Participants

Will Eglin, President and CEO of Lexington Realty Trust (LXP)

Nate Abercrombie, The Stock Podcast

Interview Transcript

Nate: Will Eglin from Lexington Realty Trust, thank you very much for joining the program. It's going to be a real pleasure talking about your business.

Will: Great. Thank you, Nate. It's a pleasure to have the opportunity to talk to you today.

Nate: Yeah. Really, it's my pleasure. So, the way that I start off all these interviews is just asking about the person that I'm interviewing. So, if you wouldn't mind just providing a little bit of background, your history at Lexington, anything you'd like to share with the listeners?

Will: Sure! Well, it dates back to May 1987, actually, when I started working at my first job in New York City. I worked for a private real estate partnership called Lepercq Capital Partners, and was hired as an associate in the acquisition group. And my job was to underwrite and value single-tenant net-lease opportunities across many different asset types all in the U.S. Lepercq was a sponsor of partnerships and raised money through Shearson and Hutton in those days. So, for the first few years of my career I was in the acquisition group, then we hit the terrible real estate depression that started in the U.S. in about 1990 or so. And so the next few years after that I did a lot of asset management work, lease restructurings, even tenant workout, forest refinancing, sales. All kinds of things. And then, as the sort of modern REIT era dawned in 1991, 1992, we had the idea that we would take a couple of our larger partnerships public, and merge them together and enlist them as a REIT, which was accomplished in October 1993. And we called the company Lexington Corporate Properties Trust, and that was an interesting opportunity for me because I was only twenty-nine years old. And so I had the opportunity, really, at the beginning of the modern REIT era to learn how to run a public company. So that was a great opportunity for me. The company had a couple of hundred million dollars of assets at the time and has grown substantially. And I guess for me, the experience in the real estate recession of having to do everything, I think positioned me well in the context of having a public company.

Nate: Yeah, you mentioned the modern REIT era. So—you probably know this—I didn't cover REIT’s when I was on the buy-side, so I would be interested to hear just sort of a brief history about REIT’s. So the structure essentially came into being in the 90's or was there a pre-modern sort of REIT era that had a different structure?

Will: Yeah, REIT’s had existed for a long time, but the real estate depression really in the early 1990's created a situation where there were a lot of very fine real estate companies that needed to be recapitalized. And so there was an opportunity in the public markets to provide capital for many of those companies and REIT seemed to be a natural successor to partnership investments, which had sort of, I think, fallen out of favor with investors for a number of reasons. And from a public investor standpoint, the opportunity to invest in very, very good real estate franchises with excellent management and liquidity was one of the driving forces in creating that opportunity in that sort of 1992, 1993 timeframe. So, yeah, so if you think about it in the context of our history, we listed in October 1993 with about two hundred million dollars of assets and twenty-five years later, we're over a four-billion-dollar company. So, it's been a good opportunity to grow. But there've been a lot of strategic changes over the years too. When we started, we were a diversified net lease REIT with a lot of our revenue, about 40%, coming from retail properties. Then we made the shift out of retail over many years and focused specifically on office and industrial assets. And now, more recently, we decided to just focus on industrial and move toward a pure play on single-tenant net-leased industrial. We've actually been in the industrial business for many years. In fact, one of the first properties I worked on, honestly in 1987, we still have in our portfolio. And its cash-flowed continually for thirty-one years. So, it's been an interesting time to reflect on the history and all of the things that we've accomplished.

Nate: Yeah, I would love to get into the recent strategic change, but I would be really curious to know what you saw in the retail real estate business that sort of influenced your decision to get out of retail.

Will: Well, there were a couple of things. When you think in the context of a long term single net lease bill banks. The longer the lease, the greater the component of your return comes from the rent in the lease. What we liked about retail was that there was always an opportunity to make retail investments generally in the sale leaseback area to provide retailers with growth capital. And what was good about that as you typically would get a 20 or 25 year lease term. On the flip side of that, many retailers didn't survive 20 or 25 years to pay all the rent. So it was very, very important to pick the proper locations. So one of the things that we noticed was that retailers often overbuilt the number of stores that they had. And sometimes for un-economic reasons. Yeah, so when you had a tenant goes bankrupt or reorganize often the first thing they did was clos many of the stores that they probably shouldn't have built in the first place. And so we found that a very challenging aspect of investing in single-tenant net-leased real estate. And our other observation sort of in the late 1990's, we decided to get out of retail almost entirely. And at that time, I think the selling space per capita in the US was about 23 square feet per person. That seemed very heavy in relation to other advanced economies more recently. I think it's increased, as much as 48 square feet. And in the context of the growth of ecommerce, which influences with the retail landscape so much, it took us a long time to feel like we made the right decision to get out of retail. But recently it sure has proven to be a good choice.

Nate: Yeah. So could you describe your current asset portfolio? What do you currently own?

