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CONFERENCE CALL PARTICIPANTS

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Echelon Wealth Partners

Sumayya Hussain
CIBC World Markets

Matt Logan
RBC Capital Markets

Himanshu Gupta
GMP Securities

Jenny Ma
BMO Capital Markets

PRESENTATION

Operator

Good morning. My name is Heidi and I will be your conference operator today. At this time I would like to welcome everyone to the Slate Retail REIT First Quarter 2019 Financial Results Conference Call.

All lines have been placed on mute to prevent any background noise. After the speakers' remarks there will be a question-and-answer session. If you would like to ask a question during this time, simply press star then the number one on your telephone keypad. If you would like to withdraw your question, press the pound key. Thank you.

Madeline Sarracini with Investor Relations, you may begin your conference.

Madeline Sarracini, Investor Relations

Thank you, operator, and good morning, everyone. Welcome to the first quarter 2019 conference call for Slate Retail REIT. I am joined today by Greg Stevenson, Chief Executive Officer, and Robert Armstrong, Chief Financial 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 measures, both of which can be found in management's discussion and analysis.

You can visit Slate Retail REIT's website to access all of the REIT's financial disclosure, including our Q1 2019 investor update, which is available now.

I will now hand over the call to Greg Stevenson for opening remarks.

Greg Stevenson, Chief Executive Officer

Thank you, Madeline, and thanks to the participants for joining the call this morning.

We continued to gain momentum and our achievements in the first quarter reflect both the team's tremendous efforts and highlight the durability and attractiveness of the REIT's grocery-anchored and necessity-based real estate portfolio.

Strong organic growth continued throughout the quarter. We ended the quarter with an occupancy rate of 93.3% and executed on more than 375,000 square feet of leasing, including two anchor renewals. Our proactive approach to leasing has resulted in 44% of all 2019 renewals already completed by the end of the first quarter. We also achieved an industry-leading 94.8% tenant retention ratio, demonstrating that our properties continue to be highly sought after by tenants in our markets.

As a result of these efforts, we achieved a 0.4% increase in same property NOI year over year and a 2% increase when including the growth from recently completed redevelopment projects. We completed another redevelopment project during the quarter, adding to the two completed in Q4 2018. NOI attributable to our three completed redevelopment projects increased to $600,000 in the first quarter, a threefold increase over the same period last year. We expect completed redevelopment projects to continue to add to NOI growth in the coming quarters.

We have begun to make progress on our disposition pipeline selling two properties for $24.9 million at a 7% cap rate. In addition, we have sold non-core outparcels for $3.2 million at a 5.4% cap rate. The dispositions will allow us to pay down debt and reduce our leverage, further strengthening our balance sheet. As importantly, we were able to accomplish this capital recycling program by selling properties that are stabilized where we have executed on our business plans and extracted value but the properties would rank in the lower tier of our portfolio. Upon execution of the disposition pipeline, we'll be left with a higher quality portfolio and excess liquidity to deploy. In addition, as income grows and capital spend on existing projects nears completion, we expect our AFFO payout ratios to decline toward 90%, setting the stage for a sixth consecutive distribution increase in 2019. Units of Slate Retail generate substantial excess yield, today above 9%, and we believe represent an attractive investment opportunity.

To summarize, we are entering the quarter with a 93.3% occupancy rate. Steady NOI growth was achieved, bolstered by redevelopment projects being completed. Two property dispositions were completed at a 7% cap rate, which compares favourably to where units of Slate Retail are currently trading today. All such factors contributed to a very strong quarter. We are encouraged by the positive underlying fundamentals in our portfolio that will set the stage for our team to execute on the business plan ahead and deliver stable and growing distributions to our unitholders.

We thank you for your continued support and I will now hand the call over for Q&A.

QUESTION AND ANSWER SESSION

Operator

As a reminder, if you would like to ask a question, please press star then one on your telephone keypad. Your first question comes from the line of Stephan Boire with Echelon Wealth Partners. Please go ahead.

