properties on October 4. Those units were issued at a price of \$29.56.

We did not use the ATM in the fourth quarter. The only equity issuances in the fourth quarter were the OP units. This variable accounting noise in this fourth quarter, so there is very little that requires a lot of explanation or results for those of you who have followed us. We've been very active and there's been a fair amount of one-time accounting items. It's nice to not have those hits in the fourth quarter here.

Just highlighting on the income statement that rental revenue of \$122.5 million compared to \$110.2 million in the prior quarter with the increases being attributable to the significant amount of acquisitions, both of our two-thirds of the way through the third quarter as well as the acquisitions on October 4 in the fourth quarter. Third-party management fees were \$2.5 million, which is comparable to the prior quarter of \$2.1 million and while the management fees remained flat property management expenses were \$2.2 million compared to \$3.3 million in the prior quarter. That decrease was entirely related to Gramercy Europe and compensation expense that was contractual and booked in the third quarter.

G&A was \$9.4 million comparable to \$9.6 million in the prior quarter. Interest expense was up slightly to \$26.3 million as compared to \$24.3 million in the prior quarter, primarily due to a higher average balance on a revolving credit facility. We did start the quarter with \$615.1 on the revolver, but it had reduced that to \$357.2 million by year-end. Our cost of borrowing at year-end was about 3.4% just up slightly from the prior quarter, which was 3.3%. Finishing up on income statement, we recorded \$22.6 million of gains on property disposals during the quarter and we had impairments of \$16.4 million on other properties for net gain of \$6.2 million for the quarter.

Just a few quick comments on the balance sheet. We've highlighted in our supplemental and we've talked about the mezzanine loan program that we have and just to point out to people that the mezzanine loan program is it – the balance is included in other assets on our balance sheet and that was one of the contributions to the increase in that line item.

Moving on to liability section and connection with the acquisitions this quarter, **we assume \$66.5 million of mortgage debt.** We did reduce mortgage debt by about \$112.5 million over the quarter was scheduled amortization payments as well as prepayment of about \$108 million during the quarter. Basically for the year, we thought prepaid secure debt prepayment windows were open to us where we could do so for little or no cost.

And also just to remind people at the beginning of the fourth quarter, we closed on our new \$400 million, five-year term loan, that term loan was swapped to a fixed rate of 3%, which was about 34 basis points inside the old seven-year term loan. Net proceeds of that we used to reduce the revolving credit facility and also to extinguish the mortgage debt that I referred to.

Gordon, that's it from me.

**Gordon DuGan**

Thanks, Jon. We'll turn it over to Q&A now.

## **Question-and-Answer Session**

**Operator**

[Operator Instructions] Your first question comes from the line of Ki Bin Kim with SunTrust.

**Ki Bin Kim**

Could you just talk about your longer-term portfolio strategy what the ultimate mixture look like and what are the asset classes that are you looking to perhaps add to ourselves.

**Gordon DuGan**

Sure. Hey good morning, Ki Bin. We've been focused on the – what I would describe as higher quality yield in industrial in good markets. And we've been – I'd say less focused on growth and more focused on yield. That's somewhat out of favor right now. But I think that investors are overlooking the possibility that there is still grow in our industrial portfolio. It's just not the same growth as the other industrial rates. The two big differences being we're

starting off at very high occupancy levels. So last year, our same-store sales was primarily hit by decreasing occupancy level, has nothing to do with the quality of the assets. It's just start at 99% occupancy. You're not going to say 99% occupancy forever.

And the second thing is we have a little bit – we have less mark-to-market in our portfolio, not every industrial REIT discloses their mark-to-market in our portfolio not every industrial REIT discloses their mark-to-market prologues has lot of mark-to-market potential. They also have a lot of CapEx. So the other things that we like focusing our investors on, if you look at our CapEx ratios in our leasing activity. They are the lowest of any peer that I know. We're consistently running in the mid-to-high single digits from a CapEx ratio. And so while we're not getting mark-to-market, the same way our CapEx ratio is significantly lower prologues use as a rule of thumb of 12% to 15% and we're consistently in the single-digits.

So we start with very high occupancy. We think occupancy is basically stabilized. If you go up a little, go down a little bit, but we had that occupancy headwind. And we haven't had the same mark to market opportunity. And so I don't think we're going to change drastically from that keeping we're still looking to add assets in our core markets like Atlanta and some delta markets that we like. But that's what I would say, Ben...

