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Dawoon Chung
National Bank Financial

Dean Wilkinson
CIBC World Markets

Jimmy Shan
GMP Securities

Michael Smith
RBC Capital Markets

Johann Rodrigues
Raymond James

PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Slate Retail REIT Q2 2016 financial results conference call. As a reminder, this call is being recorded today, Thursday, August 11, 2016, at 9:00 a.m. Eastern Time. Your host for today's call is Katie Talbot, Investor Relations. You may begin.

Katie Talbot, Investor Relations

Thank you, operator, and good morning, everyone. Welcome to the second quarter 2016 conference call for Slate Retail REIT. I'm joined today by Greg Stevenson, Chief Executive Officer.

Before getting started, I'd like to remind participants that our discussion today may contain forward-looking statements and therefore ask you to familiarize yourself with the disclaimers regarding forward-looking statements as well as non-IFRS financial statements, both of which can be found in management's discussion and analysis. You can visit Slate's website to access all of the REIT's financial disclosure, including our August 2016 investor update, which will be available now.

We'll devote most of our time today to answering your questions but first I will hand the call over to Greg Stevenson to discuss some highlights for the quarter.

Greg Stevenson, Chief Executive Officer

Thanks, Katie.

Another solid quarter for Slate Retail REIT and our dedicated team continues to do an excellent job. A lot of highlights that set us up to see increment NAV growth in the future are on the back of leasing in this quarter. We saw 6.9 percent positive spreads on shop space. We've got about 900 tenants in our portfolio and more than 700 of those tenants are shop space tenants, so that will be where a lot of our income growth comes from. We've seen about 8 percent shop space spread since listing in 2014, so very strong growth there. Anchor renewals were 2.4 percent, still well above inflation and we'll see income growth there, but a lot of this growth is in the form of NAV growth. When you take an anchor lease out, short-term anchor lease out five to ten years, the asset becomes a lot more liquid and you see cap rate compression, so we're very happy about the leasing that we've done in the anchor space as well.

The redevelopment program continues to pick up steam. The relationships with our tenants grow stronger than they've ever been and more opportunity is coming. We disposed of seven assets year to date with very strong returns, proving out our thesis that going where others aren't is paying off and proving naysayers wrong that there is a lot of money to be made in the markets we are focused on. The pipeline today is bigger than it's ever been so there's exciting opportunities to reinvest that recycled capital and the money we've raised to make our portfolio higher quality with more upside. As the largest investor, we continue to be very excited about the future of this business. I want to provide a little more detail on some of our operating metrics. Given our story is quite a bit different than others and we're at the growth stage of our life with more than doubling the portfolio over the last two quarters.

Firstly, I want to make it very clear that this includes 41 of our 68 properties and excludes 40 percent of our existing portfolio. As a result, a lot of the positive things that we're doing do not show up in these numbers. I want to make it very clear that we show unadjusted same property NOI. We do not back out large vacancies or development properties. I also want to make it clear that Buckeye and County Line, which is driving the negative 1 percent this quarter, happened in Q3 of 2015 and Q4 of 2015 and it didn't happen this quarter. We remain very optimistic that the backfill of County Line will provide outside returns for our investors. Excluding these items, same property NOI was positive 0.5 percent on the quarter.

Secondly, the chart with new leasing spreads in our MD&A showed 50.3 percent new leasing spread for shop space greater than 10,000 square feet. A reminder that this is more than 700 of our 900 tenants, so very strong numbers, and a negative 27 percent for greater than 10,000 square feet. What this is comparing to is existing rents in our portfolio. This is not a change in income in our portfolio. To give you an example, that negative 27 percent, the spread on that new leasing is actually infinite. There was bought back property at a 78 percent occupancy rate. There was no income. There was no tenant. We leased that up. We took the property to 95.8 percent occupancy and created over $2 million of value that we did not pay for and that was not there before. There is a lot of positive leasing spreads and I think you will see us change the way we report this in the future.

Thirdly, in anchor renewals we did four leases greater than 10,000 square feet this quarter totalling $5.4 million of contractual revenue over a five-year period. That cost us zero dollars in tenant improvement and leasing commission dollars. To me, that is akin to walking into the bank and saying, "I have an investment. It's about to expire and I'd like to renew that investment," and the banker saying, "Well, that's $5.4 million of income over the next four years," and I say, "How much is that going to cost us to get?" and they say, "Greg, we will give that to you and it will cost you absolutely no money." We remain very excited about the return on invested capital and the money that we're making in our portfolio today. This continues to be a capital light business and our return on invested capital remains very strong.

