CT REIT Fourth Quarter 2015 Earnings Conference Call
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PRESENTATION

Operator

Good morning. My name is Melanie and I will be your conference operator today. At this time, I would like to welcome everyone to CT REIT's Fourth Quarter 2015 Earnings 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 that time, simply press star, then the number one on your telephone keypad. To withdraw your question, press the pound key.

The speakers on the call today are Ken Silver, Chief Executive Officer of CT REIT; and Louis Forbes, Chief Financial Officer of CT REIT.

Today's discussion may include forward-looking statements. Such statements are based on Management's assumptions and beliefs. These forward-looking statements are subject to uncertainties and other factors that could cause actual results to differ materially from such statements. Please see CT REIT's public filings for a discussion of these risk factors, which are included in their 2015 MD&A and AIF, which can be found on the CT REIT website and on SEDAR.

I will now turn the call over to Ken Silver. Ken?

Ken Silver, Chief Executive Officer, CT REIT

Thank you, Operator, and good morning, everyone. We're very pleased to welcome you to CT REIT's Fourth Quarter 2015 Investor Conference Call. I'll lead off with a discussion of our investment and development activity, and Louis will then briefly review certain financial matters.

Yesterday, we announced nine new investments, including the acquisition of four existing Canadian Tire stores from CTC, the development of a new Canadian Tire store, and the intensification of four properties in the REIT portfolio. All told, these new investments represent an estimated $51.5 million of capital, with approximately 280,000 square feet of incremental gross leasable area, and are expected to earn a 6.52 percent weighted average going-in cap rate upon completion. We expect the acquisition of the stores to be completed in the second quarter of this year, three of the intensifications and the development to be completed in the fourth quarter of this year, while the remaining intensification should be completed in the third quarter of 2017.

Yesterday's press release also provides an update on a number of our previous announcements, which I'll touch on now.

Last week, we completed three previously announced vend-ins located in Hanover, in Kitchener, Ontario, and in Delson, Quebec. This added 244,000 square feet to the portfolio, at a cost of $45.5 million, and was funded by the issuance of Class B and Class C LP Units to CTC.

During the fourth quarter, the REIT acquired a Canadian Tire store property in Vaughn, Ontario, from CTC, and completed certain previously announced development projects, the construction of a Canadian Tire store and a Mark's store in High River, Alberta, and the construction of a new Canadian Tire store in Martensville, Saskatchewan. We also completed the development of a Sport Chek and the expansion of a Mark's store on a Canadian Tire anchored property that we own in Selkirk, Manitoba. Similarly, we developed a new Sport Chek and a new Mark's store on the existing site of our Canadian Tire store in Waterdown, Ontario. Finally, we purchased a parcel of land adjacent to our existing property in Kelowna, BC, allowing for improved access to the property and expansion of the Garden Centre, as well as some vacant land for future pad development in front of our Canadian Tire property in St. Paul, Alberta.

The fourth quarter press release also provides details on the development pipeline. At a high level, projects are running on time and, in total, on budget.

The REIT had previously announced its intention to acquire the Canadian Tire store property in Sault Ste. Marie, Ontario. This acquisition has been deferred, bringing the total of investments announced to date for completion in 2016 to $95.8 million, representing an increase in GLA of 526,000 square feet. These investments are expected to deliver an average going-in cap rate of 6.49 percent once complete.

With that, I will turn it over to Louis for a review of our financial results.

Louis Forbes, Chief Financial Officer, CT REIT

Thanks, Ken. Our fourth quarter results represent strong growth in AFFO per unit over the reported results for Q4 2014. In Q4 2015, we reported FFO per unit of 26.4 cents, as compared to 25.6 cents per unit in the fourth quarter of 2014. AFFO per unit was 20.6 cents, as compared to 19.1 cents in the comparable period, representing a healthy 7.9 percent growth rate.

For the year, we reported FFO per unit of $1.038, as compared to 97.9 cents reported for 2014. AFFO per unit for 2015 was 80.8 cents, as compared to 73.6 cents reported for 2014, representing a strong 9.8 percent growth rate.