### Ben Harris

Yes. I think our goal is to have – is to improve the ability to generate internal growth, but I to reiterate what Gordon is alluding to. I think where we fit within the value proposition is not to compete with some of the high growth rates, but to provide a higher level of free cash flow for investors. But we have been and we'll continue to work towards positioning the portfolio to improve its ability to generate internal growth.

One other thing, we – I would expect us to continue to harvest office assets and continue to shift the mix towards industrial that's the direction of business has been growing and will continue to go.

### Ki Bin Kim

But longer term, and you guys have done, you guys own some lifetime office from Nasdaq. At the end of the day, do you think that perhaps can be distracting to a investors view your company or your stock.

### Gordon DuGan

We're long the office and lifetimes and that's why, I pointed out Q4. I don't think – I think Q4 is a good example of how we view our portfolio. We sold four office buildings in one lifetime. And we'll continue down that path, where there's no need to do it all at one time, but I think investors would like to start their own office in lifetime and we're moved very, very drastically in that direction. And we continue to move in that direction. I don't think – Ki Bin, I think that – I don't think that the existence of those assets is particularly verdict on our company one way or the other. We're 85% industrial into keep moving in that direction. And so we own 76 million square foot industrial portfolio it's more than – I believe the seventh largest industrial portfolio in the United States.

**Ki Bin Kim**

Okay. And then...

**Gordon DuGan**

That's how investor should focus on it, but we are moving away from the office in lifetime holdings.

**Ki Bin Kim**

Okay. And this time today, if I actually look under the hood and look at the way your personnel spread or your business strategy in the industrial segment. What would you say is different from the way Gramercy is build versus some of your industrial peers.

**Gordon DuGan**

Yes. I'd say this, the DNA of our industrial peer set is development. And we've been a buyer of either stabilized or nearly stabilized assets. And that has led to – we've been very successful at it. One of the reasons I was point out about, how small all of the public peers are including for largest in the U.S., industrial, institutional market is because, we don't compete for acquisitions with the other public REITs, we compete with core funds and value adds investors, we compete with guys like Cavett [ph], TA of whole variety of institutional investors in the United States by stabilized industrial assets in competition with us. And we don't compete with the other public REITs.

I think in terms of the quality of the portfolio, it's very similar except for the two things I highlighted. We've had historically higher occupancy. And so our same-store reflects occupancy headwinds rather than a tailwind. And we have generally speaking less mark to market, because we thought more recently purchased assets, but if you look at some of

the, I know, you do, because I read the transcripts and I see your questions. Some of the other industrial REITs are losing those 2010, 2011, 2012 vintage leases and losing some of that mark to market.

And so I think our same-store sales growth of 1% to 2.5% on our industrial portfolio, while lower than the industrial peer set. It's going to come – that gap is going to narrow over time. If people – I wish we had a bunch of assets that we signed leases for in 2010 and we just don't. So it doesn't reflect portfolio quality, it reflects portfolio, it vintage of lease well.

### **Ben Harris**

Ki Bin, one other thing I'd point you to, Slide 28, we split that – split our portfolio into a stabilized portfolio and if they can see leasing portfolio. For a strategy that's looking to maximize free cash flow and stability of cash flow. You end up having the vast majority of your portfolio allocated to the stabilized components. If we were looking to generate very high same-store sales, but at the expense of that stabilize cash flow, we would change that mix. And add – we would add significantly to the vacancy and leasing portfolio. Because that's essentially where you're going to get all the growth, if we were buying millions of feet if they can build buildings or delivering millions of feet of they can develop.

In a strong leasing market that generates very high same-store sales growth. We think that across the public peer group, there are lots of operators that do an excellent job of that they have good. **They have land inventories that they're able to capitalize on.** That were acquired, that's a bottom of the market. They have mark to market opportunities, as Gordon said. But it's a different strategy that they tend to have higher CapEx and they're going to be much higher paid in an industrial market downturn. If the industrial leasing market get softer, markets get over built there highly exposed to that risk. Our portfolio is by design meant to be sort of lower volatility.

### **Ki Bin Kim**

Okay, thank you guys.

### **Gordon DuGan**

Thanks, Ki Bin.

### **Operator**

Your next question comes from the line of Karin Ford with MUFG Securities.

### **Karin Ford**

Just wanted to talk about guidance, so you had a clean run rate AFFO number of \$0.49 in 4Q, annualize and it comes out to about \$1.96 versus the midpoint of your 2018 guidance of between \$1.92, \$1.93. I know there's a bit of delevering still in there. Because you walk us through anything else, it's causing AFFO to decline in 2018 and talk about when you expect AFFOs to be flat.