Will: Well, right now a little bit over 60% of our NOI comes from industrial and that's a big shift for us. The beginning of the year was about 44%. About two thirds of our industrial portfolio is warehouse and distribution. Now, but we also have exposure to things like manufacturing and cold storage. Most of the balance of the portfolio is in single-tenant office, which we continue to exit as an asset class. And we've been, this year we've closed on close to a billion dollars of dispositions and created a lot of liquidity to continue transforming our portfolio towards single-tenant industrial. So it's really a decision to exit one asset class and focus all our resources on the other asset class that we've been invested in. And which is one that we've been involved in for many, many years and is a core competency.

Nate: Yeah. So what are you seeing in the office real estate business that has similar to what happened in retail that has influenced your decision to change the strategy? Is there a shift change in office real estate today or is it just a decision to...

Will: Yeah, so much has changed over the last ten or fifteen years. Single tenant offices, single tenant industrial use to change, used to trade at comparable cap rates. And now single tenant office is often an 8% or 9% cap rate assets and industrial is five or six. So it's very hard to have those two asset classes together in a public company context. And the things that have influenced office over the last fifteen years have been, you know, there's obviously been humongous technological change that's made office use... It's just changed the nature of how companies office their people. Globalization has had an impact on office employment in the U.S. And in the wake of the financial crisis, many tenants in the U.S. looked at improving their efficiency in terms of how they have their workers. Which has resulted in a lot of corporate downsizing and substantially less demand from our large corporate tenants.

Will: So those have been very dramatic changes in the office landscape. And given how quickly technology is changing, it's very difficult to forecast, you know, sort of fifteen or twenty years ahead in terms of how U.S. corporations are going to house their workers. So there's been a lot of change and it isn't that single-tenant office can't be a high return asset class. We've just always insisted on having fifteen or twenty year leases where there's so much return in the lease that there's enough compensation for the residual value risk at the end. It's just difficult in the public company context as the lease term burns off and you're heading toward that moment of full or empty risk with a big asset that's been been tricky to manage.

Nate: Yeah and do you talk about things in terms of your average sort of lease duration currently? And if so, could you just describe what that is right now and where you would like it to be?

Will: Yeah. Overall in our portfolio it's about eight and a half years. And as we have been selling out of office, the weighted average lease term in our office portfolio has gotten shorter. So right now that's a little bit less than six years and honestly if the economy keeps doing as well as it has, we think that the residual value outcomes in office are going to be better than we thought they were going to be a year or two ago. So we have sold many of our longer lease office assets this year, which makes sense if you're worried about interest rates going up and the value of those long term leases getting devalued from interest rates being higher. So overall on the industrial side, our portfolio has a weighted average lease term of about close to ten years right now. Our philosophy is to try to sustain a weighted average lease term of between eight and ten years.

Will: As we shift the portfolio entirely to industrial, we do think there will be some opportunities to add shorter lease terms where we can purchase assets that are subject to leases with below market rents. So we're looking across a variety of lease durations with industrial, but hoping to sustain that eight to ten-year weighted average. And we want to try to maintain a rough balance between the return that comes from the rents that are in place in our existing leases and the value of the asset at the end of the lease. So we think if we can do that will be pretty well hedged against a variety of different economic scenarios.

Nate: Yeah. So just taking a couple steps back, do you guys, do you only purchase assets or do you actually develop and build assets? You know, whether it's office or industrial real estate.

Will: Well, we do a variety of things to originate investment opportunities. Historically, we've been very active in the sale leaseback market. We've also purchased assets that are subject to existing leases. You know, as I just mentioned, if different industrial, if a 10 year lease was signed on an industrial building five years ago, chances are the rent is below market now. So that's an opportunity for us. Where we've been active in the development space as often in the context of providing capital to a merchant builder who's engaged in a build -to-suit project for a corporation that's agreed to lease the building for a long time when construction's finished. So we have been able to get some yield premium in that part of our business. You know, and gotten closer to developer economics without taking development risks. So we will work closely on merchant builders. On many of their new projects, but often they're building spec right now and often during the construction period a single tenant will come along and take the entire building subject to a long term net lease. So, we feel like we're working closely with merchant builders and trying to improve our economics, but we haven't shifted to a development model with the risk that entails and, candidly, the G&A load that that would entail as well.

Nate: Yeah. And why do companies make the decision to do the sale leaseback? Is it just to get the property or at least these assets off of the balance sheet and they prefer to pay a rent as opposed to owning the assets?

Will: Yeah, I mean some of it over the years has been driven by off balance sheet treatment, but I think primarily it should be viewed, viewed as a way of raising capital and if you have a creative use for that capital to invest it in your core business, then it's a sensible financing strategy. Sale leaseback hasn't been very active for us. Often you see lower grade credits trying to sign long leases with very high rental rates as a way of extracting a lot of value for the real estate in excess of what it might be worth empty. So it's been, you know, again, there's risk associated with that. And say at lease back hasn't been that active a space for us recently.