Net operating income was $68.1 million, a 9.7 percent increase over the $62.1 million of NOI reported for Q4 2014.

Our MD&A breaks this headline growth into its components: 3.4 percent growth on a same store basis, 4.0 percent growth on a same property basis, and the balance as a result of acquisition and development activity.

The same store growth is the result of the annual 1.5 percent average increase in minimum rent on January 1 of each year, an increase in the rate of recovering operating expenses, as well as the contribution earned from the growth in expense recoveries from capital expenditures, together with interest earned thereon. The same property growth layers in the effect of intensification on our results.

With respect to the balance sheet, the financial position is strong and liquid. At December 31, the REIT's indebtedness ratio was 48.2 percent. We also had $200 million available on the credit facility, with an accordion feature for an additional $100 million, and there was roughly $25 million of cash on hand.

Debt as compared to earnings before interest, taxes and fair value adjustments was a solid 7.43 times. Two hundred and eighty-one of the REIT's assets are not encumbered, representing in excess of $4.1 billion of assets, or said another way, in excess of 95 percent of our assets.

In addition, interest coverage for the quarter continues to be strong at 3.26 times. Our AFFO payout ratio improved to a solid 81 percent for the fourth quarter and 82 percent for the full year 2015, reflecting the benefits of our investing activity on operating results.

On an operating basis, our portfolio continues to be 99.9 percent occupied. Canadian Tire represents 94.1 percent of our annualized base minimum rent, and when combined with other CTC banners, represents 96.7 percent of our annualized base minimum rent. All metrics are largely unchanged from a year ago.

Again, I'd like to take a minute to speak to the trend in our book value per unit. This metric reflects the fair value of our real estate. Our real estate valuation metrics have been largely unchanged for the last seven quarters, since we reported our first quarter of 2014, with virtually no change in cap rates, discount rates, or other valuation assumptions.

At December 31, 2015, the book value per unit was $11.67, representing 5.8 percent growth over the book value of $11.03 a year ago. A number of factors contributed to this growth in book value: a higher value for the income-producing properties due to ongoing growth in cash flow resulting from the annual rent increases. I would remind you that the valuation metrics have not changed. Growth also comes from retained cash flow, a higher receivable balance due to the recoverable capex spend, and accretive investing activity financed in part by equity issuance that is accretive to this book value per unit.

In January of this year, the REIT provided notice to Canadian Tire of its intention to redeem the Series 2 Class C LP Units, which are redeemable or will have their rate reset as of May 31 this year. The rate of distributions on this series is 3.5 percent. We do not yet know if Canadian Tire will agree to the redemption. If they do, we have a variety of options to fund the redemption, including cash on hand, the REIT's existing credit facility, new debt, or Class B LP Units.

With that, I will turn it back to Ken.

Ken Silver, Chief Executive Officer, CT REIT

Thanks, Louis. We're only seven weeks into the new year, but I can say we're encouraged by the opportunities before us. As announced, we've already completed three acquisitions in 2016, and have announced a further round of activity for Q2. The developments we recently completed in Q4 2015 should contribute fully to results in Q1. In addition, we're hopeful that industry property transaction activity picks up from last year's sluggish level. Rest assured that we will continue to execute on the elements of our strategy laid out at the time of our IPO as we progress through 2016.

Now, Operator, I will turn the call back to you for any questions from our listeners.

QUESTION AND ANSWER SESSION

Operator

Thank you. At this time, I would like to remind everyone in order to ask a question, please press star, then the number one on your telephone keypad. We ask that you please pick up the handset or step close to your speakerphone system when asking your question to provide maximum audio clarity. We'll pause for just a moment to compile the Q&A roster.

The first question is from Sam Damiani of TD Securities. Please go ahead.

Sam Damiani, TD Securities

Thanks. Good morning, Ken. Good morning, Louis.

Ken Silver, Chief Executive Officer, CT REIT

Good morning.

