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CONFERENCE CALL PARTICIPANTS

Gaurav Mathur
iA Capital Markets

Jenny Ma
BMO Capital Markets

Himanshu Gupta
Scotiabank

Pammi Bir
RBC Capital Markets

PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Slate Grocery REIT Third Quarter 2022 Financial Results conference call. At this time, all lines are on listen-only mode.

Following the presentation, we'll conduct a question and answer session. If at any time during this call you require immediate assistance, please press star followed by one for the operator. This call is being recorded on Thursday, November 3rd, 2022.

I would now like to turn the call over to Paul Wolansky. Please go ahead.

Paul Wolansky, Senior Vice President, National Sales, Investor Relations

Thank you, operator, and good morning, everyone. Welcome to the Q3 2022 conference call for Slate Grocery REIT. I'm joined this morning by Blair Welch, Chief Executive Officer; Andrew Agatep, Chief Financial Officer; Connor O'Brien, SVP; Allen Gordon, VP; and Braden Lyons, Associate.

Before getting started, I would 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 Q3 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

Thank you, Paul. The last quarter has further strengthened our confidence in the value of our grocery anchored real estate, the resiliency of our cash flows, and the embedded growth in our portfolio.

Grocery anchored real estate has proven its ability to perform through various economic cycles, and we believe the current environment is only providing additional tailwinds for the sector. Surging construction costs and supply chain disruptions are limiting new supply in this market. This limited supply, coupled with strong demand for grocery anchored space, is accelerating rental growth in the sector.

Importantly, within our portfolio, average in-place rent is $12.17 per square foot, significantly below our U.S. peer set weighted average. This means we have significant rental rate growth embedded in our portfolio, and we believe that through modest increases to our below market rents, we can unlock this embedded growth and significantly increase our revenue.

In the current interest rate and inflationary environment--which we know can contribute to cap rate expansion--our growth and revenue can more than offset any negative impact on our valuations.

Our team's operational performance this quarter speaks to the growth embedded in our portfolio. Our asset management team has completed over 520,000 square feet of leasing in the third quarter. New deals were completed at 9.5% above in-place rent and renewals over 4% above expiring rent. On a year-to-date basis, the REIT's new leasing spread is 26.6% and total leasing spread is 9.6%-- our highest rates of growth since 2018. Occupancy remains healthy at 93.1%, and we expect positive leasing to continue through the remainder of this year.

The grocery real estate market continues to present attractive buying opportunities, and the REIT's partnership with Slate North American Essential Real Estate Income Fund provides us with the financial flexibility to pursue compelling investment opportunities.

We also achieved meaningful improvements to our balance sheet and liquidity, amending over $600 million of existing revolving credit facility in term loans at improved pricing. As of quarter-end, 89.7% of the REIT's debt is fixed, providing protection against inflation and rising rates.

Lastly, after quarter end, the REIT completed two strategic dispositions at a total sale price of $19 million, representing a 6.6% capitalization rate. We expect to recycle the proceeds from those transactions into new opportunities that create value for our unitholders.

We have strong conviction in the healthiness of the grocery asset class and our grocery anchored properties, in large part due to the embedded rent growth potential of our portfolio. And with an attractive source of private funding now available for the REIT, in addition to its public equity sources, we are well-positioned to take advantage of opportunities in a dislocated market.

On behalf of Slate Grocery REIT and the Board, I would like to thank the investor community for their continued confidence and support.

I will now hand it over for questions.

Operator

Thank you. Ladies and gentlemen, we'll now conduct the question and answer session. If at any time you'd like to ask a question, please press star followed by one on your touchtone keypad. If at any time you'd like to withdraw your question, please press star followed by two.

Your first question comes from Gaurav Mathur from iA Capital Markets. Please go ahead.

Gaurav Mathur, iA Capital Markets

Thank you and good morning, everyone.

Blair Welch, Chief Executive Officer

Good morning, Gaurav.

Gaurav Mathur, iA Capital Markets

Just firstly, focusing on the fact that your rents are considerably below market and your peers, and as you increase them going forward, how should investors think about stabilized cap rates on your portfolio versus your peer set? What I'm getting at is how does that delta begin to change?