FFO per unit was up almost 14 percent quarter over quarter due to margin improvement and NOI margin. We were 72.4 percent Q2 this year versus 74 last year. We also saw an improvement in G&A, which was 62 basis points of total assets versus 74 basis points of total assets in Q2 of 2015 and a 14-basis point reduction in our cost of debt.

We have a leases-not-renewed section in our MD&A, which was about 112,000 square feet. 85 percent of that number was Kmart. That wasn't tenants saying, we want to leave our portfolio, that was us saying please leave our portfolio and we're going to pay you to do so. We have leased, in one of those instances, re-leased Kmart space at more than two times what Kmart was paying. This isn't a bad thing. This is a good thing for us. Kmart rent in Hocking Valley was under $3 per square foot and, similar to what we've done in North Augusta, we are underwriting rents to be achieved between $9 and $15 on that space.

With that, I'll turn the call over to questions.

QUESTION AND ANSWER SESSION

Operator

If you would like to ask a question during this time, simply press star then by the number one on your telephone keypad. If you would like to withdraw your question, press the pound key. We'll pause for a moment to compile the Q&A roster.

Your first question comes from the line of Dawoon Chung from National Bank. Your line is open.

Dawoon Chung, National Bank Financial

Good morning, guys. I'm not sure if you discussed in your previous calls but could you give us a sense what the acquisition pipeline is looking like for 2016?

Greg Stevenson, Chief Executive Officer

The acquisition pipeline remains very robust. As I mentioned in a few spots in the MD&A, it's larger than it's ever been, and that's as a result of a few things. The first is we've been doing this for more than half a decade now, and a lot of folks in the U.S. know who we are, so we get a lot of inbound calls, because what we do is very niche-y. We acquire only grocery anchored properties and only in secondary markets and over the last three years we've been one of the most active buyers in the United States of this type of property. We still continue to receive a lot of inbound calls for one-off acquisitions.

What's really picked up as of late is our grocery anchors continue to bring us off-market opportunities.

The benefit of going into these markets and being one of the only folks that do what we do, bringing an institutional team and a balance sheet that our competitors don't have, is that our landlords don't have the opportunity to work with other landlords like us. They're calling us and saying, "Hey, guys, we really like what we've done with you in the past. Here are a lot of other assets that we're in, and we'd like to partner with you. Can you try and buy these so we can talk about redevelopment or even simple CapEx and lease renewals?" That's another bucket for us. As we talked about that in the past, 2006, 2007 was the largest year of CMBS issuance and ten years later that's coming due. We're seeing some distress there. The non-traded REIT space in the U.S. continues to be on life support, and we've been looking at opportunities to buy some distressed assets, well, performing assets from distressed sellers in that space.

The third bucket is every single large-cap REIT for the most part in the strip center space in United States continues to sell their secondary market assets. This isn't because of a quality thing in my opinion. This is because they need to focus on their top 40 assets that are, you know, sometimes 20 to 25 times larger in value than the assets that we're buying from them. Charles Town, West Virginia is a perfect example. Last quarter it was a $20 million asset in West Virginia, and we bought that from a large-cap REIT. The reality is they're a $5 billion market cap company. They are not focused on a $20 million asset in West Virginia. All of those things continue to happen and we continue to see far more direct off-market opportunities from these REITS, from these tenants and from distressed sellers than we have in the past. The pipeline is big. Acquisition activity will continue, and as you've seen us do, I think we can still continue to buy at attractive cap rates with future upside in all these properties.

Dawoon Chung, National Bank Financial

Switching gears here, from a modelling standpoint, is Q2's straight-line red a good number to use for the future?

Greg Stevenson, Chief Executive Officer

Yes.

Dawoon Chung, National Bank Financial

It seems like you guys acquired property in Utah. Could you guys provide a cap rate and LTV on that?

Greg Stevenson, Chief Executive Officer

We're going to target 55 percent LTV. The cap rate on that was in the mid sevens. We view the U.S. as very regional. We've got two assets already in Colorado. This will be the third in that region. Flying from these assets to our Colorado assets, just to give you an idea, is about an hour. It's like flying from Toronto to Montreal. We strongly believe that there'll be a lot of other opportunities in some of these markets, Colorado, Arizona, Utah, west coast. Similar to every one of our acquisitions, grocery doing very strong sales, low rent, shop space leasing to be done, shorter anchor lease term. You've got Salt Lake City with a population of 1.2 million people, which if you put on a trailer and moved up to Canada would be the fourth largest city in our country right behind Vancouver. The is job growth, income growth, strong demographics and a grocery with leading market share. It ticks all the same boxes that you've seen us tick in the past and we have full intention of building scale in these markets.

