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# Duke Realty Corp (DRE) CEO James Connor on Q3 2019 Results - Earnings Call Transcript

Oct. 31, 2019 9:55 PM ET
by: SA Transcripts

Q3: 10-30-19 Earnings Summary

*Press Release* *10-Q* *Slides*

EPS of $0.13661 beats by $0.01 | Revenue of $215.37M (9.38% Y/Y) misses by $-0.46M

## Earning Call Audio

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Duke Realty Corp (NYSE:DRE) Q3 2019 Earnings Conference Call October 31, 2019 3:00 PM ET

**Company Participants**

Ronald Hubbard - VP of IR

James Connor - Chairman & CEO

Steven Schnur - EVP & COO

Nicholas Anthony - EVP & CIO

Mark Denien - EVP & CFO

**Conference Call Participants**

Emmanuel Korchman - Citigroup

Blaine Heck - Wells Fargo Securities

James Feldman - Bank of America Merrill Lynch

Eric Frankel - Green Street Advisors

Vikram Malhotra - Morgan Stanley

Ki Bin Kim - SunTrust Robinson Humphrey

Michael Carroll - RBC Capital Markets

John Guinee - Stifel, Nicolaus & Company

Caitlin Burrows - Goldman Sachs Group

Richard Anderson - SMBC

Robert Metz - BMO Capital Markets

Michael Mueller - JPMorgan Chase & Co.

**Operator**

Ladies and gentlemen, thank you for standing by. Welcome to Duke Realty quarterly earnings conference call. [Operator Instructions]. Also as a reminder, this teleconference is being recorded. At this time, I'd like to turn the call over to your host, VP, Investor Relations, Mr. Ron Hubbard. Please go ahead, sir.

**Ronald Hubbard**

Thanks, Tony. Good afternoon, everyone, and welcome to our third quarter earnings call. Joining me today are Jim Connor, Chairman and CEO; Mark Denien, Chief Financial Officer; Nick Anthony, Chief Investment Officer; and Steve Schnur, Chief Operating Officer.

Before we make our prepared remarks, let me remind you that certain statements made during this conference call may be forward-looking statements subject to certain risks and uncertainties that could cause actual results to differ materially from expectations. These risks and other factors could adversely affect our business and future results. For more information about those risk factors, I would refer you to our 10-K or 10-Q that we have on file with the SEC and the company's other SEC filings.

All forward-looking statements speak only as of today, October 31, 2019, and we assume no obligation to update or revise any forward-looking statements. A reconciliation to GAAP of the non-GAAP financial measures that we provide on this call is included in our earnings release. Our earnings release and supplemental package were distributed last night after the market close. If you did not receive a copy, these documents are available in the Investor Relations section of our website at dukerealty.com. You can also find our earnings release, supplemental package, SEC reports and an audio webcast of this call in the IR section of our website. Now for our prepared statement, I'll turn it over to Jim.

**James Connor**

Thanks, Ron, and good afternoon, everybody. Demand for well-located, state-of-the-art logistics space in key submarkets continues to remain robust. Overall fundamentals are still strong, driving rent growth and development opportunity, and our platform continues to provide creative solutions for our clients and outstanding value creation.

Let me start off with a bit of macro and strategic front, and then the rest of the team will expand on our operational results and our capital activity. Yesterday, preliminary third quarter GDP was announced at 1.9%, down slightly from the 2% pace in the second quarter but still above consensus. While the bright spots in the GDP report was consumer spending, which was up 2.9% on an annualized basis, the report also indicates business spending continues to weaken a bit, which we've seen in some of the other recent indicators. We're monitoring this closely for any possible impact to the consumer, but it doesn't appear to be an issue at this time. Initially, e-commerce sales have grown by 13.1%, and brick-and-mortar retail sales were up 2.4% for the first half of the year. The retail inventories continue to trend up at 3.9% year-over-year through the third quarter.

As we've noted previously, we're seeing significant investments by not only e-commerce company but also retail and consumer products companies into their supply chains to improve delivery times and efficiency. This, combined with continued increases in consumer spending, will continue to drive demand for well-located logistics real estate.

Now turning to the real estate fundamentals. Vacancy across the U.S. markets ticked up about 10 basis points in the third quarter to 4.4%. CBRE preliminary data shows third quarter absorption of 45 million square feet, trailed by deliveries of about 56 million square feet. On a year-to-date basis, the gap is less than 15 million square feet with projected full year 2019 deliveries exceeding demand by about 25 million square feet.

To put this in perspective, across a 14.5 billion square foot stock in the U.S., this gap will approximate to about a 10 basis point rise in vacancy from the beginning of the year levels. So we're looking at roughly 4.5% nationwide vacancy range by the end of the year. This is still 300 basis points below long-term historical average vacancies in the United States. CBRE is also reporting asking rents during the third quarter have increased 5.7% year-over-year, more than 2 percentage points above the average annual growth rate since 2012.

So at a high level, we're continuing to see low vacancies, good rent growth and positive demand for buildings in high-quality, well-located portfolio.

I'll now turn it over Steve Schnur to touch a bit more on market fundamentals at the submarket level as well as our third quarter operational performance.