Sam Damiani, TD Securities

Just on the outlook for acquisitions, I'm just curious if you're seeing any slowdown in the pipeline from Canadian Tire, and also any potential activity on some of the locations that might become redundant as they move into the former Target locations that they acquired.

Ken Silver, Chief Executive Officer, CT REIT

Sam, it's Ken. With respect to the pipeline from Canadian Tire, there's still a fair bit of property left in Canadian Tire. As well, we're continuing to work with Canadian Tire in their ongoing space requirements. So, we see that as a continuing source of potential acquisitions for us. The Canadian Tire Real Estate Team is turning its attention to the properties that will be made redundant as Canadian Tire moves out of those stores into the new Target boxes, so we're working with them as well in terms of potential redevelopment re-leasing and acquisition by the REIT. So, that is progressing, but I don't have any announcements at this point.

Sam Damiani, TD Securities

Would you look at those, you know, regardless of what Canadian Tire does with those spaces, like, as sort of a redevelopment for third-party tenants? It's that the way you'd approach it, or …

Ken Silver, Chief Executive Officer, CT REIT

Yes, no, absolutely, and we've already acquired—earlier on, we acquired a couple of formerly redundant Canadian Tire stores that have been subdivided and re-leased, so that is—you know, in these markets, it's still good real estate. It's just Canadian Tires has outgrown the properties and they're suitable for other retailers, and we would certainly be interested in acquiring some of those.

Sam Damiani, TD Securities

Okay. Secondly, on the funding of acquisitions and developments, so far, you know, virtually all of the growth post-IPO has been funded by equity from Canadian Tire. Is there any sort of expectation for that to change going forward?

Louis Forbes, Chief Financial Officer, CT REIT

Sam, it's Louis. Your statement is close to absolutely correct, but I'd like to remind you that we had an over-allotment option from the IPO that left us with some cash, we're retaining good free cash flow, and so those are sources of equity, and then we have the DRIP, which is a small contributor to our equity. But, you're quite right, we have—to the extent that we've issued equity, we have issued it to Canadian Tire and not to the public, and that's a correct observation.

I think on a go-forward basis, we're open to multiple possibilities. To the extent that we are doing vend-ins from Canadian Tire, there may be a bias towards using Class B LP Units, but there are no absolute hard rules around this.

Sam Damiani, TD Securities

Okay, good. Thank you very much.

Operator

Thank you. The following question is from Pammi Bir of Scotia Capital.

Pammi Bir, Scotia Capital

Thanks. Good morning. Just looking at the internal growth for a minute, I'm just wondering whether again in Q4 there was any sort of a catch-up, or those types of recoveries that pushed the same-store NOI higher than what may carry forward into Q1.

Louis Forbes, Chief Financial Officer, CT REIT

Pammi, it's Louis. There are two things that maybe were affecting our recovery rate in Q4, or in the back half of 2015, and part of it may soften a little bit in 2016, but not a whole lot, but, principally, our leasing at Canada Square improved later in the year, and so higher occupancy rates tends to improve recovery rates, and that part of it will continue.

Pammi Bir, Scotia Capital

Okay. So, nothing unusual or out of ordinary in terms of any sort of catch-up that related in Q4?

Louis Forbes, Chief Financial Officer, CT REIT

No.

Pammi Bir, Scotia Capital

Okay. Then, just looking at the property management and the service agreements, and their renewals, can you comment on any expected changes there in terms of fees versus last year, which I think were capped at just under $6 million?

Louis Forbes, Chief Financial Officer, CT REIT

Right. So, the cap, as programmed in the contracts, has come off the fees, the contracts have been renewed, and the REIT will be exposed to whatever Canadian Tire costs are on a go-forward basis. In terms of our diligence around managing the contracts, we have an awareness as to what their costs actually were, and we have a sense that they will be going up in 2016. It's not a huge amount, but I think it's relevant to talk about it.

Our fourth quarter G&A run rate reported was $2,671,000. If you annualize that, you get $10.7 million. If you allow for a bit of inflation and you allow for the third year of LTIP accounting—and that expense grows in years one, two and three, and then, theoretically, hits a steady state going forward—you would get a G&A run rate of $11 million, somewhere between $11 million and $11.5 million, and that's what I would indicate to you would reflect both the contracts and our expectations around other G&A costs.

