C O R P O R A T E P A R T I C I P A N T S

Blair Welch
Chief Executive Officer

Andrew Agatep
Outgoing Chief Financial Officer

Joe Pleckaitis
Incoming Chief Financial Officer

Connor O'Brien
Managing Director

Allen Gordon
Senior Vice President

Braden Lyons
Vice President

Paul Wolanski
Senior Vice President, National Sales and Investor Relations

C O N F E R E N C E C A L L P A R T I C I P A N T S

Sairam Srinivas
Cormark Securities

Brad Sturges
Raymond James

Gaurav Mathur
IA Capital Markets

Jenny Ma
BMO Capital Markets

P R E S E N T A T I O N

Operator

Good morning, ladies and gentlemen, and welcome to the Slate Grocery REIT Second Quarter 2023 Financial Results Conference Call.

At this time, all lines 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. This call is being recorded on Thursday, August 3, 2023.

I would now like to turn the conference over to Paul Wolanski, Senior Vice President, National Retail Sales and Investor Relations. Please go ahead.

Paul Wolanski, SVP, National Sales and Investor Relations

Thank you, operator, and good morning, everyone. Welcome to the Q2 2023 conference call for Slate Grocery REIT. I am joined this morning by Blair Welch, Chief Executive Officer; Andrew Agatep, outgoing Chief Financial Officer; Joe Pleckaitis, incoming Chief Financial Officer; Connor O'Brien, Managing Director; Allen Gordon, Senior Vice President; and Braden Lyons, Vice President.

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 Q2 2023 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. Our Q2 results highlight our team's continued operational excellence and ability to drive consistent organic growth across our portfolio.

Our team achieved a record 1 million square feet of total leasing at attractive spreads that drove occupancy and revenue growth. New deals were completed at 23.7% above comparable average in-place rents, and non-option renewals at 10.9% above expiring rents.

New leasing drove a 70-basis point occupancy gain from the beginning of the year. Our occupancy at the end of the quarter was 93.9%, with no grocery expiries for the remainder of this year. Our strong operational performance continues to drive same property NOI growth, which has increased 2.7% on a trailing 12-month basis.

Throughout the quarter, we further strengthened the REIT's balance sheet to create liquidity and financial flexibility. To maintain our fixed debt that helps keep our cash flow strong, we entered into a $175 million forward swap and amended an existing $137 million swap that was set to mature in July of 2027.

At the close of the quarter, 96.6% of the REIT's total debt is fixed, and no debt maturities remain for the remainder of this year. Year-to-date, the REIT has repurchased nearly a million units at a significant discount to our net asset value.

We have strong conviction in the value of our grocery-anchored real estate. Fundamentals for grocery-anchored centers remain strong. Limited availability, coupled with the lack of new supply coming into the market, is creating a favorable dynamic for owners to grow rent.

As consumers continue to spend more on goods and services that are close to home, tenant mix has become increasingly important. Centers like ours, with a strong anchor tenant that drives foot traffic and a high proportion of essential tenants, are benefiting.

We believe our portfolio is well-positioned for continued, stable growth. At $12.29 rent per square foot, average rent in our portfolio remains well below market. This provides significant runway for us to increase rents and grow the overall value of our business.

We also continue to actively underwrite compelling single asset portfolio opportunities that would be accretive to unitholders and enable us to grow further strategically through high-quality acquisitions.

On behalf of the Slate Grocery REIT team 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, as a reminder, if you wish to ask a question, please press star followed by the number one on your telephone keypad. Please wait a moment while we compile the question and answer.

The first question comes from Sairam Srinivas with Cormark Securities. Please go ahead.

Sairam Srinivas, Cormark Securities

Thank you, operator. Good morning, and congrats on a good quarter. Just looking at the renewals for next year, how should we be thinking about any options that are there in those leases, and how would those options impact the spreads next year?

Blair Welch, Chief Executive Officer

Most leases have options and most of them are done at market. And that's why we keep on driving home the fact that our rent across our entire portfolio at $12.29 is significantly low. We feel at lease expiry, when the tenant has the option and it resets to market, there will be continued growth, as we've performed in the last couple of quarters. I think it will remain consistent.

And we're optimistic, because in the entire space there's a lack of space available. So, I think there's going to be more continued pressure on rents, which is a good news story for Slate Grocery REIT.

Sairam Srinivas, Cormark Securities

Thanks for the color, Blair. Just following back on that, so in terms of proportion of leases that probably have these spreads, would you say all of the major leases, the grocery-anchored leases, have the options next year?

Blair Welch, Chief Executive Officer

No, it's probably about 8% of GLA. But most of them would go to market and there would be a negotiation on that. I think where we're really seeing significant growth is in what we call the in-line or shop space.