Stephan Boire, Echelon Wealth Partners

Thanks. Good morning. I just had one very quick question regarding the Hocking Valley Mall. I was just wondering is the yield on the redevelopment in line with your expectations?

Greg Stevenson, Chief Executive Officer

Slightly below expectations. Stephan, I think you'll see a mix of redevelopment projects. Some are going to be high yield on costs where you see significant income generation. Others like Hocking Valley, where the yield on cost isn't as high, which is what I think you're alluding to, you're going to see meaningful cap rate compression. So that was a centre that we redeveloped and we bought at a higher cap rate that I think we've probably achieved 150 to 200 basis points of cap rate compression. So, the IRRs in both instances, which is whether it's a high yield on costs or cap rate compression project, are always going to be probably similar, like in the teens to low 20s. But Hocking Valley, it's a 25-year brand new Kroger. We have scraped the box. It's a rebuild. New shop space tenants. Everything is relatively new. It is a bit different than the others where we've replaced a few tenants using the existing box and where we've seen a high yield on costs. It is just a bit of a different plan but the IRR is still very strong due to the cap rate compression.

Stephan Boire, Echelon Wealth Partners

Okay, thanks, but could you remind me what was the initial or the expected yield on that project?

Greg Stevenson, Chief Executive Officer

Around 6% was the expected yield.

Stephan Boire, Echelon Wealth Partners

Okay.

Greg Stevenson, Chief Executive Officer

I don't know that that really matters but I think the important part is that we hit our IRR targets, which is how we calculate our return on invested capital.

Stephan Boire, Echelon Wealth Partners

Okay. Okay, great. Thanks.

Operator

Your next question comes from the line of Sumayya Hussain with CIBC. Please go ahead.

Sumayya Hussain, CIBC World Markets

Thanks. Good morning. Greg, in your letter to unitholders the tone felt a bit more positive and you mentioned that sentiment is improving. What are you seeing on the ground and maybe in your conversations that's behind this optimism? Is it just feedback from your asset sales or do you think it was just a matter of time for people to realize that fears for ecommerce just aren't playing out they way they expected it to?

Greg Stevenson, Chief Executive Officer

We have always been positive. We believe in our business and I think, going back for the last two years and more, the fundamentals have spoken for themselves and so have our results. We've been effectively 94%, 95% occupied for five years now.

I think on the sentiment side, outside of these four walls, I think everyone at Slate has always been a believer, you are for sure now starting to see, and I'm sure you have as well, that the headlines on grocery retail have been more positive. We talked at the AGM yesterday a lot about Amazon saying that they're really struggling with online grocery and that they're going to create their own brick-and-mortar grocery store outside of Whole Foods. You've read about how Wal-Mart and Kroger and Publix have been very successful leveraging their network of stores. So, I think it's a bit of a mix. I mean our operating fundamentals continue to be strong, our asset sales continue to have interest and are at prices that are very attractive both on an absolute and relative basis, i.e. there is lots of demand for grocery-anchored real estate. Thirdly, I think that the headlines, Wall Street Journal or otherwise, have just been far more positive in the last six months than they have in the last probably two years.

Sumayya Hussain, CIBC World Markets

That's fair. And then just kind of to pull on that, as you continue to sell more of your bottom tier assets how do you see the NOI growth profile of the remaining portfolio evolving? And just related to that, what kind of valuation or cap rate do you think the residual portfolio should be valued at once you're sort of through your sales program?

Robert Armstrong, Chief Financial Officer

I think the residual portfolio, we are definitely trying to sell assets that are either risk profile, don't make sense and we want to upgrade the quality or two, and I think just as importantly, where we believe that we've realized maximum value and execute on our asset plans from that perspective. The NOI growth that we would see from the residual portfolio we still think would be, on an annual basis, between 1% and 3%, depending on the year. But as far as the cap rate compression, we are at a 7.49 weighted average. I think we would see that come in, all things being equal. But we think that if we sell the $170 million, $200 million of properties within the next year it would be a positive story for what's left for growth as well as what we have for growth capital and definitely upgrade the quality of the overall portfolio.