Blair Welch, Chief Executive Officer

That’s an excellent question and very relevant in today's environment. I think a cap rate is useless if you don't know what rent you’re capping, which is your question.

Gaurav Mathur, iA Capital Markets

Right.

Blair Welch, Chief Executive Officer

The cap rate and rent equate to a total value. What we're saying is that our value, we believe, could go up just because our revenue growth, because of our embedded rental growth, will outpace any expansion in cap rate.

Another way of saying this is that cap rates should be lower on a portfolio where there are lower rents. That being said, we are extremely comfortable with our current cap rate on our IFRS value, probably much wider than most of our Canadian comps and U.S. comps, but still we can buy assets with positive leverage in the market.

To answer your question, we believe NAV could probably grow in this cycle and the cap rate could expand. We don't see that anytime soon because our rents are so low, but we think NAV could grow because of the amount of rental growth.

Gaurav Mathur, iA Capital Markets

Okay, fantastic. And that does lead me to my second question, which is the acquisition pipeline in a fragmented market must be looking very attractive. But can you talk about how that's changed or if that's changing over the beginning of the year?

Blair Welch, Chief Executive Officer

In general, I think there are a couple of things going on.

For grocery transactions, you can still get financing if you're well-capitalized and Slate Grocery REIT has proven that we can do that. There are about 40,000 grocery stores or neighborhood strips anchored by grocery in the United States, a highly fractured market and a lot of CMBS financing, and that markets not there.

What we're going to start to see are two things. People that can't re-fi at the old rates on onesie /twosies needing to sell, and then people can sell grocery to get cash for other parts of their business.

I think it's changing and we're being cautious, but we're very excited about the coming months on opportunities. I'll pass it to Connor to give some specifics on market color.

Connor O'Brien, Senior Vice President

Overall, the grocery anchored sector has been more resilient than other areas of the retail asset class, as well as other asset classes where cap rates trade closer to their financing rate.

Going forward, there may be thinner buyer pools given the increased financing cost. And that just may create opportunity for Slate going forward to identify opportunities where we can buy under market rents at a very attractive low basis, at a discount to replacement cost, and to continue to grow our portfolio strategically.

Gaurav Mathur, iA Capital Markets

Okay, great. And just lastly, can you talk about the implications of the Kroger/Albertson's merger on the portfolio? Is there any cause for concern just yet or it's still very early days?

Blair Welch, Chief Executive Officer

We believe that it's too early to tell. That being said, we do not see any significant impact on our portfolio. This deal is not scheduled to close until 2024, and I think it's a competition thing.

What's interesting is, those food stores are still selling grocery, but it's become a competition. Kroger and Albertson will be very hesitant to shed those stores because they have to to a competitor. It’s not like those stores are not selling food or that they need food, they're just being cautious about how they do it.

We think it's too early to tell, but we don't see it as a negative on the portfolio. Moreover, because of our cheap in place rents, we think our stores are quite attractive.

Gaurav Mathur, iA Capital Markets

And just to stay on that line of questioning, is there any positive that may come out from this entire merger for you guys?

Blair Welch, Chief Executive Officer

I think that could be. Again, it's too early to tell. To put in context from a U.S. perspective, it's such a fractured market. The combination of these two grocers is still less than 10% of the sales.

The top 20 grocers in the U.S. are 40% of all grocery sales, where in Canada you have three or four main grocers that dominate the market. So, yes, it could be good, but the market's so big that we don't see this being a huge deal for our portfolio. To your question, it could be positive, but it's too early to tell.

Gaurav Mathur, iA Capital Markets

Okay. Thank you for the color, Blair. I really appreciate it. I'll turn it back to the operator.

Blair Welch, Chief Executive Officer

Thanks a lot.

Operator

Thank you. Your next question comes from Jenny Ma from BMO Capital Markets. Jenny, please go ahead.

Jenny Ma, BMO Capital Markets

Thank you. Good morning.

Blair Welch, Chief Executive Officer

Morning, Jenny.