**Steven Schnur**

Thanks, Jim. I'd like to start by expanding a bit on the market supply data points as it pertains to certain markets, and more importantly, the submarkets that have been in the headlines for the last several quarters.

Let me first say that you have to be careful when looking at MSA level data on supply, particularly in some of the larger Tier 1 metro areas that can have a geographic diameter of up to 80 miles. So if you look at our NOI exposure at the total city level of Atlanta, Dallas, Chicago, it comprises about 24% of our total NOI. However, in the heavier supply pockets of Northeast Atlanta, South Dallas and I-80 of Chicago, our exposure is just 9 assets would contribute only 2.8% of our total company NOI.

Furthermore, only about 800,000 square feet in those three submarkets expires through the end of 2021. From a vacancy standpoint, the three submarkets I mentioned are about 9.5% vacant, yet comparatively, our remaining assets outside of these three submarkets, or the other 21% of our NOI, the market vacancy is 6%, and our portfolio occupancy across those three cities is between 99% and 100%. Finally, as a testament to our portfolio performance in these three large metros, our rent growth year-to-date in these three cities has averaged 14.6% on a cash basis and 30% on a GAAP basis. The supply risk data points and rent growth figures at the submarket level support what we have been emphasizing, that our location strategy is heavily focused on the top logistics corridors for local and regional distribution within each MSA. As a result, as a case in point, across our 20 markets, there are roughly 220 total submarkets. Of these 220 submarkets, our 513 properties touch only 77 of those submarkets. So again, you have to be careful with some of this data, and hopefully, each of you will have an opportunity to get out to our regional markets to see this firsthand.

Now we move on to the highlights in our portfolio for the third quarter. We executed over 7 million square feet of leases across 17 markets at an average size of 117,000 square feet. This includes 22 leases signed over 100,000 square feet and 5 leases signed over 250,000 feet. Some of the more notable lease transactions were with customers such as Snyder's-Lance Foods, International Paper, Coca-Cola, Walmart and XPO Logistics.

At quarter end, our stabilized portfolio was 97.9% leased. Our in-service occupancy increased from 95.4% to 96.2% during the third quarter, primarily through the lease-up of recently completed speculative developments. We signed over 1.8 million square feet of first gen leases and recently completed spec project that helps us stabilize over 7 facilities. As everyone is aware, this first-generation leasing will not impact same-store results in the near term, but it will drive significant overall NOI growth going forward.

The lease activity, combined with strong fundamentals, led to another quarter of solid rent growth of 14% and 27% on a cash and GAAP basis, respectively, with only 5% of this activity derived from our coastal markets of California, New Jersey and Florida. There's also been a lot of discussion recently about tenant demand by building size, so I thought it would be important to share with you some of our year-to-date stats by building size.

Year-to-date, we've realized GAAP rent growth for buildings under 100,000 square feet of 18%; 29% rent growth for buildings between 100,000 and 250,000 feet; 23% for buildings 250,000 to 500,000; and 48% for buildings greater than 500,000 feet. This reflects strong fundamentals across the size spectrum, and it also echoes our strategic and concentrated submarket focus I just laid out.

On the development side of the business, momentum continues to be very strong. During the third quarter, we generated $211 million of starts across 6 projects, totaling 2.1 million feet that are 49% preleased. The new development starts included a 210,000-foot build-to-suit in the Atlanta airport submarket for Porsche USA and a 615,000-foot build-to-suit in the Eastern Pennsylvania for one of the largest tire wholesalers in the Northeast.

On the speculative development side, we started a project in the Inland Empire totaling 800,000 square feet and a 210,000-foot project in the East Bay submarket in Northern California. Our overall development pipeline at quarter end had 19 projects under construction, totaling 7.2 million square feet at a projected $916 million in stabilized costs. These projects are 46% preleased, and our estimated margins on the pipeline remain over 30%. Our development outlook for the remainder of this year is very solid. We have a healthy pipeline of prospects across our entire platform. This, combined with our outstanding year-to-date results, is driving our increased guidance for development, which Mark will cover later on. I'll now turn it over to Nick Anthony to cover capital transaction activity.

**Nicholas Anthony**

Thanks, Steve. We continue to be strategic in our capital recycling for the purpose of both self-funding development, achieving our strategic objective for Tier 1 geographic exposure. During this quarter, we closed on the sale of 5 transactions located primarily in the Midwest totaling $280 million. The bulk of the activity comprised an 18-building, 4.1 million square foot portfolio across Indianapolis, Cincinnati and Columbus that sold for $218 million. The buildings in this portfolio have an average age of 25 years, and we believe the sale maximized our return on these properties. The remaining sales were small portfolios of one-off assets across Minneapolis, Atlanta, Indianapolis and Washington, D.C.

In turn, we recycled a portion of these proceeds during the third quarter into a 252,000 square foot facility located in Miami at Countyline Corporate Park. In addition, after the third quarter, in late October, we completed a second acquisition also at Countyline totaling 241,000 square feet. In aggregate, we acquired from 490,000 -- 493,000 square feet for about $78 million. We now own 1.8 million square feet in this park, and together with our Miami industrial logistics park nearby, we own over 2.4 million square feet of what we believe are the most desirable facilities in the Medley submarket of Miami.