Nate: I see, okay. So you mentioned the asset sale or asset divestiture earlier this year. Could you just describe what those, what you sold, how much you sold it for and then what you still hope to sell going forward?

Will: Sure. No, the last couple of years as we've shifted toward industrial, we've been selling sort of 250 or $300 million are primarily office buildings and you know, managing the capital redeployment in the context of what our new acquisition opportunities were in industrial. We felt like this year, since there's been a lot of capital chasing real estate investments and with interest rates going up, but still pretty low, that there was an opportunity to get good value for our shareholders and accelerate the transformation. So the big the we completed was a $726 million joint venture on a portfolio of 21 single tenant office buildings, that were characterized by pretty long weighted average lease term of nine and a half years and good credit quality. But also, we're 23 years old on average. So, we sold those properties to a joint venture or the price of a $190 a foot, which we thought was good value for our shareholders, and a cap rate on a cash basis of a little bit above 8%.

Will: And we stayed invested in the joint venture with 20% of the equity and are managing it for a fee. And we have a promote structure. So, we're going to work hard to make that investment successful for our joint venture partner and hope that our promoted interest turns into real value. So those transactions together put our disposition so far this year, close to a billion dollars. We'll have some other things to close over the balance of the year that should push us over a billion dollars in sales, which is a record. And that joint venture, it was $565 million of liquidity that we've used to substantially deleverage the balance sheet and make some new investments and also repurchase shares. So, now as we look at the rest of our office portfolio, you know, we're committed to maximizing the value of every single one of those properties. We think about half of what's left is in a position where we can either put that property in the market for sale now or sometime next year and we think that we've asset managed those buildings to the point where we can get full and fair value.

Will: So that means that there will be a lot of capital coming back to the company in 2019. That again, we can use that capital to continue to advance our strategic objectives. After that, the office portfolio has shrunk considerably in size, but it's still a several year process to maximize the value in each case. And the tricky thing with single tenant office buildings is that at the end of the lease there's a binary outcome. Either the tenant renews or you have a vacancy and until you know that outcome it's very hard to find the right buyer for the asset that will pay the full price.

Nate: Yeah, makes Sense. Could you just sort of highlight the differences between, I mean I know you talked a little bit about lease terms and some of the differences between the two different asset classes, industrial and office. But, what do you think is most important for potential investors to understand about, at least the value proposition or maybe the cash flow structure of office real estate versus industrial?

Will: Well, the key difference between single tenant office and single tenant industrial, is that all the things that we're buying in the industrial area right now, we believe we're purchasing buildings with rents that are close to market or a little bit below market. So as those leases roll, we think there's an opportunity for us to raise rents and so it's an asset class where our ability to preserve or make our shareholder's capital appreciate we think is more favorable. What happens in the context of single tenant office is, almost everything that we've done since the financial crisis has been a build-to-suit. And build-to-suits are great because you typically get a 15 or 20 year lease term, but they typically start with rents that are high in relation to market. And then usually rents grow at 2% fixed per year. Say you have rent that's very full in relation to market growing every year and there are many, many suburban office markets in the US where there's been next to no or even negative rent growth in the last 10 years.

Will: So even though there can be a lot of economics during the lease term, when you get to the end of the lease, it's very often that you have a rent that resets to a lower level. So you know, like I say, single tenant office can be an asset class where the internal rates of return are very high, especially for private investors using much higher leverage than we do as a company. But it's not unusual for you to have rents that reset lower when the leases expire compared to what we're underwriting on the industrial side today. The other thing about single tenant offices, is when you have a vacancy, it's very expensive to modernize a building and position it for a new tenant and it can be very expensive to convert a single tenant building to a multi-tenant building. So, the capital costs associated with addressing vacancy is considerably more substantial than anything that we've ever seen on the industrial side of our business.

Nate: Do you mind throwing out hatome dollars per square foot values for listeners to understand how what that capital cost would be if you were to stick in single tenant office.

Will: Well, it varies considerably depending on the bill that's required by whatever new tenant might be coming into the building. But it's not unusual in the context of securing a new 10 year lease for an empty building to spend five or six years worth of rent upfront to secure the lease. And in industrial that might be five months of concessions. Just to put it into, those are our rules of thumb. They can be more or less in both cases. And they're almost never more in industrial, but it's a completely different asset. In terms of the cost of re-tenanting,

Nate: Yeah. Has it always been like that. Is real estate investing, obviously there's some cyclicality to it, but just when you compare the different asset classes, is there sort of an inverse cyclicality between industrial and office and retail. Or is it more because of just the sort of secular changes in the market that the shift from brick and mortar stores to ecommerce and you know your traditional offices to work, whatever they call them, like the We-Work shared workspace buildings.