### **Gordon DuGan**

Yes. Thanks, Karin. It's a good point. There are couple of things, there's a slight delevering effect. And then in Europe, we're going to lose AUM in the second half of this year, that's \$0.02 roughly. And we also have a known move out on an office building in Columbus that we've highlighted. It's small, but that will also have a small effect. We only have two office maturities this year, one of which we released and that building is going to hit the market for sale. And then the other one is just building in Columbus.

### **Jon Clark**

One other thing to add to that is, we expect to term out debt, it's really issuance of bond. So there's an effect to add as well.

### **Gordon DuGan**

Yes, that's right. And the last thing, I would say, Karin, our same-store sales guidance of one to one and half specialty in office takes into account that known move out. So there is an effect there. So we're getting some other rental increases, but we will have that rolling down.

### **Karin Ford**

That's good color. Thanks for that. My second question is, I think you said on the last call that you are allowed to sell industrial assets today. But given a continuing strong bid in your stock trading at 20% discount to NAV. Why not consider selling some to delever, buy back stock. Can you just talk about – just sort of list what your capital allocation priorities are right now.

### **Gordon DuGan**

Yes. I think that's a great question. I would say that – it's amazing what a quarter, a difference quarter mix. And in public REIT world, you never, if we looked at this call or quarterly earnings call every time over the last 5.5 years. Our cost of capital has been all over the place. And it's one of the real challenges, up being a public REIT management

team. I would say that, what's different today is we would sell some of that industrial real estate, where we think, we can get good value for on the sale. And so I would say in 2018, you should expect the sale of some of our industrial – some of the industrial assets as well. And then we'll recycle that capital, where we think we're improving the quality of the portfolio. And that is the bit of a difference from last quarter and reflects the fact that we're now trading at a significant discount to NAV.

### Ben Harris

We'll look to harvest assets, I've mentioned in my comments on same-store sales, opportunities where we believe there's been a significant value created through a leasing transaction, where we've signed a new long lease, but where we believe that capital could be reinvested into other industrial assets that will generate higher longer term growth. So if you think about an industrial assets that will generate higher longer-term growth. So if you think about it – if you think about an industrial asset where its maximum value is the moment you sign a new long lease those would be the assets that we would consider selling in this environment. And reinvesting into assets where we think, they have to pay a potential for both NOI growth and value growth overtime.

### Ben Harris

And saw the note in or the comment in your note on the stock buyback, so I want to address that specifically. We don't have any intention of having a stock buyback today. But we will revisit that from time to time, we have had – we put in place a stock buyback program before some time ago. Interestingly, when we put in place we weren't able to buy any shares and the stock ran off. But today we do not have a stock buyback plan.

And we'll revisit that as time goes on. It's a –my view on stock buybacks is it can be good use of shareholder capital an accretive use of it. But it's never really fundamentally a business plan, it's just something you do around the edges. And in my career going back to W. P. Carey, we use them from time to time. So I'd like them at times but we don't have one at this current time.

### Karin Ford

Okay, great. Thanks for that.

### Gordon DuGan

Thanks Karin.



## Operator

Your next question comes from the line of Craig Bibb with CJS Securities.

## Craig Bibb

Hi, guys. Actually just a little quick on the – thought on the buyback. You just issued OP units at \$29.50 more or less, I mean, why not buyback stock at \$21.60 so I haven't just offset that?

## Gordon DuGan

We've been delevering since – we use Q4 to delever, we're continuing to delever a little bit. So it just doesn't feel like the right time to buyback stock even though, we're trading at a significant discount. As I said, we'll revisit that from time to time. But right now, we're using proceeds from the sale of non-core assets to delever. And part of that is, we maybe in this REIT funk for a while.

And I've also seen companies they pull the arrow out of the quiver and announce stock buyback. And a year later it makes absolutely no different. So I think this is a little bit different time than the last time we announced the stock buyback. It feels like we maybe in a REIT funk for a while. And I think it's totally overblown, but it is the reality of the situation today. And so we'll take our time on that. And right now, we're using asset sales to delever.

## Craig Bibb

Okay. So, back to growth. You guys do have a growth avenue, it seems to be with build-to-suit that activity is picking up. Could you give us kind of the timeline and then maybe strategically what you are thinking, correct thinking on build-to-suit?

