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CONFERENCE CALL PARTICIPANTS

Jenny Ma, BMO Capital Markets

Gaurav Mathur, Industrial Alliance

Pammi Bir, RBC Capital Markets

Sumayya Syed, CIBC

PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Slate Grocery REIT second quarter 2022 financial results conference call. At this time, all participants are in a listen-only mode. Following the presentation, we will conduct a question-and-answer session. If at any time during this call you require immediate assistance, please press star zero for the operator.

Today's call is being recorded on Wednesday, August 3, 2022, and I would now like to turn the conference over to Mr. Paul Wolanski, Senior Vice President, National Sales and Investor Relations. Please go ahead, sir.

Paul Wolanski, Senior Vice President, National Sales and Investor Relations

Thank you, operator, and good morning, everyone. Welcome to the Q2 2022 conference call for Slate Grocery REIT. I am joined this morning by Blair Welch, Chief Executive Officer; Andrew Agatep, Chief Financial Officer; Connor O'Brien, Senior Vice President; Allen Gordon, Vice President; and Braden Lyons, an Associate.

Before getting started, I'd like to remind participants that our discussion today may contain forward-looking statements, and therefore, we ask you to review the disclaimers regarding forward-looking statements, as well as non-IFRS measures, both of which can be found in management's discussion and analysis. You can visit Slate Grocery REIT's website to access all of the REIT's financial disclosure, including our Q2 2022 investor update, which is now available.

I will now hand over the call to Blair Welch for opening remarks.

Blair Welch, Chief Executive Officer

Thanks, Paul. Today, I'm pleased to share Slate Grocery REIT's strong second quarter results, which highlight our team's continued operational excellence and underscore, once again, the resiliency of grocery real estate.

This quarter, Slate Grocery REIT achieved significant growth through the acquisition of a $425 million grocery anchored real estate portfolio. We acquired 14 high quality properties, adding 2.5 million square feet, or 18.6 percent of gross leasable area to the REIT’s portfolio. The acquisition increases our exposure to leading markets for population growth in the U.S and to top performing national and regional grocers.

Importantly, the REIT’s acquisition basis of $174 per square foot implies that in-place rents in this portfolio are well below market. We believe there's an opportunity to grow organically over the long-term with this portfolio.

The REIT also entered into a strategic joint venture with the Slate North American Essential Real Estate Income Fund, or the North American Essential Fund. This partnership with the North American Essential Fund, which includes a leading sovereign wealth fund, provides institutional validation of the REIT's platform. It also establishes the structure for a consistent source of private capital in addition to the REIT's public funding strategies.

As part of the joint venture, the North American Essential Fund made $180 million cash investment into the REIT's assets, at a valuation in line with the REIT's Q1 2022 IFRS value. This once again validates the value of the REIT's real estate. The REIT allocated the entirety of the investment by the North American Essential Fund toward the $425 million acquisition, which was completed in July.

Importantly, after the period, the REIT amended its existing revolving credit facility and term loans, totaling $608 million. The amendments enhanced the REIT's liquidity position and financial flexibility through improved pricing terms and covenants. The REIT's debt profile mitigates near-term rising interest rate risk, as 91.4 percent of the REIT's debt is fixed.

Finally, our operational performance continues to trend positively, even amid a broader economic slowdown. Our asset management team completed 440,000 square feet of leasing. Renewals were completed at a 5.9 percent rate above expiring rent and new deals at a 26.6 percent above in-place rent.

On a year-to-date basis, the REIT's total leasing spread is 12.4 percent, providing protection in an inflationary environment. Occupancy has increased 20 basis points over the past quarter, with net positive leasing expected through the second half. Additionally, our in-place average rental rate for the portfolio is only $11.82, which is significantly below market.

We believe that limited supply of new construction in neighborhood centers in the market, coupled with increasing the cost to construction, will continue to drive demand at our location, which gives us the ability to push our rents over time.

Slate Grocery REIT is uniquely positioned to benefit from the current macroeconomic environment as grocers continue to be the focus of where people are spending their money.

With inflation rates at all time highs, consumers are pulling back on discretionary purchases and spending more on groceries and essential goods. We also continue to see a deep pipeline of accretive opportunities.

Our strategic joint venture with the North American Essential Fund, together with our recently upsized credit facility, gives us the flexibility to pursue strategically and opportunistically during challenging times. On behalf of the Slate Grocery REIT team and the board, I'd like to thank the investor community for their continued confidence and support.