Will: Yeah, in our view, it's the secular shifts that have mattered more. Especially on the industrial side, the shift away from bricks and mortar into ecommerce has created demand for industrial that's been continuous and seems likely to continue for the foreseeable future. And in office as I said earlier, there've been tremendous changes that have shifted the landscape from a landlord's perspective. So, those have been the primary drivers and it's not that there aren't other factors. Including the general strength of the economy, office employment in general. But the big themes have been corporates, industrial and the tremendous demand from ecommerce.

Nate: Yeah, and are there regions to be in? I mean, is there a geographic focus for Lexington. Or, does geography matter significantly or is it kind of a secondary thought whenever you're looking at buying industrial or owning industrial real estate assets?

Will: Well now, geography matters. You know, we have a nationwide platform. We want to be looking in many markets to find the right mix of the real estate itself. Its locational attributes, right? Sustaining what we think is the optimal amount of weighted average lease term across the portfolio and trying to find opportunities where we're also investing buildings, leased to very, very good credit tenants as well. But what we found over the years since we're focusing primarily on new construction, we tend to be following where corporations are building new. Which tends to track with demographics as well. So our portfolio has been shifting more and more to the southeast and Texas compared to other regions of the country. Although we have a very strong presence in the Midwest because automotive is our largest economic segment in our industrial portfolio. But most of the portfolio at this point tends to be on the eastern side of the country. And again, Texas is our biggest state from a revenue standpoint.

Nate: Okay, yeah just as an aside, I live here in Denver and I'm from Oklahoma and I drive out to Oklahoma for Christmas and the occasional Thanksgiving. And I've been here for almost 10 years. And I am just completely blown away by the number of buildings that are cropping up between Denver Metro area, out towards the airport. And then just heading east. There are just all sorts of different Amazon, Ebay types of large industrial buildings that are just cropping up over again the past 10 years. It's just been an amazing ride.

Will: Yeah it's an amazing transformation

Nate: Yeah It really is.

Will: And Denver's been a very strong market for us too.

Nate: Yeah. So you know, I'm kind of curious from, and I'm asking this question a little bit more frequently just because lots of people are, have been at least mentioning recessions or you know, the potential for recession going forward and I'm curious whether or not industrial from your perspective is a more recession proof asset class than office real estate.

Will: In my mind, it is more defensive. Part of that is that the impact of vacancy is less compared to the impact of office. And the costs associated with addressing vacancy are simply less. I think that I would rather bet on the shipment of goods in the US versus own office employment in a recession. And so from our standpoint, yeah, we think we're shifting toward an asset class that's likely to do better in a recession than office. And what we've done by tweeking our leverage so much as well. Is we put our balance sheet in a position to be prepared for pretty much anything that comes at us. So there is speculation. No business cycle lasts forever.

I think we're optimistic about how the economy is doing, but mindful that money is going to cost me more, labor costs me more. The trade tensions mean that many goods are going to cost more too. So that does sap economic vitality to some degree and one of the reasons why we like sustaining long weighted average lease term in the portfolio is that you tend to do better in an economic slowdown than companies that have loaded up on a lot of short term leases hoping that the economy will be strong forever and they'll have the ability to mark the rents to market faster.

Nate: Yeah. And you mentioned the eight and a half years today, currently lease life in your portfolio. Where would you like it to be once you achieve your goal of... And I can't recall, did you already mentioned exactly what your goal is in terms of the proportion of industrial real estate in the portfolio as compared to office?

Will: Well, ultimately we're shifting to a 100% industrial model. It's just going to take time for us to extract value from each of our office buildings so that we can maximize the value of those holdings. In terms of weighted average lease, we'd like to sustain a weighted average lease term of around nine years. But anywhere between eight and 10 years we think is fine. You know, in our mind, then we've balanced our return between the income that we have from net leases with the value of the asset at the end of the lease term.

Nate: Could you talk about the competitive landscape? Who do you compete against and how competitive is it right now in the industrial real estate market?

Will: Well, industrial has been quite competitive for several years because we invest in multiple markets and across different types of industrial assets with different lease terms. I don't think the competitive set is the same in every investment opportunity that we look at. In the past when we've been working on a build-to-suit, we've often felt like we were getting close to direct looks at business from merchant builders that we have relationships with. There are other people in that business, but that's generally a product type that isn't broadly shopped to the market. But you know, it's been competitive for several years. Cap rates have been compressing. We think that the cap rate compression has probably leveled off right now in the context of interest rates going up. So it's competitive. But one of the things we like about the size of our company at about four billion dollars is, if we can find four or five hundred million dollars of good new risk to take every year, it really can move the needle meaningfully. So, you know, we like that we can be selective in how we deploy our capital. And make sure that we're finding the best risks to take in the market.

Nate: Who are most of your competitors? Other real estate investment trusts? Or are they private companies or are they all of the above?

Will: It's all the above and it's situation specific. In certain markets you'll find different kinds of investors, but the competition is broad based.

Nate: Yeah. And so you mentioned relationships with some of the merchant builders is. I guess I'm just trying to. I'm curious what competitive advantages does Lexington have relative to your competitors? Is it relationships or is it something else that you think Lexington has that sets you apart from the competition?