Jenny Ma, BMO Capital Markets

I'm reading through your letter to unitholders, and hopefully I'm not picking apart the words too much. But about halfway through, one thing that you write was "Through modest increases to our below market rents, we're confident in our ability to unlock embedded rental rate growth." I'm a bit fixed on the word modest just because it looks like there's a gap, and you talk about rent being quite far below market. And I'm just a bit unsure about the disconnect between these modest increases versus the gap. Is it because of the contractual rent steps that are already in place, or are you just taking a little bit of a cautious view given the economic circumstances? Just maybe give us a little bit more color on your thinking on that.

Blair Welch, Chief Executive Officer

We might be sandbagging a bit. As we said, our annual rental spread is 9.6%. Is that modest? No. Do we feel confident that we'll be a little bit better than modest? Yes. But that's not a forever thing. If it is, it's good for us.

For the next couple of years, maybe it's more than modest. But we're not trying to shoot the lights out. Slate Grocery REIT has proven to be a stable company with defensive cash flows that always pay their distribution. We're looking forward to growing our revenue, but we're being cautious in this sector.

The numbers speak for themselves with our current leasing spread. You're right, maybe modest wasn't the right choice. But we're Canadian, we have to be gentle.

Jenny Ma, BMO Capital Markets

Well, maybe we'll dig a little bit deeper then. So, when you look at the portfolio, on the grocers, given their longer-term leases, is the contractual rent step going to limit the growth? Are you going to have to look to your smaller tenancy or use to offset that, or are there opportunities to get a bigger mark-to-market on some of the grocery anchors just to given how far below market you say Slate Grocery's rents are?

Blair Welch, Chief Executive Officer

Yes, it's a combination. Our grocery-anchored rent is just below $9.00 a foot, which is extremely cheap especially when you compare that to Canada or industrial rent.

Our grocers make up about 40% of the portfolio. We are seeing more dynamic growth for our shop space than others. It's a fine balance. We are still seeing above modest growth with our grocers. It's going to be mid-single digits where usually it's low single digits. When you blend them all together, we're over 9% this year.

We've always believed you don't need much growth to go from $9.00 to $9.50 to $10.00. That's huge growth, right? I think there are good steps there. It's a balance, making sure our anchors are happy and doing it. But you blend that over time, because once you have that anchor there at that rent and they love these stores, you have a little bit of room. But where you're going to get more growth is, once that anchor is anchoring that center, everyone's going to be around that anchor.

So, it's a blend of both. You're right.

Jenny Ma, BMO Capital Markets

Okay, great. Just looking at your capital stack, that $83 million term loan that's coming due in the next few months, just wondering what the plans are there, if you're going to roll it into another term loan and get some secured financing in place, and what the indicative rent rates might be on the new piece that you need to refinance.

Andrew Agatep, Chief Financial Officer

We're actively in the market looking to refinance that. We don't have any particular concerns getting that done. What we've seen is that the market has slowed down considerably, but there's still active interest for grocery assets.

What they're really looking at when they're underwriting now is the strength of your rent roll, how strong is your occupancy, and is it going to grow? We check all of the boxes, and feel uniquely positioned to refinance this at a rate that we think is consistent to what you've seen in the past.

Interest rates have gone up, but spreads-- as it relates to grocers—have been the same. Our cost of debt will probably be slightly closer to high 5s.

In terms of our weighted average cost of debt, that's a 10-basis point increase to our overall portfolio, so 4.3%. We are still at positive leverage, and we have enough liquidity to invest in opportunities during this time.

Jenny Ma, BMO Capital Markets

Okay. So, if you're talking about the high 5s, that is a big jump on that piece specifically, right, just given that you're coming off less than 3%?

Blair Welch, Chief Executive Officer

Yes, there's still demand there. There's still growth in the rents to offset that. There's still going to be rental growth.

You're right. The cost has gone up, but we still have positive leverage for our valuation and cap rates, and we believe our revenue growth will more than offset that.

So, being able to finance in this market, there is demand to do it from various sources-- life co's, local banks, or we could do it on our bank line. There's flexibility, and we're going to choose what's best for the company.

Jenny Ma, BMO Capital Markets

Okay. And is the desire still to keep it unsecured versus going secured to re-fi?

Blair Welch, Chief Executive Officer

Yes, we're looking at all options. It's nice to be in a real estate asset class where you have options for debt right now. We're going to see what's best for flexibility and best for pricing.