Pammi Bir, Scotia Capital

Okay, that's really helpful. Then, maybe just going back to the Series 2, the Class C Units, what's your sense there of the outcome between redemption or reset; and then if you could just remind us on the reset what the expected spread it would be?

Louis Forbes, Chief Financial Officer, CT REIT

We don't have an indication as to what Canadian Tire's answer is going to be, so I can't tell you it's going to be reset or redemption. We will learn that in the days and weeks ahead.

In terms of the reset rate, it would depend on term, but if you think of it as a five-year reset, if that's what it were, the cost of our debt in the marketplace for a five-year term today would probably be somewhere between 2.5 percent, 2.7 percent. Now, the markets are volatile, so I'm going you probably a broader range, and I think a reset would fall probably within that range, as well, because we refer to the market when we're negotiating resets.

Pammi Bir, Scotia Capital

Right, okay, that's helpful. Thanks very much.

Operator

Thank you. The following question is from Troy McLean of BMO Capital Markets. Please go ahead.

Troy McLean, BMO Capital Markets

Good morning.

Ken Silver, Chief Executive Officer, CT REIT

Good morning, Troy.

Troy McLean, BMO Capital Markets

What level of intensification activity do you expect to complete in 2016?

Ken Silver, Chief Executive Officer, CT REIT

Troy, it's Ken. Our intensification activity takes two forms. One is expansion of Canadian Tire stores. Canadian Tire has the rights to use the excess density on their property, so we go to them first to see what their requirements are. Secondly, pad development. I can't give you a precise number on the intensifications, but I would say that our focus is increasing on the pad development as we go into 2016. I don't know how many of those opportunities will be revenue producing in 2016, or will carry over into '17, we'll see, but we do have a decent pipeline of interest from a number ancillary retailers who would like to join Canadian Tire on their properties.

Troy McLean, BMO Capital Markets

Can you kind of give us the range of yields on the different intensification investments, so pad development versus Canadian Tire expansion versus adding a gas bar?

Ken Silver, Chief Executive Officer, CT REIT

I mean, it varies. As you would expect, it's better than our development or acquisition activity, given that we've already got the land. It depends on the market, on the retailer, but, typically, the intensifications do help increase the going-in cap rate overall, relative to the acquisition activity.

Troy McLean, BMO Capital Markets

Thank you all. I'll turn it back.

Operator

Thank you. The following question is from Alex Avery of CIBC. Please go ahead.

Alex Avery, CIBC World Markets

Thank you. Louis, in your introductory remarks you spent a bit of time talking about your IFRS fair value of properties and I just have, I guess, a few questions as to how you think about that process. Correct me if I'm wrong, but I don't believe there have been any Canadian Tire properties sold to third parties with a 14-year average remaining lease and annual rental rate escalations from Canadian Tire since CT was formed. Is that fair to say?

Louis Forbes, Chief Financial Officer, CT REIT

Are you talking about sales from Canadian Tire or sales from a third-party landlord to a third-party buyer?

Alex Avery, CIBC World Markets

Well, either, if you would be aware of those specific asset transactions.

Louis Forbes, Chief Financial Officer, CT REIT

Yeah, I'm aware of one sale in Canmore, Alberta, where a party totally unrelated to us was the landlord and they sold it to somebody totally unrelated to us, so there is one trade in the market. I'm not sure Canmore, you can extrapolate from Canmore, but there has been a trade.

Alex Avery, CIBC World Markets

When was trade?

Louis Forbes, Chief Financial Officer, CT REIT

It was in 2015. I'll say mid-year, to minimize my error.

Alex Avery, CIBC World Markets

So, would that be the best comp when you're going through the appraisal process?

Ken Silver, Chief Executive Officer, CT REIT

It's Ken, Alex. Canmore is an unusual market and that was an unusual store. It's a multi—it's a store with underground parking. Canmore is a very geographically and municipally constrained town, so it has a real scarcity value that's probably reflected in that transaction, so I wouldn't say it's a great comp.