The acquisitions at Countyline bring our year-to-date total acquisitions to $188 million and, coupled with development, have increased our Tier 1 exposure on a GAV basis to 64%. This is up from 59% at 12/31/18 and on the path to reach our Tier 1 strategic goal of approximately 70% by the end of 2021.

I'll now turn it over to Mark Denien to cover our earnings result and balance sheet activities.

**Mark Denien**

Thanks, Nick. Good afternoon, everyone. Core FFO for the quarter was $0.37 per share compared to $0.36 per share in the second quarter of 2019 and $0.35 per share in the third quarter of 2018. On a year-to-date percentage basis, core FFO per share is up over 9% compared to the similar year-to-date period of 2018, and AFFO on a share-adjusted basis is up right about 10% year-over-year.

Same-property NOI growth on a cash basis was 2.8% for the third quarter, down from 4.4% in the second quarter. As we discussed extensively in our last earnings call, this moderation of same-property NOI growth was expected due to coming off an extremely high comparable occupancy level of 98.8% in the third quarter of 2018. In addition, third quarter same-property NOI was negatively impacted by previously announced tenant bankruptcy which was immediately backfilled but will not begin paying rent until the end of the year and also from the relocation of a tenant from 2 of our existing properties to one of our newly completed build-to-suit developments.

The combined impact of these tenant situations to same-property NOI was about 35 basis points for the third quarter and will be about 60 basis points in the fourth quarter. Once again, we expect this negative impact of 50 basis points on the second half of 2019 to turn to a positive in 2020 as rent commences from the bankruptcy backfill and the other 2 spaces are leased. We do expect same-property NOI growth to accelerate modestly in the fourth quarter, and this is considered in our revised guidance which I'll cover in a minute.

Same-property NOI growth on a GAAP basis was 2.9% for the third quarter and 3.5% on a year-to-date basis. In August, we took advantage of the low interest rate environment and issued $175 million of unsecured notes as part of the reopening of our 3.375% coupon 2027 bonds at a 2.8% effective interest rate. Between August and early October, we issued 6 million shares through our ATM program at an average price of $33.56, generating net proceeds of $200 million. I'll add some context given we're very thoughtful and deliberate on issuing equity.

With our significantly increased development prospects since the beginning of the year, we felt it was prudent to issue a bit of equity to maintain a strong competitive balance sheet to fund these investments. In addition, the equity markets are providing a very competitive cost that we estimate is significantly accretive to our overall investment returns. While our leverage metrics improved this quarter from already strong levels, this is temporary. We view this as a portion of the prefunding for our current development pipeline along with future development prospects rather than a delevering activity. This funding will come from future unsecured debt issuances and other capital sources.

As we head into 2020, I anticipate a gradual path towards a debt-to-EBITDA ratio in the low 5x area from the mid-4s area currently. This level is in the range we previously discussed.

Last week, we redeemed $250 million of 3.9% unsecured notes which had a scheduled maturity in February of 2021. The approximately $6 million prepayment of interest incurred in connection with this redemption will impact FFO as defined by NAREIT in the fourth quarter 2019 with no impact to core FFO. The source of funds for this redemption will ultimately come from a new unsecured debt issuance we anticipate in the near future.

Let me now address revisions to our 2019 expected range of estimates, which is an exhibit at the back of our quarterly supplement as well as on our website. As we near the end of 2019, we have narrowed our guidance for core FFO to a range of $1.42 to $1.46 per share, which equates to an additional $0.01 per share increase at the midpoint and 8.3% growth over the prior year. We increased our guidance for same-property net operating income to a range of 4.4% to 4.8% from the previous range of 4.0% to 5.0%. We've also increased our guidance for development starts to a range of $1 billion to $1.15 billion, representing a $75 million increase at the midpoint. Revisions to certain other guidance factors can also be found in the Investor Relations section of our website.

Now I'll turn the call back over to Jim.

**James Connor**

Thanks, Mark. In closing, we're very pleased with the team's execution on leasing performance, capital redeployment and development starts. We laid out solid growth expectations for the year, and we have exceeded all of those expectations. In addition, we're executing on our long-term strategic goal to generate high single-digit AFFO growth in a modest economic environment and execute on our goal to achieve 70% Tier 1 geographic exposure by 2021 with a very targeted submarket focus. Of course, we're carefully watching macroeconomic data trends, trade negotiations and our customer sentiment. But for now, we continue to be optimistic about a solid finish for the remainder of the year and demand drivers continuing intact for a good start to early 2020.

I'm also very pleased that our overall strong performance has allowed us to raise the quarterly dividend by $0.02 a share or 9.3% over the previous dividend rate, while maintaining our very conservative payout ratio. The increase is reflective of our team's outstanding execution and strong year-to-date results.

We will now open up the result -- open up the lines to the audience. [Operator Instructions]. I've also been notified that there was some static on the line during my remarks and Steve's remarks, so if you need us to readdress any of those numbers or any of those comments, feel free to ask, and we will address them.

Tony, you can open up the lines for our first question.

**Question-and-Answer Session**

**Operator**

[Operator Instructions]. We'll take our first question from Manny Korchman.