Dawoon Chung, National Bank Financial

Okay, great. I'll turn it back. Thank you.

Greg Stevenson, Chief Executive Officer

Thanks.

Operator

Your next question comes from the line of Dean Wilkinson from CIBC World Markets. Your line is now open.

Dean Wilkinson, CIBC World Markets

Thanks. Good morning, Greg.

Greg Stevenson, Chief Executive Officer

Good morning, Dean.

Dean Wilkinson, CIBC World Markets

Just a question on the acquisition versus disposition metrics. Those seven assets, were those predominantly the SUSO 3 stuff or the SUSO 1?

Greg Stevenson, Chief Executive Officer

Yes, SUSO 1, however, one asset was SUSO 4. The Ocean Plaza was an asset that we bought in conjunction with our grocery anchored tenant there. It was one of the ones I described where they said, "Can you please buy this? We've got a redevelopment play we want to do here." It turned that they wanted the entire center so there would be no shop space left and no reason for Slate to be there. They just said, hey, we're going to buy this back from you, and they bought it back from us from a pretty good premium to what we bought it for and we were able to collect a lot of NOI over that year and a half holding period and put absolutely no capital back into it. That was a good one for us. Madison Center, which we did in Q1, same thing, our anchor bought it there, but that was a SUSO 1 property, so we bought that early on. The Food Lion portfolio assets, four of those were SUSO 1, older legacy assets that we've held for a long time and done very well with. One of those was a SUSO 3 asset.

Dean Wilkinson, CIBC World Markets

In terms of the 313 acquisition price, does that include the pro rata share of the portfolio premium that came across when you did the vend-in transaction or was that just sort of the flat value?

Greg Stevenson, Chief Executive Officer

That's inclusive and would be all vend-in.

Dean Wilkinson, CIBC World Markets

On the North Augusta and the Hocking Valley, that's $17.5 million of CapEx that's left to go, that's still a pretty firm number?

Greg Stevenson, Chief Executive Officer

Yes.

Dean Wilkinson, CIBC World Markets

I'm assuming that's just going to be funded probably from a draw on your facility?

Greg Stevenson, Chief Executive Officer

That's correct.

Dean Wilkinson, CIBC World Markets

The lease at the Merchants Cross, the 425, obviously, a big lift from zero but given that it's markedly below, say, market, was that just a case of you wanted to get the tenant in there? Had you waited six months or something you probably could have done better but there would have been a drag on the asset so you just wanted to get it leased up?

Greg Stevenson, Chief Executive Officer

When we purchased the asset, we underwrote a $4 rent, so we beat underwriting. To give you an idea of underwriting, we underwrite to mid-teen IRRs. We think we'll be higher than that. To your point, we did it faster than anticipated. This was just tougher space, and our guys did a good job leasing this up. The prior landlord had this space sitting vacant for years, and I think it comes back to our strategy of focusing on assets that prior landlords just didn't focus on, it was a tough space, we got it leased, and we never thought we'd lease it for $8 or $9 or $10. I think this is exactly where we thought we'd lease it, so very pleased with the outcome.

Dean Wilkinson, CIBC World Markets

On the AFFO, you calculate that on an as-spent, not a normalized basis, but you're still in that $2.5 to $3 million a quarter expectation there?

Greg Stevenson, Chief Executive Officer

Yes, that's as-spent and I think it really speaks to the quality of our cash flow and the quality of our distribution coverage, because those are actual numbers.

Dean Wilkinson, CIBC World Markets

On a normalized basis, it'd probably be at an additional $0.04?

Greg Stevenson, Chief Executive Officer

It will be lumpy and there'll be quarters where it picks back up again.

Dean Wilkinson, CIBC World Markets

That's all I had. Thanks, Greg. Talk to you later.

Greg Stevenson, Chief Executive Officer

Thanks.

Operator

Your next question comes from the line of Jimmy Shan from GMP Securities. Your line is now open.

Jimmy Shan, GMP Securities

A couple questions on the asset sales, the numbers you put up there in the letter, 22 percent ROE analyzed are pretty good numbers for what look to be sub-par assets, at least relative to the portfolio. First question is why not do more of these going forward as a source of capital? Secondly, I think most of those were tenant buyouts or end-user buyouts and wondered if it's any difference between what they would pay versus what a typical cash flow buyer would pay.