Sumayya Hussain, CIBC World Markets

Okay, great. I'll turn it back. Thanks, guys.

Operator

Your next question comes from the line of Matt Logan with RBC Capital Markets. Please go ahead.

Matt Logan, RBC Capital Markets

Thank you and good morning.

Greg Stevenson, Chief Executive Officer

Good morning, Matt.

Matt Logan, RBC Capital Markets

Just following up on the last question, in terms of your organic growth, in your letter to unitholders you mentioned about 3.4% NOI growth. How much of that would be organic and how much of that would be driven by redevelopments?

Greg Stevenson, Chief Executive Officer

We have signed leases that haven not yet commenced paying rent and that number in the letter is $1.7 million, which excludes recovered income, so I think you can comfortably move that number to $2 million to include that. That is $2 million on less than $100 million of NOI, so that's 2% right there that's already contractual that just hasn't started yet. You can probably add the other $2.5 million to $3.5 million of NOI number that we used in the letter from redevelopment, that won't all be 2019. Some of that will carry into 2018. If we add those two numbers together, we are somewhere between $4.5 million to $5.5 million of NOI on $99 million of NOI. There is somewhere between 4.5% and 5.5% growth, and you can split that between organic and redevelopment, that we expect to come in the next 18 months.

Matt Logan, RBC Capital Markets

Okay, that's good colour. Appreciate the commentary. Just shifting gears, in terms of some of your recent leasing activity, can you give us a sense of which tenants are expanding in your portfolio and which ones are rationalizing space?

Greg Stevenson, Chief Executive Officer

Expanding, it's been pretty consistent. There is health and beauty, fitness, medical, dental, quick service restaurants, and dollar stores I would say at the top of the list and off the top of my head. Not a lot of rationalization. We have been, and I think this is because we are less power and we have virtually no apparel and like no books or electronics or any of those things you see in a power centre, the rationalization within our portfolio has been extremely muted. You can see that just looking back at our occupancy levels. I believe we have lost a Payless Shoe Store or two and that is really it.

So, nothing yet and we don't see anything on the horizon. That doesn't mean it may not come but we talk to all of our grocers and all of our junior and regional national tenants on a very, very regular basis and everyone's business seems to be going quite well. In the markets that we are in the customers are supportive of the businesses and, again, it's just everyday necessity-based retail, so it's not discretionary spend, and I think we're pretty optimistic on the outlook for our portfolio being durable in the next few quarters as it has been over the last two years.

Robert Armstrong, Chief Financial Officer

What I would add as well is in a number of cases where we don't have grocers turning back space and haven't had any instances of that, we have had requests for additional capacity or different things at the site to be able to support some of their ecommerce activity that's being delivered by the store, so whether it be parking spots, places to deliver van parking for delivery, all things which are positive and just making that real estate more valuable as they get entrenched in that business within our markets. So, from that perspective, all positive as it relates to the grocers.

Matt Logan, RBC Capital Markets

And in terms of your ecommerce initiatives, is it still more along the lines of click-and-collect or are we starting to see grocers using their stores as kind of last mile distribution centres to an extent?

Greg Stevenson, Chief Executive Officer

It's been a mix. There is click-and-collect, personal shoppers, recently a lot of mobile and digital technology coming to the stores, grocerants, which is a word I hate to use but that's what they call it, which is just prepared foods in restaurants that are now taking space inside the grocery stores. Also, there are a lot of our grocers and stores talking about the last mile distribution and leveraging their stores in order to do that. I think that's moved from speculation or from theory into practice. We talked about this at the AGM yesterday. At $850 billion of at-home food spend in the United States, there is a lot of venture capital in the United States looking to figure out how to help the grocers turn their boxes into mini distribution centres and there's real-life examples out there today and we talked yesterday a bit about takeoff technologies and there's others. So, it is happening. Not in massive quantities at the current moment but the one thing we love about the US is that these things tend to happen pretty quickly, so we're optimistic.