Will: I think since the franchise has been in the business of investing in real estate since 1973, we have a very strong franchise in the context of build-to-suit that's been a specialty of ours. And we've worked directly with merchant builders for many years in that space. So we are a reliable closer. With an investment grade rated balance sheet. So a commitment from us is bankable for our builders. So in that context, when you're a merchant builder competing for build-to-suit, opportunity for cooperation, I think certainty of execution is very valuable. And that's what we bring to the table. Often these construction projects can be very complex and maybe take 12 or 18 or even 24 months to complete. So you need to have a capital partner that's willing to take that forward risk, if you will. And you want to make sure that your partner's very well capitalized, which we are.

Nate: I'd like to get to the financials and the outlook, but I'm curious just from a market perspective. You've been in the real estate business for a long time. I was wondering if you might be able to share either a story about, or just an observation, of some of the most significant market changes that you've witnessed during your tenure in this space.

Will: I would say the biggest thing that I've observed is disclosure and transparency. You have to understand that when I started working, getting a financial statement on a company in real time, required you to order it from SEC Disclosure and pay the costs of having the financial statements delivered overnight. So think of that compared to the world we live in right now, where in essentially our cell phones, we have access to almost universal knowledge. That's such a profound change and obviously with so much real estate now held publicly, and with the amount of disclosure that public companies make— Like, in our case, we list the address for every single one of our properties. You know, just think of the difference that that makes in terms of making informed investment decisions now. It’s been a fascinating transformation, but I think it's in the area of disclosure. Everybody essentially knows the facts. That's the biggest change.

Nate: Yeah. That's interesting. So getting into the financials and the outlook. I guess just as a precursor to that, I'm curious if you'd be able to share some of the just important financial terms and acronyms that are specific to REIT’s. And so when I think of REIT’s, some of the acronyms are like FFO, cap rate. Do you mind just walking through those, what they mean, and what they are, and how important they are? I think it would just be very helpful to hear what some of the specific financial terms and acronyms are.

Will: Well, I think the biggest thing in the REIT space is funds from operations, or FFO, which has been a broad brush attempt by the REIT industry to take gap net income and then try to reconcile it to something that reflects cash flow better. So, in the context of net income, real estate companies deduct depreciation, for example, to get to net income, and yet many real estate companies would argue that the value of their assets is going up over time, not depreciating. So that's the big thing. If you're trying to start with net income and then get back to FFO depreciation, that non-cash expense that’s called depreciation is the biggest adjustment. We would argue however, that FFO, which is based on gap revenue, which straight lines rental increases over the life of a lease so it's not actually a true cash number. That investors should make an adjustment to FFO to get to AFFO to reflect true cash flow. And we would argue that to really get to a true cash flow number, you should also deduct the costs associated with leasing to get to an adjusted FFO number or something of that sort. And in our case, the difference between those two numbers right now, since we have costs associated with sustaining occupancy in our office portfolio, the difference is fairly considerable. Over time, that difference should dissipate, and those actual FFO and adjusted FFO numbers should converge over time, so our FFO will become a better measure of cash flow over time. The other thing that people talk about is cap rates—essentially, net income or in the case of single-tenant buildings, the rent itself divided by the purchase price, to give you a sense of the unleveraged return in the first year of an investment. So that's a good measure in terms of understanding initial yields on an investment. Of course, they can be misleading if rents are very high in relation to market, or a building might require substantial investment during the lease term.

Nate: Okay. Thanks for that. That's really helpful. And so you mentioned the costs. Actually, before we get to that, what would you say are the big differences between FFO and free cash flow?

Will: Well, I think the first thing is adjusting to get to a true cash rent number versus gap revenue, and then we pay all the costs of leasing out of our returning cash flow. So we would say that that should be— Some people will look at that as an investment in real estate and perhaps some of it is, but those costs associated with sustaining occupancy, we believe that it should be funded out of cash flow. So those would be the two principal deductions.

Nate: I see. Okay. And what are some of the other costs items associated with running a real estate business? You mentioned sustaining occupancy, but is there anything else that is worth highlighting for new investors in the real estate business?

Will: Not so much in net lease. Remember, G&A is an important cost to shareholders to keep an eye on, but because the lease structure generally requires tenants to manage the properties themselves and pay the operating costs directly, it's a very clean property type for investors to be able to underwrite and understand just from looking at the financial statements. And we can, with a head count of about fifty people, operate a pretty large portfolio with very good geographic diversification and that's an advantage of the lease structure.

Nate: Yeah, that's one thing that, as I look through and screen for different companies to come onto the podcast, I do take a peek at the total number of people that work at a company and it is surprising that there's just so few people that work at LXP relative to your market valuation. Which I know that doesn't say very much other than the fact that you guys own assets and it doesn't take that many people to actually manage the assets.

Will: You can get a lot of diversification for the overhead.