## Gordon DuGan

We have three built-to-suits that are currently underway. It's been a way for us to compete in the development sector without having to do speculative development. And we gain a little extra yield on it, call it 50 basis points or so by four funding build-to-suit developments. So at the moment, we don't have any plans to really ramp that up. The back part of the build-to-suit business, Craig is pretty diluted from an earnings standpoint because you fund a punch of development, you make an interest return on it. But you're not getting your full – you're not getting rent NOI on it.

So it's always been a part of our portfolio but it's not a big part of it. And I think we – the growth we have is again through some of our more assets like – our assets like JV's. We have immense program and we have a good portfolio that should track market rent growth.

**Nick Pell**

Our view of build-to-suits and the build-to-suit markets, it's a component of the overall acquisition market. So we may recycle into build-to-suits but we wouldn't issue equity today to fund new build-to-suits to operating.

**Gordon DuGan**

Yes, that's a good point.

**Craig Bibb**

And that's a good transition into my other question. So your funding service to Europe with new capital and then strategic partners got active again in the quarter maybe there is a little thought process there?

**Gordon DuGan**

Yes. Basically the ROE's in both of those businesses are very high. They're much higher than balance sheet acquisitions. So we've like those, we're also aware that – I don't think they're particularly popular with investors. And so they're very small components of our overall activity. But they are – the rationale for them is they are very high ROE activity and higher – significantly higher ROE activity than that we do on balance sheet. But they're very small. We're talking about at this point less than \$50 million invested.

**Craig Bibb**

Okay. I'll turn it over to next person. Thanks guys.

**Gordon DuGan**

Thanks, Craig.

**Operator**

Your next question comes from the line of Mitch Germain with JMP Securities.

**Mitch Germain**

Hi. Thanks for taking my question. Gordon, I think you and Ben have done a really good job and been asked several times throughout this call about your thoughts on asset sales. And so obviously it's been evident that a big focus of sales so far has been office and industrial. And while you're obviously more keen to maybe sell industrial today and there is certainly a bid there for those sort of product.

It seems like things were leader cycle and my intelligence is telling me that the bid has spread for some, call it, single family office is probably widening a bit. I guess, I'm just curious why not just cut the cord and try to get – I think you are probably at about \$1 billion or so other industrial assets in your portfolio. Why not just kind of get rid off as much of as you possibly can right now. Instead of bleeding it out given the fact that we could – next year may not offer you that same opportunity.

### **Gordon DuGan**

Yes. It's a good question, Mitch. I think, here things one, the big – the private market bid is still pretty good for those assets. It's not what it is for industrial obviously, but it's still pretty good. And two, I would say all options are on the table. So, we would not stop a one – a one fell swoop solution for those non-core assets. We don't have any current plans but we wouldn't stop any and all options for those assets.

### **Ben Harris**

The way we view that portfolio is just – we own it has a market price and what's the net return that we're going to get on it. And so if we can sell all those assets as portfolio and had a return that we're willing to for go and sort of derisk and concentrate. That's a great option in our view. And if we're selling it so someone else can generate a 30% IRR it's probably not a good deal for our shareholders, so we probably wouldn't do it.

### **Mitch Germain**

Got it. Go ahead.

### **Gordon DuGan**

No, that it. That was a good point.

### **Mitch Germain**

Okay. Gordon, I know you are a big football fan. So, just looking playing a little Monday morning quarterback here pretty monumental change in your business a couple of years ago when you bought Chambers Street and you really accelerated that repositioning and

now your – I guess what's left of Chambers Street is really just has been able to help fund. Your growth into industrial looking back is there anything that you maybe – you might have done a little bit differently.

### Gordon DuGan

Well, it's always hard to speculate on that. I'd say, no. I mean, we've grown – I said it in my remarks and I mean it, that at the kind of closing had we flashed to the future and seen where the world is today. We would have done everything, we've done – we probably would have bought more industrial faster and we bought \$2.7 billion of industrial. We're probably should have bought more. Because everything we've bought is worth more today than when we bought it.

But you're talking about – we've been the most acquisitive public company of industrial real estate in the United States. So, it's not a regret – it's just a point that directionally we've been entirely right. And if we have to harvest some of that to show that then we well.

### Ben Harris

Mitch, I would say that we were a little bit conservative in how we reinvested a lot of the proceeds. We kept fairly narrow box sort of high quality stabilized assets. I think with perfect hindsight if we had allocated a portion of back half at all to spec development or more speculative industrial assets, we would have been exposed to what has been a tremendous run in industrial rents over the last two years. Or we would have been more exposed to that. And I think that would have been beneficial, but that would have been a pretty big deviation from the business plan settle.

### Mitch Germain

Yes.