**Emmanuel Korchman**

Can we focus on the asset sales for a second, talk about the buyer pool that you're looking at -- or that was looking at those assets and whether you marketed other assets that you didn't sell to them?

**Nicholas Anthony**

Yes. So Manny, the most significant one was the Midwest portfolio sale, and we were very pleased with the buyer pool. It was very deep. It was a low double-digit number of bidders offering on that. And I believe we had, I think, 3 or 4 rounds of final bidding with a final field bid process.

**Emmanuel Korchman**

And then as we think about your portfolio improvement from selling out of these more secondary markets, what is it that limits further sales? Is it the gains and sort of using those into other properties? Do you like the rest of your portfolio? And as you get to that 70% goal that you mentioned, do you think you do that for buying and development? Or do you think there are more sales that we should think about?

**Nicholas Anthony**

I would tell you that we are very happy with our existing portfolio, so it is very -- it's getting harder and harder to find assets that we do want to sell. So we've been gradually doing the sales to partially fund our development. But going forward, the bulk of our growth into the Tier 1 will be through development.

**Operator**

Our next question in queue will come from the line of Blaine Heck.

**Blaine Heck**

So you guys highlighted the fact that only 5% of your leasing volume was in Tier 1 markets, and you're still able to put up very strong rent spreads. Can you provide us with that percentage of 2020 rents that are in Tier 1 markets? And I guess what are the implications for rent spreads as we look forward?

**Mark Denien**

Yes. Blaine, I'll try to address that. First of all, to make sure we're clear, and I just made that in the part where there was static, the 5% was actually not Tier 1 markets. It was coastal markets. So that was California, New Jersey and South Florida. We obviously count Atlanta, Chicago and Dallas as Tier 1. So that was not in that 5% number, just the coastal markets was 5%.

So as we look forward for the next 18 to 24 months, that 5% is going to be about 20%. It could be lumpy from quarter-to-quarter. For example, we've got, I want to say, about 22% to 25% in coastal markets that are expiring in 2020. But it's likely we made -- get a couple of those deals done here in the fourth quarter actually.

So the way that translates into overall rent growth expectations if we look forward, I would tell you for the next 12 to 24 months, on average, and like I said, there may be some swings from quarter-to-quarter, but on average, we expect similar results to what we've shown this year. So call it high to low -- high single to low double digits on a cash basis and right around the mid-20s on a GAAP basis. And then for our whole portfolio, we've done -- tried to do an analysis to look at what that would be on a mark-to-market basis on a GAAP, and we think we're close to 14% to 18%, somewhere in that range on a total GAAP basis.

**Blaine Heck**

Very helpful. And then so what's the break out of your exposure between Tier 1, Tier 2 and Tier 3 at this point? And then maybe for Jim, what's the ideal portfolio? Is it all Tier 1? Or is it the targeted 70% that you're looking for by in 2021 and you still do want to have some exposure to those secondary markets?

**James Connor**

Well, I'll let Nick give you the breakdown between the high-barrier Tier 1s, the Tier 1s and the remainder. But at this point, we're just trying to get to our target of 70. I think beyond that, you'll continue to see that number grow, but we haven't set specific targets. We've grown pretty substantially in Southern California and New Jersey, but we have a long way to go before we think we would reach our long-term target size. Plus we're still relatively new in Northern California and Seattle. Those also represent good growth opportunities for us in those Tier 1 high-barrier markets.

**Nicholas Anthony**

Yes. And in terms of the composition, our high-barrier Tier 1 on a gross asset value basis is just over 40%, and the low barrier Tier 1 is right around 25%. Going forward, and what we've seen historically, is the high-barrier Tier 1 is the ones moving the most, that's moving us to that 70%. The low-barrier Tier 1 are really staying rather static as we go through this repositioning.

**Operator**

The next question in queue will come from Jamie Feldman.

**James Feldman**

So we see more consolidation in your sector this week with Prologis and Liberty. I just wanted to get your thoughts, you now have a player in this space that's just getting larger and larger and is kind of pitching the idea that there's real synergies in the business from doing that. I just want to get your thoughts on the need to get larger to compete. And as you think about that combined entity as a competitor, what changes for you guys?

**James Connor**

Well, Jamie, I'll take the second one first. I don't think anything changes. Our friends at Prologis had been a proverbial 900-pound gorilla for some time, and I don't think this really changes the landscape. We've all talked about the advantages of scale in this sector, and we are, in fact, big believers in that. But with an enterprise value of $14 billion or $15 billion, we don't have to get big for the sake of getting big. I would have a hard time convincing our Board and our senior leadership to get big if we weren't creating additional value. So when we look at portfolios and we look at M&A, obviously we're looking at the impact to top line FFO growth, but we're also looking at AFFO growth and NAV. And the sector is very expensive today and a little bit frothy, and we haven't seen that value creation opportunity since probably the larger Bridge Portfolio that we bought a couple of years ago. So -- and I think that's probably a fairly realistic outlook for the foreseeable future in our sector in terms of the pricing.

**James Feldman**

Okay. I mean did you take a close look at Liberty? And did you -- strategically, did you think it would've been a good fit? It sounds like pricing, maybe not.