Nate: Yeah. Would you say that for the industrial business, there's fewer people that you would need because you've got a larger building, a larger number of square feet and you maybe have fewer people focused on whether it's doing the accounting or...

Will: Yeah, absolutely. What is happening as we exit the office space and focus on industrial is that our operations are becoming more simplified. And often when we've had a single tenant building go vacant, we've turned it into a multi-tenant building. You know, which is much more asset management intensive and requires more personnel supporting the assets. So now what we've seen is last year our G&A was about $35,000,000. This year we think it'll be $32,000,000 or $33,000,000 and next year our preliminary thought around our G&A budget is in the $27,000,000 to $29,000,000 range. So there should be a real benefit to our shareholders from the shift in terms of the overall costs that it takes to run the company. And you're absolutely right. Industrial will be a less expensive asset class for us to manage.

Nate: I was hoping you could talk about the balance sheet. So could you talk about where leverage was before the asset sales this year and then where you hope to have the balance sheet once you kind of pruned the portfolio or adjust the portfolio to closer to where you would like it to be?

Will: Sure. You know pre the large portfolio joint venture our leveraged was at a little bit above six times net debt to EBITDA and we think right now we'll be running the company at roughly five times, which is considerably lower leverage. Over time as we transition to 100% industrial, we'd be very comfortable running the company between sort of five and a half and six times debt to EBITDA. So that means that we have some balance sheet capacity to act on acquisition opportunities and be a net acquirer. Even though we have substantial disposition proceeds coming back to us, we think next year we still have balance sheet capacity to grow

Nate: Yeah, and relative to your competitors, is five and a half to six times roughly where they are as well is that kind of a..

Will: I think the average, the net lease sector is about five/six. So we have below average leverage, at least right now.

Nate: And what types of debt instruments do you, or debt financing do you use as a term loans associated with buildings or?

Will: Yeah, we have all kinds. What we've done with the balance sheet is we've tried to maintain a high degree of flexibility so we can optimize the best capital that's available in the debt markets. So we have a $500 million revolving credit facility with our bank group. We have several million dollars of term loan from our banks. We're also investment grade rated. So we have two bond issues outstanding and we use mortgage debt from time to time. Most of our debt is unsecured, but sometimes when we have a long term lease on a more specialized building, we'll use secured financing. So again, what we're trying to do is create as much optionality for ourselves as we can on the debt side so we have flexibility and we can make the right choice in every instance.

Nate: With respect to capex, I'm curious how you envision or see your capital expenditures changing relative to just call it your average capital expenditures over the past, call it three to five years. Is there going to be a shift once you become more weighted to industrial?

Will: Yeah, I mean the, the shift has been underway for several years and it's going to keep going until we're out of the office space. So it's hard to forecast specifically. Because one quarter we might have heavy capital costs around a leasing project and not have it the next quarter. But compared to a few years ago, our spend on capex is probably half. And historically about 90% of our expenditures have been around office. So if I look five years from now they'll be, I don't want to say that, they're going to come down considerably again as we get out of the office space. So that's going to be really great for us as we move to a much cleaner and more efficient investment model where there isn't so much noise around capital costs to sustain occupancy and in the office portfolio.

Nate: Okay. So the 90% that you mentioned that was primarily, I mean, would you characterize that as maintenance capex or are you talking about growth capex as well in terms of buying more assets

Will: Across the board to sustain occupancy and also maintain our buildings.

Nate: Yeah, and do you talk about maintenance capex very often within, with investors and potential shareholders? Do you break out what maintenance capex is versus growth capex?

Will: It doesn't come up that often in the context of our discussion with investors simply because of the lease structure where most of the costs are paid directly by our tenants, so typically where we have heavy capital expenditures is when we have a vacancy and most of those expenses are then associated with repositioning the asset for lease-out.

Nate: I see. So the real benefit, or one of the real benefits, of shifting from office to industrial is that you won't have that expense when you do have a change in tenant. Well at least with industrial, the expense is much lower than it is with office. Than it is with office.

Will: Correct. That's part of our investment thesis.

Nate: And why is that? Is that just because somebody who may come into one of your new office buildings, they want specific things and because office buildings are a little bit more complex than a large industrial building, it just costs more?

Will: Yes. And if you think about how office space is configured now compared to, Say 10 or 15 years ago, many tenants have switched to open floor plans and that can be enormously expensive to take a building that's older and bring it up to modern standards.

Nate: Huh. Interesting. Yeah, I hated that by the way. My previous firm that I worked for made that decision at least for most of the different floors in the building, to change to an, an open office space and I just don't see how people enjoy that. It drives me crazy. I would like to shut my door and not hear anybody else when I'm working.

Will: I agree with you. It's nice to have some privacy when you're in the workplace.

Nate: It is. Yeah. So I understand that you guys haven't talked about next year's dividend, but at a high level, I was just curious if you might be able to share what your aspirations are as it pertains to shareholder returns.