Jenny Ma, BMO Capital Markets

What's the spread that you're seeing between secured and unsecured debt on U.S. grocery anchored assets?

Blair Welch, Chief Executive Officer

It's more on size. The unsecured market is choppy right now.

Jenny Ma, BMO Capital Markets

Yes, that's why I asked.

Blair Welch, Chief Executive Officer

I believe you're going to get better pricing in the secured. If you're in the high 100 spreads over the base rate for fixed financing right now, and that's reasonable. I wouldn't trust unsecured pricing right now if I got it, and my assumption is it would be much higher than that.

Jenny Ma, BMO Capital Markets

Okay, perfect. Thank you very much. I'll turn it back.

Blair Welch, Chief Executive Officer

Thanks, Jenny.

Operator

Your next question comes from Himanshu Gupta from Scotiabank. Please go ahead.

Himanshu Gupta, Scotiabank

Thank you and good morning.

Blair Welch, Chief Executive Officer

Good morning, Himanshu.

Himanshu Gupta, Scotiabank

So, on the two asset dispositions, it sounds like you got 6.6 cap rate on that, so looks like good pricing. So, just wondering, what was the profile of the buyer? And in general, how is the appetite for grocery anchored assets in the transaction market?

Connor O'Brien, Senior Vice President

Both of those buyers were private groups focused on completing a 1031 exchange. They were motivated to transact quickly, and that was something we identified when we went from the LOI stage to closing.

They were looking for cash flow, had limited need for financing, and we were happy to transact with them. Again, the profile of both of those assets, one was a non-grocery anchored center, so nonstrategic, and the other had a large exposure to gross leases, which is something that in an inflationary environment, we were looking to strategically move away from.

Blair Welch, Chief Executive Officer

It's a good question, Himanshu. One of the strengths of Slate Grocery and the sector that we focus on is it's very granular. If you think about each deal size, it's $15 to $25 million, plus or minus.

For the large funds, it's hard to focus, but we get to see all of that. This granular in nature means privates can do deals, and what we're seeing globally is that's where the activity is, on the granular types of real estate.

It's hard to do big deals right now because of the way the financing market is. I'm not talking about the cost of financing. I'm talking about the availability of financing big deals. We are still seeing globally more granular transactions, and especially in the grocery space, getting done.

Himanshu Gupta, Scotiabank

Got it. That's helpful color there. And sticking to dispositions, do you expect to do more dispositions in the near-term? Any strategic like disposition program in the near-term?

Blair Welch, Chief Executive Officer

Historically Slate Grocery REIT has always recycled. If we believe we've executed our business plan and if one of the assets that was sold is more gross leases, then we think in an inflationary environment we don't like that. So, we've always done pruning.

Our portfolio is in pretty good shape. There's probably a couple, but not many. The team has done a great job executing strategies and selling assets when we think it's the right time. I don't think there's going to be a significant amount of dispositions, because our portfolio is in such good shape and we want to capture all of that embedded rental growth before we sell anything.

We'll continue to monitor. There's not going to be anything huge, unless, Himanshu, you want to pay us a 4 cap for our portfolio. We'll sell it to you.

Himanshu Gupta, Scotiabank

Well, that will mean negative leverage too. Thanks for the color there. And then just moving on to the leasing environment, clearly leasing has been very strong in the last few quarters, and yet if I look at you in the small shop occupancy, that continues to be in the range of 87% to 88%, give and take. Just wondering, in the recessionary scenario, do you see further downside from here, or are we still talking upside from this number?

Allen Gordon, Vice President

Yes, we foresee that. We've got a deep and new leasing pipeline. We've got a lot of national tenants that are continuing to show strong interest within the market. So, we certainly do not see that slowing down.

Blair Welch, Chief Executive Officer

Himanshu, we are seeing demand from all sorts of different sectors. Our average base rent is so attractive to all tenants, the traditional neighborhood strip tenants.

If you're leaving an enclosed mall, what you want is two things. You want to be around traffic, which our grocers create because they use omnichannel, whether they shop in the store, click-and-collect, or in-grocery delivery. They want that traffic, and they are going to pay way less rent, even though it's good for us, than they would in an enclosed mall.