**James Connor**

I think you can assume that we're large and substantial enough that we look at every opportunity, both private and public. The amount of detailed underwriting we do depends on what we think the fit would be. But we've had a lot of respect for Bill and the Liberty guys and their portfolio over the years, and it's a good company, and we applaud our friends at PLD for putting the deal together.

**Operator**

The next question in queue will come from Eric Frankel.

**Eric Frankel**

I just wanted to drill down dispositions a little bit further. The Midwest portfolio, is the cap that you guys disclosed in your supplemental, would that apply to that portfolio? And I'm assuming that, that was fully occupied for the last year, and it should be for this year. So is that correct?

**Nicholas Anthony**

Yes, that roughly equates to that portfolio. The reason that portfolio was so -- was highly leased though is we actually, as part of that transaction, spun a vacant building out of that portfolio and sold it to another buyer that was ascribing more value to that building.

**Eric Frankel**

And then that was part of that 4.1 million square feet?

**Nicholas Anthony**

No, that was outside of the 4.1. The 4.1 was the Midwest portfolio.

**Eric Frankel**

Okay. Got you. Got you. Okay. That makes sense. And then more broadly, I think the public market has had pretty different views on how fundamentals and where values are for different markets in the U.S. so I think coastal markets seem to be getting a really good bid, and anywhere else is probably a little bit softer. What are you seeing on the ground, maybe in your noncoastal Tier 1 markets and some of the markets you're recycling out? What are the fundamentals actually look like? Have rents gone up a good bit for last year? Have they been kind of flat with where supply has been?

**Steven Schnur**

Yes. Eric, this is Steve. Yes. I would tell you we see good demand in all the submarkets we operate in. I think we're pretty choosy as I try to lay out and hopefully it came through with the static, but I think we're pretty choosy on our submarket focus.

In terms of the demand drivers, Jim touched on this, but e-commerce, retail, consumer, nondurables, food and beverage. So -- and I guess the one thing that I would point out that we don't publish but we track pretty closely here is our build-to-suit development pipeline. And that pipeline for us has been pretty consistent in terms of the number of prospects we're chasing, and that seems to be a good indicator of the health of our clients. So we're looking out 12 to 24 months for a new space, and we watch that pretty closely, so I think that's a good indicator for us.

**James Connor**

**James Connor**

Eric, the only thing I would add is if you look at the occupancy of our noncoastal markets, it's continued to be very strong. And as Mark alluded to earlier, our rent growth numbers, which were pretty good for this quarter and have been pretty good for the year, are based on the fact that only 5% of our leases rolled in those high-barrier coastal markets.

So look, we've said this all along. The sector is in great shape all across the country. Vacancies are at record low. There's still really strong demand, and there's still really good rent growth, and we see that at all sizes as well.

**Operator**

The next question is from Vikram Malhotra.

**Vikram Malhotra**

I have two quick ones. So just based on your commentary around expirations now being -- going forward, being a bigger part in the coastal markets. Would you actually expect accelerating cash rent spreads or similar cash rent spreads to this year?

**Mark Denien**

It's probably going to be fairly similar, I would say, Vik, in the near future. But part of that, you got to remember, the leases that will be rolling in the coastal markets are generally shorter-term leases, 5-year deals, let's just call it on average, while some of the leases that are rolling in the noncoastal markets were kind of what I would call legacy longer-term build-to-suit leases of 10 years. So you have just as good of embedded rent growth as some of those non-high-barrier markets because of the length of the lease term that's coming up.

**Vikram Malhotra**

Okay. That's fair. And then just to clarify, I know you narrowed the same-store NOI growth range, but I just want to understand, what caused you to kind of narrow the top end.

**Mark Denien**

Well, we narrowed both ends, I think. We raised the bottom end, and we lowered the top end, just to get closer to where we are at the end of the year. So our new midpoint went from 4.5 up to 4.6. And then if you just compare that to our year-to-date number, where we're at 4.9, keep in mind that's 75% of the total year NOI, at the 4.9, that would imply, I think if you just do simple math, a 3.5% expected growth in the fourth quarter to hit that 4.6. But the narrowing, that you'll see later in the year, we have better data now.

**Vikram Malhotra**

And the decel is essentially what you called out at 60 basis point impact.

**Mark Denien**

Yes. Well, it's 60 basis points -- from the third quarter -- for the 2 tenants in the third quarter that I mentioned in sort of 2 situations, 1 bankruptcy tenant in Atlanta and then we had 1 tenant in 2 spaces in Cincinnati that we moved into a new development. The 2 spaces in Cincinnati, the tenant held over in 1 of them for most of the third quarter while they were moving into their new building, and then they'll be out of both spaces in the fourth quarter. So what you have with those 2 situations, you had a 35 basis point negative impact in the third quarter that will grow to 60 basis points in the fourth quarter because they will be out of all of those spaces.

But more than offsetting that, because that is part of the 2.8% growth for the third quarter, we do expect a reacceleration. So more than offsetting that will be the continual pop we get from all the leases we've been signing on the rent growth side, plus a little bit less free rent in the fourth quarter of 2019 compared to 2018.

So all that, even though occupancy will probably dip down a little bit more in the fourth quarter because of those situations, should be more than offset by continued positive momentum elsewhere.

**Operator**

Next question is from Ki Bin Kim.