I will now hand it over for questions.

QUESTION AND ANSWER SESSION

Operator

Thank you, sir. Ladies and gentlemen, we will now begin the question-and-answer session. If you would like to ask a question, please press star followed by the number one on your telephone keypad. If you would like to withdraw your question, please press star followed by the number two. One moment, please, for your first question.

Your first question comes from Jenny Ma of BMO Capital Markets. Please go ahead.

Jenny Ma, BMO Capital Markets

Thanks. Good morning, everyone. Given that interest rates have risen quite materially, investment spreads are presumably compressed, especially when you consider that cap rates for your appetite have been slack or also saw a little bit of compression. I'm just wondering what your thoughts are in terms of what the minimum investment spread would be for the market and maybe for Slate Grocery in particular? There's obviously a lot more wiggle room with the going cap rates where they're at, in that high six to low seven range. But at what point do you start to see the market flatten out or slow down?

Blair Welch, Chief Executive Officer

Thanks, Jenny. You and I have talked about this a bunch. I think a cap rate is somewhat useless if you don't know what rate you're capping. We believe at Slate Grocery REIT, with our rents at $11.82, we estimate that's probably half of market. At our existing cap rate, there is tons of room to run.

Effectively, what we're saying is: I would compare our rents - because we do - to any U.S. peer, or any Canadian peer, and we would be below them, and yet, we still have a wide cap rate.

I think investors get the benefit of our positive financing spread, which I think your question was. I think that the U.S. tenure is well below three - it's kind of volatile. But when you are buying in the mid sixes, I think that's positive leverage, which is nice.

More importantly, you're buying a significantly discounted rent, that should grow your topline revenue. Last time I checked, the only way to make money in real estate is compression of cap rates or growing your rents. I think we all know that cap rates are going up. But Slate Grocery REIT has positive leverage, because we can still buy wide cap rates, but we can get significant revenue growth because of our low in-place rents.

I think people need to start focusing on where rents are compared to market and where new supply is. I think the neighborhood-anchored grocery space is extremely compelling because of that.

We think, Jenny, we can buy positive leverage right now, we have a lot of room, but it's really more because of our low in-place rents.

Jenny Ma, BMO Capital Markets

In that sense, when you look at the Slate Grocery portfolio, do you think that that rent grows over time as we think it will? Or do you think you'd have to put some material capital to bring it up to market rent?

Blair Welch, Chief Executive Officer

We've done 12.4 percent positive leasing spread this year. I think that's pretty good. It’s happening, and our capital spend hasn't changed because Slate Grocery shows actual cash spend on a quarter-to-quarter basis. I think that's pretty positive growth.

If you break that number out, is that a forever number? If inflation stays like this, maybe. I think the next question could be, can our tenants afford it?

Our grocers are some of the biggest retailers in the world with great balance sheets, and the tenants need to pay for non-discretionary things like food.

Where people are going to get squeezed is non-discretionary spend and they might have issues. We feel very confident that our tenants can pay modest increases. In their minds, they are going from 11.82 to 12, 13, 14 bucks, and that's huge growth. It's still less than a new build that would cost in the low to mid 20s.

We feel confident that we are a great inflation protected bet. I think we love that play because Slate Asset Management always focuses on low basis because you buy low rents.

Jenny Ma, BMO Capital Markets

When you talk about continued growth through acquisition -- in the last deal that you did, you were able to get financing from the North American Essential Fund at IFRS NAV for Q1. That's great.

Just given where the public equity cost of capital is, it doesn't seem like it's necessarily a viable source of capital over the very near term. My question is: you've got these additional sources of capital now-- would you be willing to issue in the public market to fund acquisitions if the math works? Or is IFRS NAV that line in the sand that determines whether or not you would issue public equity?

And if you're not able to, maybe lean more heavily on the alternative sources of capital to get deals done.

Blair Welch, Chief Executive Officer

We do what's best for the investor and we will only do accretive deals and deals that make sense. Right now in the public markets, that's a little bit challenging. I can't comment on deals in the future. If you said, here, Blair, here's a deal at a 50 percent return, I might look at it, but it needs to make sense. We're not going to rush out to dilute the equity. That's not what we do. We've never done that. We try to focus on total return for our investors.

We feel really, really proud that we have some of the largest investors in the world supporting this strategy and supporting Slate Asset Management. They came in with a real cash bid for our NAV. It wasn't a stock for stock trade. It was real cash injected. They believe in the strategy.