Greg Stevenson, Chief Executive Officer

All seven assets were inbound calls. We didn't market any of them to your point. Two of the seven were our anchors or end-users buying them, and the other five were just the Food Lion portfolio, just an inbound call from someone looking for that type of real estate. Would we do more of this? Sure, but I think what we believe is that there's a lot of low-hanging fruit left in our portfolio, and our guys are doing a tremendous job of, bringing that to fruition. But we don't want to sell anything before our work is done because we don't want to leave any money on the table, and in these seven cases, the phone calls we received and the prices that we were offered were over and above what we think that if we would have applied our asset management strategies it would have been still in excess of what we thought it was worth, so it makes lots of sense to us. To your point, the demographic information that we show in that same table in the letter, and demographics don't tell the whole story, but I think when you look at our existing portfolio at over 100,000 people within five miles and the sold portfolio of around 30,000, we can then take that money and buy higher quality properties.

We're not actively looking to sell because we still believe there's a lot of value in being larger. If we fast-forward X number of years, and you look at a 100 percent grocery anchored portfolio located in the United States, 100, 150 properties, whatever the number may be, I think you can think about First Capital as a good case study, that's a pretty interesting thing. Investors over the last 15 years in First Capital made a lot of money. They compounded at high teen returns and Buffett talks about this all the time, it's a lot harder to do that in a large business. Investors are rewarded coming into a business like ours today and our goal is to continue to grow it. If we can sell a property for above NAV, which we've done in every case here, there's a good chance we'll do it, because we've got the pipeline to redeploy the money into, but otherwise, our goal is to grow the portfolio because we think there's value inherent. There was another transaction with Hines this past quarter and it was at $202 a foot for comparable properties and we're trading at an implied $115 a foot. I think we continue to believe that there's value in being bigger.

Jimmy Shan, GMP Securities

Okay. Going forward, will it continue to be the same in the sense that you're taking more of a passive approach to the sale as opposed to once you feel the value is maximized on a neutral basis, you won't actually go out and try to seek a bid?

Greg Stevenson, Chief Executive Officer

That's correct.

Jimmy Shan, GMP Securities

On the redevelopment side, the two redevelopment assets, Hocking Valley and North Augusta, I read in the MD&A that the value were already marked up in the latest quarter. Could you run through the math in terms of what the delta would have been versus last quarter?

Greg Stevenson, Chief Executive Officer

That was largely at Hocking Valley this quarter because of the Kmart lease buyout and the Kroger lease getting signed. The cap rate compression from that, having the new lease and getting Kmart out of there is still largely offset in our NAV by all the capital that we have to spend. We haven't actually seen that NAV improvement in our numbers yet, and we won't until we get through our capital spend.

Jimmy Shan, GMP Securities

At a higher level, those two redevelopment assets, I think you're buying out the leases for $3 million combined and you've got another $17.5-ish million to spend, how do we think about that from an ROI perspective?

Greg Stevenson, Chief Executive Officer

Our goal is to do a high single digit to low double digit yield on cost. That's what we're pencilling out right now. Income growth is great and those numbers compare very well to what you're seeing a lot of folks do up in Canada with tremendously more risk but for us.

When you think about North Augusta for example, we bought that at an 8.8 percent cap rate. It had a 90,000-square foot Kmart in it that had a short-term lease. Absolutely no one wanted to buy that center, which is why we were able to buy it at such a good yield. We're going to redevelop that center, no more Kmart, no more short-term lease, investment-grade tenants, more than double the rents, and that cap rate is going to go from 8.8 to, conservatively, because it's a public anchored shopping center with very strong sales, and very low GROC - 6.5 percent. Yield on cost is important and we like to grow income, but for these projects, a lot of this is NAV growth. We're thinking about it both ways but I think the really compelling thing here for these developments is the per-unit NAV growth that our investors will receive as a result of it.

Jimmy Shan, GMP Securities

Lastly, on G&A I know there was some capital taxes in Q1, is that the run rate now or is that Q1 it ramps back up? How do we model that out?

Greg Stevenson, Chief Executive Officer

I think if you took the average of the two, that's a pretty good number.

Jimmy Shan, GMP Securities

Okay, great. Thanks.

Operator

Your next question comes from the line of Michael Smith from RBC Capital Markets. Your line is now open.

Michael Smith, RBC Capital Markets

I just wanted to touch on your pipeline, which you note is as big as it's ever been. Greg, you talked about getting a lot of inbound calls from grocers who want you to buy and talked about the CMBS market. I wonder if you could just give us a little bit of colour on those items. What percent of your pipeline would be from inbound grocers? Can you describe the distress in the CMBS market? Is it just nonrenewal or is it high loan to values?