I think you'll get more consistent steady growth from our anchors when they'd come up, and 8% isn't a big number. But we're seeing very significant rental spreads in the shop space. Because the occupancy is strong, there's not many options for the tenants to go anywhere else, as it's still at a significant discount to new construction or new build.

So, they can't build a new and pay these rents, and there's no space to go in other malls or other shops. So, it's really a perfect storm for rental growth.

Sairam Srinivas, Cormark Securities

That's a great segue to my next question. I know you mentioned lack of supply and said no new builds coming into those markets. How does the new supply cost come in terms of build cost per square feet, and what does that mean for implied rents?

Blair Welch, Chief Executive Officer

I'll let the team talk about that.

Connor O'Brien, Managing Director

New construction cost for a blank shell would be roughly $275 to $300 per square foot, depending on market. And that does not include tenant inducements or the cost of land. So, that would translate to a grocer needing to pay $15 to $20 per square foot, which really emphasizes the value of our portfolio and the under-market rent that we can offer our grocers to be profitable in our locations.

Blair Welch, Chief Executive Officer

Correct me if I'm wrong, but Green Street says market rents for these centers are $23 or $24.

Connor O'Brien, Managing Director

That would be across both existing supply and new supply. And when you look in the inline rents for new construction, it's probably $25 to $35 for inline space, and that's going to be market dependent as well.

Sairam Srinivas, Cormark Securities

Awesome, Connor. Thank you so much for the color. I'll turn it back.

Blair Welch, Chief Executive Officer

Thanks.

Operator

Thank you. Your next question comes from Brad Sturges with Raymond James.

Brad Sturges, Raymond James

Good morning. In theme of acquisition environment or transaction environment, I'm curious to get your thoughts on whether or not you're starting to see bid/ask spreads start to narrow, any green shoots in the transaction market that we're starting to see a little bit more pricing discovery in the market at this stage.

Blair Welch, Chief Executive Officer

What we're finding in this space, the real estate specifically, if you didn't have any debt on these assets, the fundamentals from the real estate are extremely strong. Rental growth is strong. Performance of the tenants is strong. You can still finance at positive leverage.

But what we think will happen is that there are 40,000 of these types of assets in the U.S., but there's no big owner. It's a lot of onesie-twosies, and a lot of those have been financed through regional banks or securitized CMBS. And we are finding that the capital structure on some of these assets is going to need to be reset. So, we think there's going to be compelling opportunities because of capital structure, not the underlying real estate fundamentals. So, we're excited about that.

Connor, maybe you can provide some color on the market.

Connor O'Brien, Managing Director

You mentioned the bid/ask spread, and that was certainly the theme for the first half of this year. Transaction volume was substantially down, but as you alluded to, I do believe that the bid/ask spread is starting to narrow, and we would expect more transaction volume in the second half of this year.

In terms of where positive leverage is, you can finance grocery-anchored real estate at roughly 5.5%, and you're seeing well above 100-basis points of positive leverage from there. So, both our in-place IFRS values as well as new acquisition opportunities are quite compelling at this point in time.

Brad Sturges, Raymond James

Okay. So, it sounds like there could be--I don't know if you want to use the term distress, but there could be some sort of balance sheet related or leverage related opportunities as we go forward from here. I guess from the opportunity set now that you're seeing, it's more of an expectation than what you're seeing specifically in the market right now. Is that a fair characterization?

Connor O'Brien, Managing Director

We're certainly trying to identify those motivated sellers and provide a solution that would be compelling for us as an investment opportunity today and going forward.

Brad Sturges, Raymond James

Do you think that there could be better portfolio opportunities that come about too, or would it be more the onesie-twosies that you alluded to?

Connor O'Brien, Managing Director

We've had a lot of success buying great portfolios historically, and we are continuing to try and identify those opportunities. The competitive set from a purchase standpoint when we're looking at a portfolio is certainly more limited than a one-off. So, I can certainly see that being an area we'd focus on in the second half of this year, if possible.

Brad Sturges, Raymond James

Okay, great. Thank you.

Operator

Thank you. Your next question comes from Gaurav Mathur with IA Capital Markets.

Gaurav Mathur, IA Capital Markets

Thank you and good morning, everyone. Congratulations on the strong quarter. You mentioned the retail supply that's coming into the market is about 11 million square feet in 2023. Could you provide some color on how much of that could be potentially grocery-anchored related versus some of the other asset class types?

Blair Welch, Chief Executive Officer

Sure. Morning, Gaurav. Maybe to put it in context, just the size of the market and how little this space is would be helpful for him.