Matt Logan, RBC Capital Markets

I appreciate the colour. That's all for me. Thank you very much.

Greg Stevenson, Chief Executive Officer

Thanks, Matt.

Operator

Your next question comes from the line of Himanshu Gupta with GMP Securities. Please go ahead.

Himanshu Gupta, GMP Securities

Thank you and good morning. On the asset disposition, what is your asset sales target in 2019? Should we still expect $200 million of sales in the current year? And how far are you in that process? What kind of bids are you seeing in the market?

Greg Stevenson, Chief Executive Officer

The plan is to hopefully still hit the $200 million. If it's $175 million or something around there, we are not going to be disappointed. I think it's still a large enough number to both get the portfolio from a quality perspective to where we need to be, increase our liquidity to where we want it to be, de-lever it to where we want it to be, and as importantly, highlight that valuations relative to where Slate Retail is trading. There's some mispricing there by the public markets. We are $25 million in the first quarter. I think in Q2 we could do another $40 million to $50 million, which would leave another $100 million for the second half of the year. That's sort of what we're seeing right now from a timing perspective.

Himanshu Gupta, GMP Securities

Right. And then on the large public-listed peer group, are they still net sellers of the product or do you see them back in the acquisition market?

Greg Stevenson, Chief Executive Officer

I would say they were large sellers in 2018 and I think most all of them hit or exceeded their disposition targets for a lot of the reasons we've talked about on this call and some of the other ones, which is there's a lot of demand still at attractive pricing for grocery strip centre in the US. I think as a result of those REITs hitting their targets is that there's not, there's not as many of them selling as there was last year, which should be good for Slate Retail REIT with less supply in the market.

Himanshu Gupta, GMP Securities

Got it. Okay. And then shifting on the leasing side, it looks like good momentum on the anchor tenant renewals. Around 220,000 of square footage of leases renewed at, I think, $6.11. Where do you think the market rents were for these anchor renewals and how much did you spend for that renewal?

Greg Stevenson, Chief Executive Officer

No dollars spent on renewals for the anchors, which is usually the case. They generally fund any store remodels themselves, because their cost of capital is just so much cheaper than ours. With that said, they have options. So, 90% of our portfolio when it comes to grocers is option rents. The REIT has a few that expire without options where we think we can lift rents. Now some of those have options where it's 2% or 3%, some are 0%, which is why we have always said we think the anchor growth rate is probably somewhere between 1% and 3% over time. But both of those this quarter and 90% of them going forward will be renewed at their option rents.

Himanshu Gupta, GMP Securities

Right. Okay. And then on the Windmill Plaza redevelopment, I think Kroger will build a brand new, I think around 130,000 square footage of Kroger Marketplace. How will the space look different compared to your existing Kroger stores? I mean apart from click-and-collect, what are the landlords being asked to install now to digitize their sales experience?

Greg Stevenson, Chief Executive Officer

They are focusing right now on the inside of the store for the most part and then the parking stalls, as Bobby mentioned earlier on. So, it's really just coming to us for approvals on uses within their box and within the parking lot. We think that this will expand into the future, they are going to want more space in the parking lot potentially for mini logistics or sort of a distribution hum onto the side of the store, as well as designated, room for more designated van parking, again, which is why we think some of our access land could prove to be valuable in the future.

Himanshu Gupta, GMP Securities

Okay. And then on the small shop occupancy at 87%, and I know you gave some good colour on the trends in the near term, where do you see the upside or downside to this number? And then the 118,000 square footage of leases signed but not commenced, is that already included in that 87% number?

Greg Stevenson, Chief Executive Officer

The small shop occupancy, yes. There is a difference between leased occupancy and economic occupancy and so that is the upside. Right now, it is a 2 to almost 3 percentage point difference between lease and economic, which is obviously a good thing, because that just means that there is built in growth into our NOI. But there is only upside in that small shop space occupancy. There are three boxes that drive a significant portion of that number going higher and we are making progress on all three of them, so only upside. We do not see any downside to that number whatsoever.