In this inflationary environment where they have rising costs and they've got to look at their margins, we're seeing demand from tenants that we never thought would do this. We also see demand from tenants that would traditionally be in a pad site going inline.

We're confident that for the foreseeable future there will be demand. I'm sure other companies that you cover in the U.S. who are our peers, they're seeing the same thing. There has not been a lot of new supply added in the space since before the financial crisis, and construction costs are high. So, we see occupancy and the demand for our space picking up. We're excited.

Himanshu Gupta, Scotiabank

That's fair enough. I think continues to be resilient, those grocery-anchored assets, there. Yeah. And I think just final question on the balance sheet. I think you did some $275 million term loan. What was the pricing on that?

Andrew Agatep, Chief Financial Officer

The pricing of the term loan is pretty consistent with what we have with our other credit facility. It's about a 185 basis point spread on top of one month SOFR. We did enter into two swaps, which fixes that, so our fixed debt's about 90%.

Himanshu Gupta, Scotiabank

Got it. And what will be the rate on that, like an absolute number, including the spread there?

Andrew Agatep, Chief Financial Officer

It's about 4%.

Himanshu Gupta, Scotiabank

Got it. Okay. Well, that's very good. Yeah. Okay. Thank you, guys. I'll turn it back.

Blair Welch, Chief Executive Officer

Thank you.

Operator

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

Pammi Bir, RBC Capital Markets

Thanks. Good morning. Just on the portfolio acquisition that was done of the quarter, what can you say with respect to the performance relative to your underwriting as far as it looks like, if I'm not mistaken, that the occupancy does--I think it's actually up relative to the initial announcement, but just curious if you can provide some color there.

Connor O'Brien, Senior Vice President

We've been very pleased with that acquisition that was completed in July. We're seeing a strong leasing pipeline at those properties, and see ourselves outperforming our initial underwriting with substantial income growth within the portfolio over the next 12 to 18 months.

Andrew Agatep, Chief Financial Officer

Part of it too is when we signed the deal, it was about a high 91% occupancy. Just between then and actual closing, we added another 60 basis points to that portfolio. In addition, the timing of our capital assumptions has been pushed out. So, we've definitely seen a lift this quarter, but there is embedded growth that we're excited to see over the next four to five quarters that'll be accretive to our bottom line.

Pammi Bir, RBC Capital Markets

The leasing that you mentioned moving up or seeing some pickup there, was that particular to any of the specific markets, like the Sunbelt, or just was it more broad based?

Andrew Agatep, Chief Financial Officer

More broad based. The leasing has come on early, but just more timing of our capital spend. Just thinking roofing and that kind of spend, it's just been pushed out a bit.

Blair Welch, Chief Executive Officer

We like the Southeast and other places, where there is population growth, because it's cheaper cost of living than other cities. However, we have seen good demand from all of our assets from leasing.

So, it's not anything specific. It's not region specific. It's more asset class. Neighborhood strips are showing good demand across the board.

Pammi Bir, RBC Capital Markets

Got it. And then just coming back to the acquisition outlook, are you seeing anything similar in terms of the opportunities of this size and scale? And would you be prepared to transact, or are you still--are you taking a bit more of a cautious view?

Blair Welch, Chief Executive Officer

We're being cautious because we always are. Grocery anchored is a pretty attractive asset class, so big deals are hard to do. We'll always look at ways to add value to unitholders.

We see more opportunistic pricing on the single assets for the next bit. But it's a combination of both. It's anyone who's well-capitalized and doesn't want to sell their grocery unless they have to, and we think it's going to be in the smaller scale.

But you never know what the future holds. We're always looking at portfolios and single assets. In Europe, picking up small portfolios is happening, but it hasn't happened in the U.S. yet.

Pammi Bir, RBC Capital Markets

Perfect. Thanks very much. I'll turn it back.

Blair Welch, Chief Executive Officer

Thank you, Pammi.

Operator

There are no further questions at this time. I'll turn it back to you.

Paul Wolansky, Senior Vice President, National Sales, Investor Relations

Thank you, everyone, for joining the Q3 2022 conference call for Slate Grocery REIT. Have a great day.

Operator

Ladies and gentlemen, this concludes your conference call for today. We thank you for participating and ask that you please disconnect your lines.