I think global investors want assets that earn U.S. dollars, that are defensive, that offer inflationary protection. The grocery real estate market in the U.S. is extremely fractured. There's almost 40,000 grocery stores, and we estimate the largest portfolio is only 500.

I think in a tougher financing environment when the average asset size is 20 to 30 million, when syndicators and privates, typically you see them get financing – well-capitalized buyers will see great opportunities. We're not going to rush out to issue equity to be foolish. We're going to do what we've always done and be prudent. The deals we've done historically at Slate Grocery REIT show that.

Jenny Ma, BMO Capital Markets

Great. That's very helpful. Thank you very much.

Blair Welch, Chief Executive Officer

Thanks, Jenny.

Operator

Ladies and gentlemen, once again, if you would like to ask a question, please press star one now.

Your next question comes from Gaurav Mathur of IA Capital Markets. Please go ahead.

Gaurav Mathur, Industrial Alliance

Thank you, and good morning, everyone. I have two quick questions on my end, and I'll begin with the first. Staying with the acquisition line, there seems to be a healthy appetite for grocery anchored assets in the U.S. A question here on how that's affecting your capital deployment strategies, especially in terms of the buyer pool that you're facing from maybe six to 12 months ago.

Blair Welch, Chief Executive Officer

I'll start it and Connor, if you're on, you can jump in. I think that the market is in two groups. I'll call the onesie, twosie market – I know that's a very scientific term for it – but buy one grocery store, finance one grocery store, usually a group of privates. That market is tough to get financing on individual assets. As we all know, the financing market in North America and Europe, for that matter, is tightened.

I think you can find good one-off deals that come up to refi or really well-capitalized buyers. That's how we've traditionally grown Slate Grocery REIT, with the exception of the deal we did this year and the deal we did on the Annaly deal. We're constantly looking at that.

On the portfolio side, there are portfolios of grocery stores that are mixed together in portfolios of other assets, similar to it. Sometimes they sell the grocery assets because they can and get liquidity and can get good pricing.

We're looking at both, Gaurav, and there's no shortage of pipeline. But we will only do deals that makes sense.
And really what that means is, can we buy cheap rents? We believe buying cheap rents in this kind of environment makes all the sense in the world. We believe it makes all the sense in the world all the time. Right now, in an inflationary environment, that's what we're looking for, and there's no shortage of pipeline.

Connor, I don't know what you want to add to that.

Connor O'Brien, Senior Vice President

Right now, it's a wait and see. There's still a lot of pricing tension in the grocery anchored space. A lot of that has been from the 1031 exchange buyers, where they have the opportunity to take down an asset and not pay taxes on a previous trade. I think it will be interesting to see how that plays out over the next three to six months.

Then also in speaking to our brokers in the business, if you go back six months ago, a grocery anchored deal, you would have a very deep buyer pool of qualified groups at very competitive pricing. The number they referenced is you'd average 12 qualified buyers around the purchase price. Whereas now, that's shifted down, and pricing really hasn't moved much on good quality grocery-anchored assets. But now you're seeing closer to five to seven qualified buyers close to the purchase price, and there's a lot more discipline with choosing a group that is well capitalized, that doesn't have to have financing contingencies.

We're still in the early stages, but we're going to continue to monitor and try and seek out interesting opportunities and be there to pounce when the opportunity is right.

Gaurav Mathur, Industrial Alliance

Great. That leads to my next question. We've seen the rental spreads, that 12.4 percent year to date. What kind of rental spread can investors expect going forward with renewals and new leases, especially when you bifurcate the portfolio between the Sun Belt and the non-Sun Belt region?

Blair Welch, Chief Executive Officer

I'll let Allen give more detail, but I'll start by saying, we focus on the rents wherever we are and we focus on the number one or two grocer. But we really break the portfolio into the grocer rental spread and then what we call the national, or the junior anchor, or the shop space spread. What we have found is, tenants moved from enclosed malls because they want to be around the traffic that the anchor generates. And if you think of our portfolio, we can offer much cheaper rent for those tenants coming out of the enclosed malls.

We're also seeing tenants that we usually have – whether it's a Ross, or a typical pad buyer, or a user like an Aspen Dental – they'll go in inline now because they can't afford to construct space.

Traditionally, we have seen – before the inflationary environment in the last year or so – we've seen grocer rents probably go to 1 to 3 percent and we were doing shop space growth probably 3 to 5 percent. You mush that together; we would do – in the 2010 to 2018 – 3 to 4 percent growth.