Connor O’Brien, Managing Director

If you look at the 11 million square feet, that represents roughly 50-basis points of total inventory, so it's quite limited. And while I don't have the breakdown between grocery and non-grocery development, the vast majority of that new development is associated with residential growth, where a new subdivision would be built and there will be additional retail supply to serve that new market, as well as additional intensification on existing sites through pad development. Our team has done a great job identifying those pad development opportunities, and we continue to add GLA to our existing sites across our portfolio.

Braden Lyons, Vice President

One additional point, Gaurav. It's really just single tenant and small multitenant builds we're seeing. We're really not seeing net new grocery-anchored centers going up.

Gaurav Mathur, IA Capital Markets

Okay, fantastic. That does lead me to my next question, and you may have touched upon this earlier, but as you're looking at the product and some of these portfolios that you could start thinking about, is there a chance that you'll also bring in the North American Fund to go after larger portfolios here?

Blair Welch, Chief Executive Officer

We will look at all sorts of ways to look at doing a accretive acquisitions for the REIT. We're a creative group at Slate, so, if there's a compelling deal, I think we need to do what's in the best interest of the unitholders. That's first and foremost. But if there's large deals, we can call on other investment partners the REIT has to look at things.

But at this time, there's more than enough that the REIT can do. I'd also like to point out that we have been actively buying our own units back, because we trade at a discount to the market but we're extremely comfortable with our NAV and we trade at that discount. So, we can look at other external ways of growth, but we also think we're pretty attractive and cheap. So, we have to balance all that.

Gaurav Mathur, IA Capital Markets

Okay, great. Thank you for the color, gentlemen. I'll turn it back.

Blair Welch, Chief Executive Officer

Thank you.

Operator

Thank you. The next question comes from Jenny Ma with BMO.

Jenny Ma, BMO Capital Markets

I wanted to get a sense on how inflation may be changing how you approach leasing negotiations. I think we mentioned that you're going to see some of the anchor leases go to market next year. So, could you talk about how leases are being structured, if that's changing, and also the mark-to-market gap that you would be seeing on that 8% for next year?

Blair Welch, Chief Executive Officer

Thanks, Jenny. It's great to have you back.

Jenny Ma, BMO Capital Markets

Thank you.

Blair Welch, Chief Executive Officer

What we believe is real estate is pretty simple. We try and buy cheap rents, and there hasn't been a lot of inflation, but there is now. That being said, our grocers pay on average around $9 a square foot. As Connor mentioned earlier, a new build would require $15 to $20 rents.

When you think of a $9 rent, and we look at grocery as food logistics, think about what the main warehouse rent would be in industrial. So, we own the spoke of the hub at $9. It's pretty much an industrial rent and an infill location around the rooftops.

That is a very important piece of real estate and logistics for these grocers, and I think we will see growth, it could be significant growth, in those rents over time. That being said, what we try and do is balance the grocer rent with the shop space rent, because the shop space and other nationals want to be around the anchor that provides that traffic.

We're seeing good growth, and because we're at $9 rents for our grocers, that's significantly cheap real estate for them. And it's a tight margin business, so we will get growth there as they come up, but we're also seeing significant growth from the shop space.

Inflation is important and we'll see it. It makes the conversation easier with the tenant for rental growth. But the reality is they don't have many options, and they don't have many options at this rent.

Jenny Ma, BMO Capital Markets

So, my question is, I'm trying to triangulate what the opportunity would be for you then, because your occupancy is fairly healthy, there's inflation, there's higher construction cost. So, when you go to negotiate these renewals, how hard you going to push on this growth?

Connor O'Brien, Managing Director

First off, given the lack of new supply, there's very few options. Our view is that we have the ability to be aggressive on these lease negotiations, and I think that's represented in that 11% non-option renewal spread.

And how that ties into inflation, if you look back at our renewal spreads historically, we have outperformed inflation in a high inflation environment, as well as had positive rent spreads even in a lower inflation environment. I think that speaks to buying under market rents and being able to create that mark-to-market going forward.

As an asset management team, we plan to be aggressive on all renewals going forward and are hoping to maintain these really attractive rental spreads on all leasing going forward throughout the rest of this year and into next year.

Jenny Ma, BMO Capital Markets

Okay. So, when you look at your renewal options, how much of them would be going to market versus how much of them have fixed terms that you would just renew for? What would be the proportion in your portfolio?

Connor O'Brien, Managing Director

Roughly half our portfolio is grocery-anchored. Often, they like to be able to control their sites long-term. That being said, when a grocer has 10 years of term left, they come to us with a conversation around how they can control the site even longer. And often, that leads to the ability to push rent.

So, we'll certainly have those conversations with limited grocers. But where a lot of the rental growth will occur is in the non-grocer shop spaces, where we can have outsized rental growth year-over-year.