Himanshu Gupta, GMP Securities

Right. And then on the same subject, I mean overall $3.3 million of expected NOI growth, are you accounting for certain tenant fallouts or expected vacancies in this number? Or that will be over and above that?

Greg Stevenson, Chief Executive Officer

There is a vacancy factor built into that and, as we talked about in our letter, we think even with that included we think we will still hit that NOI growth number. That is total NOI. That includes organic plus redevelopment, because we count both. But I think the reason is because, and this is going back six years of empirical data for Slate Retail REIT, is we really expect the vacancy factor to be muted. There is no new supply, leasing has been strong, we are spending capital at our centres. We are still a very highly sought after landlord in our markets and I think our centres are at the top of the food chain in all of the markets that we're in. So, again, I think it's been historically this way and we see no change to the future that we'll remain, you know, 94%, 95% occupied for some time.

Robert Armstrong, Chief Financial Officer

Himanshu, I would add that half of that growth target, as Greg said before, is redevelopment. When you peel that back as to the normal recurring business of a percentage and a half, that is well within the range we have been doing over the last couple years as far as same store growth. So, we do not think there is a lot of juice in that number. We think it is completely achievable on the portfolio as a whole.

Himanshu Gupta, GMP Securities

Right. Okay. And then maybe, you know, just last final question, on the bankruptcy of Sears and Kmart, how do you think, in general, the demand has been for former Kmart grocery boxes in the market? And I know you don't have much exposure there but generally what are you seeing? I mean the bulk of them will be backfilled and what rates are your peer group achieving on those vacant boxes?

Greg Stevenson, Chief Executive Officer

I think there has been more demand than people expected. There are rumours Amazon is going to take 100 vacant Sears or Kmart boxes. Like I said, similar to the uses we have seen in our properties with health and beauty and fitness and medical and dental and theaters and entertainment, et cetera, it's been strong.

As it relates to our portfolio, we do not have a lot of that. We have two vacant Kmart boxes, which is, again, when I said there's some units really driving that shop space number, those would be two of the reasons. The REIT has very strong demand at both of those. From an economic perspective the math is pretty favourable because you can take a $2 Kmart rent up to somewhere between $9 and $13 depending on who your tenants are. You have to pay to do that but I still think that your high single digit yield on costs and you are taking your cap rate, once you get rid of your Kmart centre, down at least 50 basis points.

So the IRR, again, is like high teens to low 20s on that box, so it feels pretty good.

Himanshu Gupta, GMP Securities

Awesome. Thank you. Thank you for all the colour. I'll turn it back.

Operator

And again, if you would like to ask a question, press star then one on your telephone keypad.

Your next question comes from the line of Jenny Ma with BMO Capital Markets. Please go ahead.

Jenny Ma, BMO Capital Markets

Hi. Thanks. Good morning.

Greg Stevenson, Chief Executive Officer

Good morning, Jenny.

Jenny Ma, BMO Capital Markets

I just have one question with regards to the distribution. You had mentioned in the letter, the MD&A, that you're looking to raise the distribution again and I'm just wondering how you reconcile that. I understand there's some same property NOI growth coming, but then you're also selling assets and you're deleveraging and the payout ratio is, you know, at about 100%. So given that the general trend is to reduce payout ratios in the sector, I'm just wondering how you reconcile another distribution increase at this point and whether or not it would be more prudent to sort of hold that and save some capital for other uses.

Robert Armstrong, Chief Financial Officer

A couple comments on that. One, our current AFFO payout ratio is, you're right, it is about 100%. A few things.

One, that includes the capital leasing and TI costs that we are paying now for leases that will start about a year from now. We have historically run on leasing costs and TIs about 9% historically. We think the new norm is about 12%. Our current number is about 14% to 15%. But that's because we're doing a lot of leasing and we think that leasing is a good thing that's going to drive a lot of the value and NOI growth that we're expecting to get over the next year. So, we feel pretty comfortable from that perspective.