Now, what we're seeing is the grocer is probably from 1 to 2, maybe that's 2 to 5 percent, because you want to keep them. This is rough math. But then the shop space rents are growing much higher. When you blend that out, we could do, in the next little bit, 6 to 9 percent. It's kind of bumpy, so it's hard to tell, but we're beating that right now.

We're very conservative in what we do. There's no place for them to go, but you have to do the fine balance of keeping your anchor, and then, there's no space being constructed.

Allen, maybe you can jump in and correct all the math I just said.

Allen Gordon, Vice President

No, I think that's very well said. This past quarter, we had, on new leasing alone, the 26.6 percent spread. And quite candidly, we do not see that slowing down on the new leasing slide.

Gaurav Mathur, Industrial Alliance

Thank you for the color on those. I'll turn it back to the operator.

Operator

Your next question comes from Pammi Bir of RBC. Please go ahead.

Pammi Bir, RBC Capital Markets

Thanks, and good morning. Looking at the leasing trends and given the current environment, all the concerns around a slowing economy, can you talk about what you're hearing from your tenants in terms of demand for new space? Where you're seeing strength versus weakness?

Blair Welch, Chief Executive Officer

I'll start, and then, Allen, you jump in.

We're seeing it across the board, but maybe you can give more detail Allen on – say you had a pad user, and they're deciding to go into inline space. That's an amazing decision because of cost. Or when you see a tenant that usually you have to spend a lot of money on façade work – and again, we're talking grocery center, so our below line capital isn't a normal enclosed retail or high shelf retail. It's cheaper. But they're even scaling that back.

We're seeing demand into built out space like we've never seen, and that's a good thing. Moreover, historically, if you look at the neighborhood grocery-anchored strip center market in the U.S., it's always bounced around the low 90s, even in bad times.

The portfolios we purchased recently – the Annaly deal, which was below 90 percent, and the most recent deal we closed that was in the low 90s – we feel that there's leasing upside. All the space in the next short term, I believe, could go to 100 percent full. Do I think that's sustainable forever? No. But you can look back historically, it's always in the low 90s.

I think you're going to get full utilization of space, pressure on rents, in the short to medium term here. And it's demand from across the board. But Allen, maybe talk about what you're seeing from tenants and what you're hearing about what they need.

Allen Gordon, Vice President

In this environment, as Blair stated, it's very costly to build. Timing is an issue, as it relates to construction and getting projects completed. Across our portfolio, we typically have white or vanilla shell, and some second-generation boxes. Tenants are able to come into our shopping centers and open quickly and at a significant discount to new construction. That's where we see our real advantage.

Pammi Bir, RBC Capital Markets

Got it. If I were to sum up, is it fair to say that, it doesn't sound like you're really seeing any signs of weakness between, certainly not the grocers, but whether it's the juniors or some of the smaller shop independent space. It all seems to be fairly healthy. Is that fair?

Blair Welch, Chief Executive Officer

That is exactly right. For example, if you're a Walmart, I think the squeeze on them is the discretionary spend items, or the higher margin items. Sales of those items are going down, but the grocery spend is going up. It's just a lower margin business.

What does that mean? They're making money, but not as much. But the grocery sales are going up. Our tenants, the grocers, are very well capitalized, they're still making money, but it's the food business and that's good.

As it relates to the other tenants in our space, we still offer cheap rent, compared to other options. Are they going to stay in business or not? We feel very confident that our tenants that are in our space are healthy. We also are the low-cost provider because their weighted average rent is lower than any other retail and any new construction.

The question is, do they want to be in business? Do they not? Where do they go? They want to be around the activity of the grocer. The grocer's fulfilling the omnichannel strategy. Shop in the store, click and collect, or online delivery pickup with the vans in the parking lot. That activity is where all the other retailers want to be.

We see activity across the board. We offer the best rent in the street, and that's why demand is pretty strong. This is essential real estate. In the COVID lockdowns, people still went to their neighborhood center, and I don't think that's changing.

Pammi Bir, RBC Capital Markets

Right. You mentioned the Annaly portfolio and some leasing there. Do you have an estimate of how much the occupancy in that portfolio has risen since, or if it has since the closing of the acquisition?

Andrew Agatep, Chief Financial Officer

It has been positive. We came in at about 88 percent on the portfolio. I'd say it's about low 90s right now - 91, 92. We still think that there's traction there, speaking to Blair's point of the demand you see in our space. The in-place rents are really attractive to drive the inline shops.