### Gordon DuGan

I think from a strategic standpoint it's worked out as well or better than we were expecting.

### Mitch Germain

Great, and just to make sure, since I missed a few comments along the way throughout the call. Selling assets and likely most of the fund that will be within the joint venture funds share right, is that the way to kind of think about where you think is the best place to be putting capital to work?

**Gordon DuGan**

I wouldn't say most but I'd say a material amount. And it really is going to depend on cost of capital going forward. I think our guidance and our attitude reflects the fact that we think this is going to be a REIT fund for awhile. We were one of the first three to start highlighting that in Q3, part of it is the very strong private bid for industrial assets. But we don't expect our cost of capital come roaring back immediately. These things come and go. Again if you look at our cost of capital over the last 5.5 years it's been all over the place. I would say that that we'll see how things go with our cost of capital this year. But at this point I would say yes the material amount in the JVs.

**Jon Clark**

And on balance sheet, I think, it's going to be primarily just capital recycling. So if we have an opportunity to rebalance into a market that we are more constructive on long-term or trade out of one asset by another asset those will be the transactions that we'll look out. Not external growth through issuance of stock and acquisition of assets.

**Mitch Germain**

Thank you.

**Gordon DuGan**

Thanks.

**Operator**

Your next question comes from the line of John Massocca with Ladenburg Thalmann.

**John Massocca**

Good morning everyone.

**Gordon DuGan**

Hey John.

**Jon Clark**

Good morning.

**John Massocca**

I think touching on that last point a little bit if capital recycling is going to be kind of what you're doing on balance sheet necessarily. I mean what would you expect the spreads to be between dispositions and acquisitions?

**Gordon DuGan**

I would assume that they are flat or in our favor on the industrial side.

**John Massocca**

Okay and then in terms of with everything though including kind of office dispositions is that going to be a drag on earnings.

**Jon Clark**

I think flat to may be flat to may 50 basis points of drag overall. It's not going to be a massive drag.

**John Massocca**

Okay. I may take notice.

**Jon Clark**

But just to add I think we – 2015 and 2016 we embarked on a on a pretty programatic asset disposition strategy. We were really managing to portfolio composition and less towards earnings. We were looking to take a portfolio that was roughly 50% office, 50% industrial. And reorient or rebalance that portfolio towards industrial. Our view of that is that's been largely completed. It will continue on the margin but our view is that going from 80% to 85% industrial, or 85% to 90% industrial doesn't materially change anything. So...

**Gordon DuGan**

Primary strategy in this market.

**Jon Clark**

Our primary strategy is really just around specific portfolio optimization, earnings optimization. So we'll be looking for opportunities to if there's an office building that we look at the next five or ten years of NOI growth time we don't like it, that would be potentially an asset that we would sell, but it's not going to be programmatic in the way that it was over the last two years.

**John Massocca**

Okay so not really go wholesale kind of portfolio shift?

## Gordon DuGan

That's right. Unless there's the really interesting opportunity to do that, yes.

## John Massocca

Okay. And then kind of looking at Page 24, going through your lease expirations this year, it seems like there's a decent amount of rent roll downs in the industrial sector as well. I mean what's kind of driving that?

## Ben Harris

I'd describe where we've seen rent roll downs in the industrial sector it's typically one of two scenarios. It was either sale leaseback where rents were necessarily set at market. We have none of that in this portfolio or in these explorations, but we have had some of that in the past. The CEVA transaction in Houston last year was a significant rent roll down on high quality in Houston. But the rents have been set too high in the sale lease back that had been done by another company.

The other place where we've seen some rent roll downs is build-to-suits. And at the expiry of a build-to-suit, typically in the build-to-suit you get a 10-year or 15-year lease. But typically those rents and we said this in the past I'll call it 10% to 20% of our market. And the developer rolls in some specialized CI or the tenant has specific desires in terms of increased lighting or increased parking or what have you that may not translate within the market.

So we set a good rule of thumb on build-to-suit as a 10% to 20% over market brand. And where you've seen roll downs those have been in this slide those are build-to-suit transactions for large very high quality credit companies in those markets. One I would point out in Wilmer, Texas that was a ten-year lease renewal with a single-A-plus credit. And in South Dallas, which is a one of the few weak markets where there's a little bit of oversupply, that had an 8% CapEx ratio. So the thing that you're not – the reason I keep harping on the CapEx ratios is that there is some tradeoff between CapEx ratio and least roles. And so when you see those leasing spreads you also have to focus on CapEx ratios. And we have much lower CapEx ratios than other typical REITs.