Greg Stevenson, Chief Executive Officer

CMBS is both. While they may not be underwater they're maybe 90 to 95 percent or 85 percent loan to value and to right-side the loans they've got to cut cheques, which, as you can imagine, not a lot of them are willing to do. It's that. Then there's the ones that are, not as high percentage, most of them are what I've described, the ones that are underwater and they're just not renewing. As it relates to the grocers, we've got several hundred million dollars worth of these types of opportunities on our desk today. What percentage of that? I don't really know what the percentage of that is but absolute dollars. It's a very big opportunity for us in the future. Does that sort of answer your question?

Michael Smith, RBC Capital Markets

Yes, several hundred million of acquisition opportunities coming from inbound calls from grocers.

Greg Stevenson, Chief Executive Officer

Correct, the only real uncertainty there is timing. These are big companies. Kroger for example, own 3,000 grocery stores, which is more than there are in all of Canada, and they're the fourth largest retailer in the world. They don't move as fast as Slate does. Timing is uncertain but the opportunity is quite large.

Michael Smith, RBC Capital Markets

Would you say the cap rates range? Would it be north of seven?

Greg Stevenson, Chief Executive Officer

Yes.

Michael Smith, RBC Capital Markets

Okay, thank you.

Operator

As a reminder, in order to ask a question, please press star one on your telephone keypad. Your next question comes from the line of Johann Rodrigues from Raymond James. Your line is now open.

Johann Rodrigues, Raymond James

Hey, Greg. Just big picture, I was wondering how you guys see secondary market fundamentals tracking in terms of supply and demand and then also consumer fundamentals, in terms of traffic.

Greg Stevenson, Chief Executive Officer

Consumer traffic, on average our portfolio grocer sales are up high single digits from last year, so very strong performance, and a lot of this, to your first question, is there is absolutely no new strip center supply in the United States right now. I've heard different quotes from REIT CEOs in the U.S., anywhere from between 30- and 50-year low of supply delivery, and that's not only driving rent and occupancy growth, but it's driving sales growth as well at these stores, and I think it's why a lot of the grocers are focusing on redeveloping stores and not building new ones.

Secondary markets, they continue to be very ignored by institutional investors from a cap rate perspective. From when we first started doing this in 2011 to today, they've come in, but as you've seen from the last few deals we've done, we're still finding great real estate north of a seven cap. When you compare that to, if you were to buy a very similar property, let's call it like a Sobeys or a Loblaw's with an LCBO, a Tim Horton's, a Shoppers, a hair salon and all these other things, and that was in Barry, Ontario, I mean that cap rate would probably be like a four or a five. Relative value for us and we think it's tremendous. We understand why REITs are focusing on the larger assets and the larger markets. I think back to when I worked at a very large real estate company when I first met Brady and Blair and we sold them one of our non-core assets, and it wasn't because we thought it was not a very good asset or it was of lower quality, it was because we had an asset that was $1 billion in value across the street and we had to send our people somewhere. You can imagine when you have a decision to send someone to your $40 million asset or your $1 billion asset, where do your people go? Brady and Blair, one by one, bought a portfolio of these assets and earned three times their money.

I don't think that investors ignoring the market means that they don't think that there's good things to do there, I just think that they need to send their humans somewhere and they're sending them to their larger, more important assets. We've found a really nice niche. Pricing is still very attractive. We remain one of the most active, I'll call it, larger institutional type players in the markets, and I think it's a huge advantage for us. When you look at our numbers this quarter, with continued positive leasing spreads putting next to no money back into our portfolio to get these spreads, which I think is a very big difference from spreads that you see in Canada, which a lot of them are negative, and you've had lower interest rates sort of saving a lot of these REITs. Our story is very different, and we are more bullish on secondary markets.

To your point about fundamentals, where are all the jobs in the U.S. being created right now? They're actually being created in the secondary markets, because if you're an employer you've got lower taxes and you can pay your employees a lot less. In Nashville and Charlotte and Philly and Cincy where all of our properties are, you can buy a 3,000-square foot four-bedroom house for $300,000. If you tried to do that here in Toronto or Vancouver, it would end up costing $800,000 - $1 million dollars. Cars are more expensive up here. Food's more expensive up here. Gas is more expensive up here. Taxes are higher up here. We are very bullish on the U.S. as a job creator over the mid- to long-term and I think a lot of the growth will continue to be in these secondary markets. Apple is a perfect example. They're moving employees to places like Austin and Omaha and a lot of these smaller places because there's a lot of educated people there and they're not that expensive to hire. We're excited about it.

Johann Rodrigues, Raymond James

Right. Okay. I'll turn it back. Thanks.

Operator

There are no further questions at this time. I turn the call back over to the presenters.

Katie Talbot, Investor Relations

Thanks very much for joining us today, everyone. Have a nice day.

Operator

This concludes today's conference call. You may now disconnect.