Blair Welch, Chief Executive Officer

To add to that, Jenny, if our grocers are at $9 a foot, if you add $0.50, that's not a lot for them but it's still, on a percentage basis, a pretty big increase. So, that's how we think about it.

The rents aren't going to go $9 to $16. What you do is you increase the grocer rent over time. But most of the grocers, when they go to market on an expiry, they have a five-year option at market. So, you increase it that 5% or 10%, and then in five years another 5% or 10%. You try and get steps in the rent every year.

That's how we look at it. That's the deal. It's a fine balance. And I think one of the benefits that we have is we have multiple locations with these grocers, so we do think of every asset in isolation. However, it's a bigger conversation when you own 20 Krogers, because you think about, I got you here, and I'm going to put you over here.

But that's how we think about. At $9 rent, if you add $0.50, that's significant on a percentage basis, but not that much in nominal dollars for the tenant, and you just increase it over time.

Jenny Ma, BMO Capital Markets

Okay. To the latter point about it not being that much over nominal, I'm just trying to figure out if you're going from $9 to $9.50 or from $9 to $10.50, right, which would be a meaningful difference.

Blair Welch, Chief Executive Officer

Well, we're trying to go to $16, which would solve the negotiation.

Jenny Ma, BMO Capital Markets

I was thinking you'd meet there somewhere in the middle. But okay, that's fine. So, during the pandemic, you talked a lot about the grocers using the grocery space in sort of more future forward ways in terms of maybe carving out some of it to distribution. With the world sort of having gone back to normal, quote/unquote, has that chatter continued at the same pace? Are these efforts still going ahead, or do you find it sort of reverting back to where things used to be and it's quieted down? Are you grocer tenants looking to still evolve the space towards the future of grocery as opposed to just traditional grocery?

Blair Welch, Chief Executive Officer

I'll let Allen talk about it a bit more, but I think what's really important, and it's a very good question. We provide the grocer a shell or a box or industrial shed, 20 to 30 foot clear heights with loading bay doors. What they do inside is what they do.

Depending on the local neighborhood, they will change what they offer inside. Maybe they do two rows of prepared foods in a higher income market, or maybe they do two rows of click and collect. 100% of our grocery stores in Slate Grocery REIT, every grocer has invested capital to do click and collect or other types of things in the box.

So, they pivot their use depending on the local demographic, and that cost is cheaper for them than having to go get new real estate, because at $9.00 rent, it's not that much square footage, and they respond to the local demographics.

I'll let Allen talk about it a little bit more.

Allen Gordon, Senior Vice President

Simply said and as Blair is alluding to, you're close to the rooftops, and that's our main advantage. It's the last mile logistics, and that's where it's cheaper for our grocers to operate, cheaper for them to deliver food, and closer to the rooftops.

Blair Welch, Chief Executive Officer

The biggest cost for a grocer is transportation. It's about 45% to 55% of their cost. So, when you think about a grocery store, if that's the spoke to the hub, if there's 3,000 people that live around that grocery store, a food drop gets delivered by truck from the main warehouse to these spokes. If you had individual drivers, it would increase the cost so much they can't do it.

So, how they do it, they know what the locals are doing because they load that store every day, say. So, they'll change the offering depending on what they're seeing. From a Slate Grocery REIT perspective, it doesn't change their need for the box. They pivot to what the consumer is demanding.

Jenny Ma, BMO Capital Markets

Right. So, are those efforts still going ahead at the same pace?

Blair Welch, Chief Executive Officer

Yes. It’s always been that way. It's never changed. The biggest change we've seen in the last decade is the second biggest cost behind transportation is labor. So, we've seen way more self check-out. And that means less humans, so it makes increased margins.

I think we'll continue to see the evolution of the box. Most of our grocers are 30,000 to 50,000 square feet. We like that size of box because it is important. It's not a 500,000 square foot box you've got to re-pivot. So, I think we like the optionality of our portfolio, and the grocers do too.

Braden Lyons, Vice President

Anecdotally, Jenny, we are seeing grocers in our portfolio retrofit, either expand or reallocate existing square footage within stores with an omnichannel lens. They might allocate 5,000 square feet just for cold storage and robotic sorting for their omnichannel pick up and click and collect at stores.

So, we're seeing that. They're investing significant capital in the stores, which is good for the value of our real estate as well.

Jenny Ma, BMO Capital Markets

Okay. And that doesn't require any capital commitment from you, right? You just sign off on these projects?

Braden Lyons, Vice President

Correct. Yes, that's grocer funded if it's in their four walls.

Jenny Ma, BMO Capital Markets

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

Operator

Thank you. There appears to be no further questions. I will return the conference back to Paul Wolanski for closing remarks.

Paul Wolanski, SVP, National Sales and Investor Relations

Thank you, everyone, for joining the Q2 2023 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.