I'd say lease term as a big variable in this. As I said in my remarks these were opportunities where we believe by executing a long-term lease with a high credit tenant on these Class A assets we can create significant value. And these become opportunities to



monetize those. There's a tradeoff. When a tenant goes to market with and with an RFP, they'll generally look for quotes, rent quotes on a bunch of different lease terms. So they'll ask for three-year, five-year, seven-year and ten-year proposals. And there's a big discount to get a ten-year lease versus a three-year lease. The tenants are willing to pay up for that optionality.

So it really – it depends a lot on the specifics of what you're trying to do with a particular asset, it depends on the characteristics around an individual asset. So we're usually just looking to maximize the value of an individual asset. In those cases we thought the tradeoff is getting significant turn from a high quality credit far outweighed the slight rent roll down.

### Jon Clark

And to Ben's point on the Jacksonville and Wilmer, I have those in front of me I don't have the Hazelton. All three of those credits are single-A-plus or better. And the GAAP leasing spreads on those renewals were all positive. I don't have it for Hazelton, but I do have it for Jacksonville and Wilmer, where there were positive GAAP leasing spreads.

### John Massocca

Is there any thought – maybe to taking less term just given how kind of...

### Jon Clark

No, no.

### Ben Harris

We won't generally take that trade.

### Jon Clark

Yes it depends. In certain markets and I'd also say in certain building sizes.

### Ben Harris

Yes.

### Jon Clark



These are very large bulk warehouses in what I would characterize as majestic's driven locations where a lot of those markets are competing with new supply, they're not as land constraint. If it's an infill asset in a strong market with great demographics that might be an

asset that we position for short-term rent growth.

**Ben Harris**

Yes. That's a good point. But in neither of these we would not have.

**John Massocca**

Okay. And then revenue maintaining CapEx jumped quite a bit in 4Q. Is there a specific project that was driving that or is that just something technical [ph]?

**Jon Clark**

It's the leases that we're talking about right now.

**John Massocca**

Okay. That's it from me. Thank you very much.

**Gordon DuGan**

Thanks John.

**Operator**

[Operator Instructions] Your next question comes from Ki Bin Kim with SunTrust.

**Ki Bin Kim**

Thanks for taking me back in the queues. Just looking back at the CSC transaction, do you guys have a summary of how much money you had made off that deal on the assets that you sold for this underwriting?

**Jon Clark**

No we don't – each quarter you can kind of look through and see gains in sales of dispositions, but I don't know what that is off my hand Ki Bin.

**Ki Bin Kim**

Okay I just want to clarify one comment you guys made on Lifetime. First of all, the single asset you sold, how does that quality compared to the rest of your Lifetime assets?

**Jon Clark**

I'd say right in the middle. We sold – we in fact had two, two of the ten, so we have eight remaining. And I'd say they are pretty consistent. Our base is in the remaining eight it's something like a six nine Cap rate. So they've been – we've in essence bought down our bases. We've sold two below 6.5 Cap rate.

And one comment to make on how we structure that deal, we put in place two, three property master leases and then did four individual leases. I would characterize three of the four individual leases as being average quality across the group, two of those are the two that we sold, one of the ones that we've capped is lower Cap rate individual asset and the other one I would characterize as sort of average for the group.

And then what we tried to do within the three property master leases was really create two pretty balanced portfolio. So I think each individual – if we choose to sell of those master leases, you have to sell them as a three piece unit. But I would characterize those as all kind of balanced within their own master leases.

### **Gordon DuGan**

And the best of the individual ones that we still retain is Reston, Virginia.

### **Ki Bin Kim**

Okay, and – but you had commented about possibly you are going to sell your other retail lifetime and bank branches, is that more of a interesting thought at this point, or how much is there in that view?

### **Gordon DuGan**

I'd say it's in the fault and not on the meet category.

### **Jon Clark**

We have – just to highlight we have been and we'll continue to harvest out of that portfolio. It's their small asset. If you look on Slide 11, we've sold 28 million worth of fee-based assets in Q3 – sorry Q4.

### **Ki Bin Kim**

All right. That's it from me. Thank you again.

### **Gordon DuGan**

Thanks, Steven.

At this time this concludes the Q&A portion of the call. I would now like to turn the call back over to Gordon DuGan.

## Gordon DuGan

Well we use our full hour. Thank you all for joining us today and as usual you know where to reach us if you have additional questions. Thank you for joining us.

## Operator

This does conclude today's call. You may now disconnect.

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