**Ki Bin Kim**

So going back to your comments about the Tier 1 70% goal over time, I think that's about $750 million on a growth asset value basis. Just curious how you want to get there. Is it more by building your way there or buying?

**Nicholas Anthony**

Yes. The majority of it will be through development, and obviously, we will be selling a little bit out of the Tier 2 markets and redeploying that in Tier 1. But the majority of it will be in the development side. The vast majority of our land -- current land bank is focused on high-barrier Tier 1 markets right now.

**Mark Denien**

Yes. And Ki Bin, just for example, if you look at our $900 million development pipeline now, over 80% of that's in those Tier 1 markets already.

**Ki Bin Kim**

Okay. And any particular reason why some of the assets that you sold, I think, were less than stabilized? Is the demand just that strong where you're getting kind of full pricing even though the demand falls?

**Nicholas Anthony**

Yes. There's always some unusual circumstances like that. The one was a vacant building that got carved out of the portfolio. A lot of times, if the buyer is more optimistic on the underwriting than we are, then we're a seller. That's kind of the way we look at it. And then there were 2 office buildings -- 2 legacy office buildings in that population, too, that had lower occupancy.

**Operator**

The next question, that will come from Michael Carroll.

**Michael Carroll**

I was hoping to provide some color on your ongoing development strategy. I know Steve commented that there's pretty big pipeline of build-to-suits, and through most of 2019, you've been increasing your start guidance. I mean is it fair to assume that you can break ground about 1 billion of projects a year in a stabilized pace going forward? Or is it going to be more like the start guidance that you had at the beginning of the year?

**James Connor**

Mike, I think we always want to start out the year with maybe a little bit more conservative guidance because we're building budgets effectively 15 months out. So I wouldn't be surprised if in January our guidance was a little bit more conservative. But if market dynamics stay pretty consistent in 2020 with what we've seen in 2019, I think we can absolutely replicate the year. The build-to-suit pipeline, as Steve alluded to, is as strong as it's been in the last 3 years, in terms of number of prospects, the size of the deals and the geographic coverage. So that, mixed with spec developments, selected spec development around the country, we certainly hope to be having this same conversation next year where we've raised guidance to these kind of levels.

**Michael Carroll**

Okay. Great. And then I guess second question, can you talk a little bit about your acquisition strategy? I know it seems like you've been doing a couple of one-off acquisitions in these top-tier markets. I mean is there anything behind those deals? Are they adjacent to your existing land parcels? Do you see some value-add opportunities? I guess what makes you pursue those low cap rate deals in those good markets?

**Nicholas Anthony**

We are primarily -- actually exclusively focused on the high-barrier Tier 1 markets where we want greater exposure. That's where you saw $5 billion in Northern California. We've bought several buildings in South Florida as part of a transaction where we have a right of first offer on future buildings, and we evaluate those on a one-off basis. And then obviously ones that -- assets like in Southern California that provide some diversity to our current base there in California, which is our largest market now.

**Operator**

The next question in queue will come from John Guinee.

**John Guinee**

John Guinee here. Hey, Steve, you had some great stats about, I think, you own assets in 73 of the 220 submarkets. Some of your peers actually track the key submarkets where there is simply no more land and no more ability to increase supply. Do you guys go to that level of detail? And do you have any of that sort of information about your portfolio?

**Steven Schnur**

I wouldn't say -- I guess it would depend on what sort of information you're referring to exactly. But I'd say, in all of our markets, we certainly like submarkets where there's less available opportunities for development. We do a fair number redevelopment projects. I think half of our projects we currently have in our pipeline, we're building about 24 buildings right now, half of those projects will be considered redevelopments where we've either taken down an existing facility, be it a manufacturing plant or an old office building or steel plant or something. So that's what we're spending a lot of our time and effort. So I guess it's a long way to answer your question that obviously we're focused on those markets. I don't know that there's a stat out there that tracks availability of sites though.

**James Connor**

Well, I think it varies quarter-to-quarter. I mean our people are always out looking for those opportunities to find functionally obsolete facilities that we can turn around and redevelop cost effectively into new logistics facilities. And we're doing it in South Florida. We're doing it in New Jersey. We're doing it in Chicago, Southern California. And Steve even pointed out we just torn down 2 office buildings in Northern California to develop state-of-the-art logistics in the East Bay. So they may be out of vacant land, but they're not out of opportunities, and we're continuing to find good ones.

**Operator**

Our next question will come from Caitlin Burrows.

**Caitlin Burrows**

I know we've talked a little bit about the development pipeline already, but I guess in terms of you were saying that the advance side is a strong as ever, in terms of buying land and getting entitlements, are you seeing anything from there that makes you think that you wouldn't be able to keep up the development volumes as high as you've reached this year?

**Steven Schnur**

I think other people have commented on this as well. I think it does get more difficult, and certainly with the info markets that we're pursuing and those opportunities to go through the entitlement process, I think it's added some length to the overall duration of projects. So what used to be maybe a 9- or 10-month project may drag out to 13, 14 months. So I guess that could have some lingering effect. But right now, we see a lot of opportunities. And as Jim said, I think sitting here today, assuming that the build-to-suits and the preleasing of our spec projects can keep up, I think you'll see similar results for what we have going forward.