Secondly, on the payout ratio and the availability of capital, agreed, we're selling down assets, but we have $225 million of liquidity, so we feel like, from a balance sheet perspective, we're well served to be able to do that.

And then lastly, as far as a distribution increase that we have to talk to our Board about, we would like to reward unitholders for the growth we're having within this business, but my personal view would be that if we do have an increase it would be moderate. Typically, we've had 3% increases in the past, historically, since we've listed on the TSX. It might be a little lower but it'll be in line and be prudent for how we want to manage this business.

Greg Stevenson, Chief Executive Officer

I think to Bobby's point, from the buybacks that we did in just 2018, that cancelled $2.2 million of annual distributions, which is a big number. Even if we increased it this year, I'm going to just make up a number and say by $0.01, that's $440,000 annually. So, we would actually have less distributions payable in 2019 after a raise than we did in 2018 on an absolute basis just as a result of the buybacks last year. But I do think, to Bobby's point, the reduction in capital is a big part. Even if it's what we're expecting, which is about $1.25 million, $4 million a year, that's $0.10 that you're adding back to AFFO as capital spend comes down. That excludes any growth in NOI. So, if you just take our AFFO today and add $0.10 back to it, you get about $1. On $0.86 of distributions you are down to an 86% payout ratio. And, again, that excludes any growth from income. That is essentially the math.

Robert Armstrong, Chief Financial Officer

Additionally, we view all the capital and leasing costs that are going back into the business as really additive to value. If you kind of peel back what we're actually earning from the business and what the business is yielding itself, our FFO payout ratio is 70%, which we think is pretty prudent.

Jenny Ma, BMO Capital Markets

I guess, you know, you're sitting at a 9% yield, so where are you getting the pressure to raise it from? I mean I hear you on the reduction in capital but I just feel like generally the tone from the entire sector is really just to be more conservative on the payout ratio. And if you do get that coming back I don't think it necessarily hurts to wait. Are you hearing from unitholders that they want another increase even though you're sitting at a 9% yield or where is this coming from?

Greg Stevenson, Chief Executive Officer

I think it is one, consistent distribution growth over a long period of time, and I'm talking about someone looking back 10 years from now, I think bodes well for our cost of capital in the future. Again, I don't think that, and I'm using $0.01 and I don't even know if it will be that high or not, $400,000 on a business that generates $135 million of gross revenue is going to kill us one way or another. Or, if said differently, if we were to keep that $400,000, would we have a much better use of capital than returning it to our shareholders and would it make an impact on our business by keeping it? And I think that that the positive message that the business is growing, that we're being prudent on capital spend, and that we're de-levering that distribution increase sends to the market far outweighs what Greg or Bobby or the team can do with that $400,000 that we keep inside the business.

Jenny Ma, BMO Capital Markets

Yeah, I guess my view is it's at least $400,000 every year over year. That's fine.

Greg Stevenson, Chief Executive Officer

We still have the option to buy back units, so there's that math as well. It just means that the unitholders that don't sell their units to the NCIB, let's assume that we do more of that, are the ones getting rewarded. On a net-net basis we can actually keep our total distributions outstanding the same.

Robert Armstrong, Chief Financial Officer

I would just reiterate, and I think Greg's point is a good one, we are not talking about having a 10% increase. We think it will be in the range of 1% to 3%. 1% is $400,000, as Greg discussed. In the context of our capital allocation, that is not a big deal. We spent $17 million last year on repurchasing units. So, in the context of the grand scheme of things, we like to keep the consistency. But we are not getting any pressure to increase it; it's more just a conversation we'll have with our Board to deliver returns. The business is doing phenomenally and we think we just want to continue that and be able to communicate that to the market.

Jenny Ma, BMO Capital Markets

Okay. That's fair. Thank you very much.

Operator

And there are no further questions in the queue. I turn the call back over to Ms. Sarracini.

Madeline Sarracini, Investor Relations

Thank you, everyone, for joining the first quarter 2019 conference call for Slate Retail REIT. Have a great day.

Operator

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