Pammi Bir, RBC Capital Markets

Got it. Thanks for that. Lastly, maybe just putting all those comments together on the gap between in-place and market rents. Looking back, I think Slate's historical organic growth has averaged maybe around 1 percent. It sounds like the next --call it one to two years-- should we start to see some numbers that are in the two to three range? Particularly with some of the rental spreads that you are getting?

Or should we stick with this 1 percent, maybe a bit higher?

Blair Welch, Chief Executive Officer

No, I think it should increase. When we started in this space over a decade ago, there was rental growth. If you want to pull out five years ago, or when Amazon bought Whole Foods, people thought it was the end of bricks and mortar for grocery. We didn't think so. I think there was a pullback, or a flattening, and maybe that's the growth you're referring to.

There was no new space built. People still use the bricks and mortar because it's the spoke to the hub of the distribution, it’s the last mile distribution. Now, we're seeing significant rental growth because we actually look at the grocery store as logistics, and that's how the grocers use it.

When you think of their rents in place, it's almost cheaper rent than their industrial hub. I'll put it in the Canadian context, because I think most people on this call are Canadian.

If I live in midtown Toronto and I want my groceries delivered, Loblaws doesn't go to the Mississauga warehouse with 100 vans to deliver to 100 homes in midtown. They drop a couple of trucks at the main store and then they do short trips because the biggest cost to the grocer, about 45-55 percent is transportation. You need to be more efficient on your distribution, and the next is labor.

What we're seeing now is the value of the spoke to this logistics hub. If you think of industrial rents, and we love industrial, don't get me wrong, but when you think of a grocery box as just part of that distribution chain, you're going to see really good rental growth.

To answer your question, Pammi, I think we can bump that up a couple percent and feel pretty comfortable about that.

Pammi Bir, RBC Capital Markets

Something closer to 3 percent?

Blair Welch, Chief Executive Officer

Yes.

Pammi Bir, RBC Capital Markets

Thanks very much. I'll turn it back.

Operator

Your next question comes from Sumayya Syed of CIBC. Please go ahead.

Sumayya Syed, CIBC

Thanks. Good morning. I'm not sure if I missed this earlier, but just on the recently closed portfolio, what is the mark to market on rent there, and the average lease term you have to capture that spread?

Andrew Agatep, Chief Financial Officer

The in-place rent for that portfolio is close to $13.00. It's still below market, especially compared to our peers in the U.S. space. The average lease term is what we see in our portfolio. It's not too different from what we have across SGR.

Sumayya Syed, CIBC

Okay. On the cap rate spread, obviously you made a big move into the Sunbelt states recently. How does pricing compare there versus other markets for a similar product?

Connor O'Brien, Senior Vice President

The grocery anchored space across the country has really, over the last 18 to 24 months, become more and more competitive, with large institutional groups coming in and making big portfolio and platform acquisitions. We've seen cap rates as low as the low four-caps with several deals between low fours into the low fives. There's a lot of comps in there and capital looking for the stability of the grocery anchored space.

In terms of the spreads between the Sunbelt market to other markets, it is more competitive. There is a lot of money coming into, specifically, the state of Florida. The nuance of the acquisition we just made: it was a little bit of a fragmented portfolio, it was across seven different states.

There were lots of group bids and pricing pressure on the Florida assets from multiple groups focused on that particular region. But because we have a national platform with a lot of assets in a lot of these markets, it fit really well for us and probably eliminated the amount of competition we should see there.

Simply put, more cap rate compression has been occurring in the Sunbelt markets. I think we've done a good job focusing on real estate fundamentals continuing to buy at a discount to replacement cost with strong grocery performance. There's been a bit less competition in some of the Northeast or Midwest markets. But that's not to say the fundamentals aren't still strong. It's probably just a thinner buyer pool that is driving pricing.

Sumayya Syed, CIBC

Great. That's helpful. Thank you.

Operator

There are no further questions from the phone lines. I would like to turn the conference back to Paul Wolanski for closing remarks.

Paul Wolanski, Senior Vice President, National Sales and Investor Relations

Thank you, everyone, for joining the Q2 2022 conference call for Slate Grocery REIT. Have a great day.

Operator

Ladies and gentlemen, this does conclude your conference call for this morning. We would like to thank you all for participating and ask that you please disconnect your lines.