**James Connor**

Yes. Caitlin, the thing that I would add to that is we already have the land in our portfolio or at the very least under contract in the process that's going to feed our 2020 development pipeline. The buildings we're going to build next year are not on site that we haven't identified and have to go out and find. That will be the 2021 to 2022 pipeline. So I think Steve's being -- he's very comfortable that he's got the land that he needs to meet our development needs for 2020.

**Caitlin Burrows**

That makes sense. And then maybe also on Amazon, it looks like they grew again in terms of your largest tenant. I guess, on one hand, it's definitely a positive given their growing needs and your development services. But what are your thoughts on kind of concentration risk and also what kind of pricing power do you have with such a large tenant?

**James Connor**

We've had a great, long-term partnership with Amazon, and we continue to do a lot of business with them. I've told this story before. Our direction to the Amazon team and our teams in the field is we'll take as much of that business that we think makes financial sense around the country. So we're developing last-mile facilities for them, delivery sortation facilities as well as fulfillment centers. And we'll manage our exposure to Amazon at the corporate level through Nick's group with either dispositions, joint ventures, bonds, however the case may be. Sitting here today, I think they're in the 7.5% range. Given the activity that we had if we don't do anything, that number works its way up probably to 9% or 9.5%. But I think we'll address that in 2020 as we look to maybe prune some of that exposure.

**Nicholas Anthony**

Yes. And to Jim's point, we sold $100 million facility in Columbus, Ohio earlier this year to manage our exposure.

**Mark Denien**

And then finally as far as pricing power -- sorry to keep jumping around on here, Caitlin. As far as pricing power, we've had 4 Amazon leases come up for renewal in the last 24 months. And I would tell you the rent growth we achieved on those renewals in each particular market was better than the market average we had achieved in that market. So pretty good.

**Operator**

The next question, that will come from Rich Anderson.

**Richard Anderson**

So is there anything about the Liberty deal at 4.2 cap rate that makes you recall circa 2007 and EOP selling. And that kind of topping sort of number, can it get any better? What do you think about that 4.2 number for the Liberty portfolio in the context of the future and the ability to see value creation from this point going forward?

**James Connor**

Well, Rich, I'll make a couple of comments. Relative to the cap rate, good for the Liberty shareholders, I guess. Every year at the conferences that we all see each other at, we've been asked about our projections for cap rates and the amount of capital that's flowing into our sector. And every year, I've said, and literally for the last 3 years, cap rates can't get any lower, and cap rates continue to get lower. And I think today, we're still seeing a significant amount of capital, both domestic and foreign capital, that wants to be in U.S. industrial. And there is -- there are premiums being paid for portfolios, and we've seen that consistently throughout this year and quite candidly for the last several years. So sitting here today, it wouldn't surprise me the least if cap rates continue to compress in this sector as we have more and more capital that wants to be put to work in the industrial sector. So I think it could get better.

**Richard Anderson**

Right. And when you made the comment about perhaps coming out conservatively on the development side in 2020, how much of that was just simply being conservative and not being a hero coming out of the gate? And how much of it was some of these observations that you made earlier in the call? Perhaps splitting hairs, but GDP you own are spending down, so on and so forth. Are any of those sort of observations influencing your thought process about development going forward?

**James Connor**

Well, Rich, my first thought process is to under promise and over deliver. It's been my experience that you guys don't react well when I disappoint you in the second, third quarters. So a little bit of conservative in January is a good thing. Sitting here today, I think we all recognize that the macro drivers that we look at for our sector in a lot of instances are not as strong as they have been in the past couple of years. We've heard the term decelerating in a number of these areas. So I think a certain amount of caution is probably warranted, but as we've said, and I don't want to send the wrong message, I'm pretty optimistic about 2020 based on everything that we're seeing today in terms of the drivers and what our clients are saying, our existing tenants and their need to grow. So I think 2020 is going to be a pretty good year for us, absent some really large catastrophic thing that we may not know about today.

**Richard Anderson**

Right. And then last question, I said earlier that the -- I think it was Mark or somebody, over the next 12 to 24 months, you're looking at GAAP re-leasing spreads in the 20s, and that the mark-to-market for the full portfolio is 14% to 15%. I just want to make sure I have that logically correct. The stuff that's about to expire the next year or 2 is call it -- has had the benefit of 10 years of existence and so you kind of get the market rent growth from that. And then at the other end of the spectrum, stuff that just got re-let is effectively 0% GAAP re-leasing spread at this point from a mark-to-market perspective. Is that the way to think about it like over a 10-year time horizon and that the average of all of that is somewhere in the middle? Is that what you're kind of saying when you're giving that math?

**James Connor**

Yes. I think that's the right -- first, I need to clarify, and of course, this will make Mark nervous. It's 14% to 18%, not 14% to 15%.

**Richard Anderson**

Oh, forget it, forget it then.

**James Connor**

You're absolutely right. I would tell you, in some of our infill markets, like Northern New Jersey and Orange County in Southern California, deals that we did 6 months ago are under market right now. I mean that's how strong some of those markets are. You talk about Orange County, we had a presentation on our Board earlier this week, we are talking about vacancies that are under 2% and not a lot of new supply out there. So that continues to allow developers and landlords to push rents. So it's the combination of all of those things and our ability to go out and execute on it.