Will: Well, essentially since the financial crisis, we grew our dividend from 40 cents a share to 71 cents a share. And in a low interest rate environment where deflation was a real risk, pushing as much cash flow out the door to our shareholders we thought was a very valuable thing. And dividend yield plus dividend growth worked very well for the stock for a while. In the last couple of years we've had underperformance. We've ended up distributing this year about $50,000,000 of our cash flow in excess of our minimum distribution requirements as a REIT. So, we've taken some big steps which have resulted in some dilution to our cash flow. And we've made I think, a very important decision to have a distribution policy that allows us to retain as much of our internally generated cash flow as possible and reinvest that in the business. And so over time, reinvesting that capital in new properties with good current yields and with rent growth should improve our internal growth profile considerably and results in sustained dividend growth and add an attractive rate.

Will: So we've said that we're going to reset our dividend to be more in line with our statutory minimum next year. We also said on our recent earnings call that we thought that that would be more than 40 cents a share. But we haven't actually gotten to the point where we have declared the dividend itself. So that dividend will be extremely well covered. And again the important thing is that the internally generated cash flow of the company is going to be reinvested in the business, which we think has a enormously valuable attributes over time. And you know whether we use that retain capital to buy new buildings or repurchase shares, it's going to be a benefit to the shareholders. And share repurchase for us has been a good capital allocation alternative to buying buildings recently. And is another way for us to return capital to shareholders.

Nate: Yeah. Can you talk about how many shares you've purchased since... you've been buying shares since the most recent divestiture, correct?

Will: Yeah, we were active in our, in our share repurchase plan in third quarter and our board authorized another 10 million share repurchase. We have a lot of flexibility with respect to buying in stock if the opportunity arises.

Nate: Yeah. And so what are you looking at most whenever you and the board or are considering share repurchases? I mean, do interest rates... I guess what's most important is how you're thinking about valuations in the market relative to the industrial real estate assets that you would like to buy as compared to how much cash or stock is yielding today. Just how you think about that process would be helpful.

Will: Well, it's a mixture of considerations. Recently there's been a rotation of shareholders and we've had some shareholders who were income oriented selling out of their position in our company. I think that straight created some weakness. So our share's been trading at a fairly substantial discount to net asset value. So repurchasing shares is compelling compared to purchasing the real estate. On the other hand, we do have a desire to reach this target of being 100% invested in industrial. So we will continue I think to be able to find good risks to take on the investment side that are consistent with our longer term corporate objectives. But in the near term share repurchases are our most creative use of capital so we don't want to say that I'm happy that the shares have traded down in the last couple of months, but it has provided an opportunity for us to allocate capital differently and in a way that I think is quite advantageous for the shareholders.

Nate: Yeah. I'm just curious from when I put my investor hat on and I look at your stock is yielding just if you look at FFO or FFO yield, it just seems like buying your own stock.

Will: Purchasing stock right now is very creative. But again, you really do need to do the math from getting from FFO to AFFO to understand the truer cash flow metric. But we've been, as I said, in September and October this year, we were very active repurchasing shares and we have a lot of dry powder available to repurchase shares as well. It's hard to, if you think in the context of a large distribution facility, perhaps costing $50 million dollars and you look at the opportunity set to repurchase your shares, it's smaller. It could take 100 trading days for us to exhaust our existing share repurchase authorization. And that assumes that the share price will always be very attractive. Share repurchases is a tool, but it's not the only strategy that's available.

Nate: No, that's a very good point. So I appreciate you making it. Could you talk about the valuation? What key metrics, valuation metrics investors should pay attention to? Is it just FFO and looking at net asset value or are there other key valuation metrics that investors should pay attention to with respect to LXP?

Will: I think you look at it two ways. We're very focused on on NAV. The key thing with NAV is where it's going directionally in a company. Is management implementing a strategy that adds to NAV over time. The share price is either going to trade at a discount or a premium to NAV. So if NAV Is directionally going the right way. I think that's a very good measure of what a management team is doing. FFO and AFFO multiples are a very good tool to compare companies to one another. And are again, a very important metric to pay attention to. But in a real estate company, no substitute for understanding the real estate itself. What the escalators are in the rents, how much rollover risk is there. So it's an asset class that requires a variety of skill sets to come oat both the securities analysis standpoint, but also being able to underwrite the real estate itself.

Nate: Yeah. What do you think the market is missing or what's misunderstood about your company or is it the industry?

Will: Well, in our case, I think people broadly agree with the strategy, but there's still every quarter there's going to be a lot of moving pieces around selling out of the office portfolio and how well we do on reinvestment. These office buildings will be sold, for example, at higher cap rates that we can purchase industrial for. So there will be some, some dilution that we have to work through in the context of that. On the other hand, every time we add a new lease to the portfolio with rent growth, we have in our industrial portfolio a built-in cash flow dynamic that should, over time, offset that dilution. And the big thing is when we get out of the office business, there won't be the drain on our cash flow that's associated with sustaining occupancy in the office portfolio. So we're going to get to a very clean and very efficient portfolio with I think much more sustainable cash flow growth than at any time that we've ever had.