**Mark Denien**

Yes. But I think your logic is right on, Rich. I mean obviously the deals that are closest to coming at us are generally the older deals. The deals that we just signed won't roll for 10 or 12 years, which is why quite frankly, I don't necessarily put a whole lot of stock in the numbers we just quoted, but it is what it is. So the deals that we just signed to have 15 more years of term may be close to 0, and the deals that are coming up are going to be a lot higher than that.

**Operator**

The next question in queue, that will come from Jeremy Metz.

**Robert Metz**

Jim, just a little bit of a high-level question. You guys continue to focus on the shift into the Tier 1 markets. Is there also a desire as you go ahead and buy and sell and build to also shift the size mix shift into more multitenants, create a little more of whether it'd be annual tenant roll to be able to take advantage at times of where the market's at. And is there a desire to continue to shift the portfolio in other ways beyond just kind of geographically been in those markets?

**James Connor**

Yes. Jeremy, that's a good question. I'm actually glad you brought that up because people think our portfolio is all million square foot buildings. But the reality is 20% of our portfolio is buildings 100,000 square feet or smaller. And a lot of our 200,000 and 300,000 square foot buildings are exactly as you described, multitenant. So what drives the development decisions and, in many cases, the acquisition decisions of those buildings in those markets is driven by tenant needs in those markets. So when you go to South Florida or Central Florida or even Houston, it's not million square foot, it's much more reasonable average size buildings. And we've always been an active player in that marketplace. And Steve can give you a little bit more color on our average tenant size and some of the other factors.

**Steven Schnur**

Yes. Jeremy, I've indicated in my opening remarks, I mean our average deal size is 117,000 feet. And then if you look at our new development pipeline, what we're under construction with right now, I think our smallest building is 66,000 feet, and our largest building is upward over 1 million. So as Jim said, it really depends on the submarket we're in, in terms of what the demand is that we're going after.

**Operator**

The next question, that will come from Michael Mueller.

**Michael Mueller**

A quick question. In looking at the various JVs that you have, what portion of them are actively growing?

**Nicholas Anthony**

Well, this is Nick. We've really only got one significant joint venture at this point, and that is we've had it for several years. It's primarily focused on Dallas, and there hasn't been a lot of growth in that portfolio going forward. Now we do have a couple of development joint ventures that are active on the development side, but most of those assets are sold upon stabilization.

**Michael Mueller**

And I guess for you to do something there, is it the partners bring you land, they find a site, and you'll end up doing it there?

**Nicholas Anthony**

Well, no. The land's already been established, and we are codeveloping those projects and then selling them.

**Michael Mueller**

Okay. So it sounds like it's going to -- everything's going to stay pretty small from that perspective, it sounds like.

**Nicholas Anthony**

Correct. Correct. Our JV exposure, we've cleaned it up quite a bit over the years, and it's a very small part of our business right now.

**Operator**

We do have a follow-up in queue. That's from Ki Bin Kim.

**Ki Bin Kim**

Just a quick one. How much of the new leasing or leasing in the development pipeline would you say is just net new demand, tenants expanding versus shuffling seats? I know you lost one tenant to your development pipeline, but maybe excluding that one.

**Steven Schnur**

I'd say the majority of the deals we're seeing are net new demand. We've got -- there's -- Jim indicated, I think, when he was talking through some of the demand drivers, there is a lot of investment going on in the supply chain, so there is some consolidation business that we're benefiting from. And I guess in the case of the tenant that moved out of two of our buildings into a larger build-to-suit was not a total net add to us. But outside of the consolidation, most of the demand we're seeing, I'd say, would be net new demand.

**Ki Bin Kim**

Okay. And I know this business has always been on a square foot basis, but I was just curious if you ever looked at the cost of a real estate to your tenants in terms of like cubic square foot. Could I -- I would bet the cost per cubic square foot is actually not that bad. So maybe the rent growth to a tenant is not as high as maybe what we think.

**James Connor**

Yes. Ki Bin, I would make a couple of comments. It's not unlike some of the coastal markets where rent is quoted on a monthly basis as opposed to an annual basis. We do have a small number of tenants that are looking at their occupancy cost on a cubic basis. But I would tell you that it's the minority, and those are the clients that are using the clear

But I would tell you that it's the minority, and these are the clients that are using the clear

height. They're using the full 36- or 44-foot clear. Some of them are exploring going beyond that, particularly in the infill markets. So to us, it's just math whether you use a square foot or the cubic foot. But as you have probably heard or seen, some of the tenants are starting to look more closely at that and finding that to be advantageous to go up as opposed to out.

**Ki Bin Kim**

I meant just more implicitly not verbatim.

**Operator**

Thank you very much. At this time, there's no additional questions in the queue.

**Ronald Hubbard**

Thanks, Tony. Thanks, everyone, for joining the call today. We look forward to reconvening during our fourth quarter and year-end call, tentatively scheduled for the same time on Thursday, January 30, 2020. Thank you.

**Operator**

Thank you. And ladies and gentlemen, that does conclude your conference for today. We do thank you for your participation and your interest in AT&T Executive TeleConference. You may now disconnect.