Nate: Appreciate you sharing that. That's good to know. And then with your current investor base, what are you hearing? You mentioned turnover in the investor base. Do you still have existing shareholders from two or three years ago that have held on and have they shared some of their thoughts with you?

Will: Well, the institutional investors have been very supportive of what we're doing with the company. Some of our retail investors who have been very dividend-oriented less so. Since the joint venture announcement a couple of months ago, about a third of our shares have turned over, so I'm hopeful that the weakness associated with some of those retail shareholders leaving the company is behind us.

Nate: Yeah. So what gets you most excited about this new strategy and as you execute, what puts a smile on your face when you wake up in the morning?

Will: Well, there's many things about it. One is choosing to focus on one asset class versus two, and making the right choice around that asset class in the context of what's going on in the industrial markets right now, and what it means over time for us, getting away from this model where there were such heavy capital expenditures associated with leasing office buildings. So, the balance sheet is in a great position. The asset class we're focusing on is right. The strategy is sound. And the big thing is moving from distributing so much of our cash flow, in the context of dividends versus retaining that and reinvesting. That's going to make a huge difference over time in terms of having a company with an organic growth rate in its cash flow that's easy to quantify and is reliable, versus owning these office buildings where the full or empty risk at the lease term is so hard to underwrite and the vacancy has such an impact. So that's the key thing for us to get out of and I think it ends up being a terrific business model. Obviously, the project is not finished, but every quarter, we get closer, we get very excited about the company that we're creating.

Nate: And apart from selling the office real estate assets that you hope to sell at maybe a lower price than you would like to sell it at, what are some of the other big risks to executing the strategy that you've laid out before yourself and the company?

Will: The macroeconomic risks is there for all companies. In our case, it's easier to get good value for our office buildings, if we're in a strong growth phase across the economy where we have very strong employment.

The other thing that is key is watching the direction of interest rates. As borrowing costs go up, that can impact the amount of money that investors can pay for real estate. On the other hand, in a robust economy, often lenders are very generous in underwriting loan-to-value, so, so far the debt markets have been very supportive of real estate acquisition. So I think it's the availability of debt capital, I think, will be the key thing for us to focus on.

Nate: And what would you like investors to understand? As you transition the portfolio to mostly industrial, is there something that you would encourage investors just to focus on or keep an eye on or pay attention to most?

Will: Well, keep your eye on the big picture. The picture that we have in our mind of what the company will be when it's transitioned to 100% single-tenant industrial. And you know, we get that quarter to quarter, there's a lot of moving parts in the portfolio. But you know, every quarter we're going to make progress toward those goals in terms of adding industrial to the portfolio, shrinking the office. We're going to do what we said we're going to do, and every quarter, you can keep your eye on those trends. So keep that perfect picture in your mind and pay attention to every quarter to see the progress that we're making.

Nate: Yeah. I have a question in here that I usually ask management teams about: if you weren't a shareholder, what would you feel like is most important for you to get comfortable with? But I think you've already asked answered that question. But I guess I'll change it up just a little bit. Based on the valuation today, are you buying shares?

Will: I think I might be the largest individual shareholder in the company, so I'm very long. The success of Lexington, it's a hugely important thing to me. So, I've built up a share position over many, many years and I'm not selling any stock. I'm long LXP and I'm going to stay long.

Nate: That's good to know. And so I try to end all these interviews with a little bit of humor. If you can share some sort of story or just a question that you might have had from an investor at either an investor conference or just an investor meeting that you'd be willing to share, I'd really appreciate it.

Will: You know, in twenty-five years there've been so many funny stories. It's hard to pick just one. But right when we went public, being a public company was a new thing to us, and we had a lot to learn and we were blessed because we had a shareholder who had a lot of good ideas for us. And he wasn't afraid of calling up and sharing them with us and trying to help us do our job as public company executives better than we were doing it. And so one day I overheard him. He was calling our chairman to probably share some of these pearls of wisdom and I heard the chairman's executive assistant at the time. And this gentleman was on speakerphone and I heard her say, "Well, you know, the chairman isn't here right now. Would you like to talk to Mr. Ragland?" And he said, "No thanks, I'd like to talk to the organ grinder, not the monkey."

Nate: Oh my gosh.

Will: And so on my desk, I have a mechanical clapping monkey that I look at everyday just to remind myself of that moment, which was a humble one, but it has helped me keep perspective over the years.

Nate: I can honestly say that's the best and funniest story so far of the program, so thank you.

Will: I enjoy it too.

Nate: Yeah, well Will, I know you're busy and I really do appreciate the time that you've shared with me and the IwtB community, so sincere thanks. I really do appreciate it.

Will: My pleasure Nate, thank you.

Nate: Alright, yeah. Thank you. Take care.

Will: You bet. Bye!