Alex Avery, CIBC World Markets

What was the pricing reflected in that, in terms of the cap rate perhaps?

Ken Silver, Chief Executive Officer, CT REIT

Well, we weren't a party to that transaction. It was disclosed—I think it was a public REIT that bought it and I think it was Crombie, so it's in their disclosure.

Alex Avery, CIBC World Markets

Okay, okay. Just looking at it, and, Louis, you specifically noted that the cap rate assumptions and valuation assumptions haven't changed at all. When you went public, the Government of Canada 10-year bond yield was 2.6 percent, 2.7 percent and it's 1.2 percent today. I guess I'm struggling a little bit with the IFRS fair value being almost a little bit more theoretical than highly substantiated, based on precedent transactions in the market.

Louis Forbes, Chief Financial Officer, CT REIT

Yes, Alex, I understand your frustration. The valuation metrics we are using have not changed. That doesn't necessarily mean valuation metrics in the market have not changed. To bore you with a little bit of process, we have a protocol around valuing the portfolio that makes reference to valuation metrics in the marketplace that we get from independent sources, and we apply those to the portfolio, and if they do not move the portfolio value by more than a certain amount, then we don't apply them. So, we do have, and have had for a number of quarters, what I would call a deferred gain that we have not recorded to the portfolio, but it's immaterial, and our materiality level for this conversation is $40 million. It's just an acknowledgement by us that the whole valuation process is an estimation exercise and we should never overstate the precision, so we don't. We try to avoid making small changes.

Alex Avery, CIBC World Markets

Okay, that's quite helpful. Then, just in the interest expense line, it notes that the interest on the Class C Units was deferred until January 1, in terms of the payment to Canadian Tire. I don't think that's necessarily surprising, but is there something to be learned from, I guess, the fact that the Canadian Tire Corporation would be looking to minimize taxes and perhaps that could bear some light on what might happen with the Class C redemption, or any other behaviour we can expect from Canadian Tire?

Louis Forbes, Chief Financial Officer, CT REIT

Alex, this is CT REIT speaking, not Canadian Tire, but I would say that their behaviour around the receipt of distributions is totally unrelated to their behaviour around our redemption/reset request. I don't see them related at all.

Alex Avery, CIBC World Markets

Okay. All right, that's great. Thank you.

Ken Silver, Chief Executive Officer, CT REIT

Thanks.

Operator

Thank you. The following question is from Jimmy Shan of GMP Securities. Please go ahead.

Jimmy Shan, GMP Securities

Thanks. Just on that materiality threshold that you talked about, the $40 million, that's in reference to the entire portfolio today, right?

Louis Forbes, Chief Financial Officer, CT REIT

That's correct.

Jimmy Shan, GMP Securities

Okay. Then, in your third-party acquisition, I was just curious as to whether you're seeing opportunities in Alberta, or whether you expect to see opportunities in Alberta, and whether this would be an area of focus for you in the coming months.

Ken Silver, Chief Executive Officer, CT REIT

Jimmy, it's Ken. We are beginning to see opportunities in Alberta, I would expect to see more, and, yes, we would be interested.

Jimmy Shan, GMP Securities

Right. Anything you could share in terms of, like, are you seeing just individual transactions, portfolio sale, and maybe an indication of pricing relative to what it might have been a year ago?

Ken Silver, Chief Executive Officer, CT REIT

It always comes down to pricing. Right now, I could say that, you know, we're certainly on the distribution list of anything that's being marketed widely. We are contacted from time to time in regard to off-market opportunities. It's difficult at this point to identify any movements in pricing, and I think that's probably the next shoe to drop, so to speak.

Jimmy Shan, GMP Securities

Okay. Okay, thank you.

Operator

Thank you. Once again, please press star, one at this time if you have a question.

The following question is from Michael Smith of RBC Capital Markets. Please go ahead.

Michael Smith, RBC Capital Markets

Thank you, and good morning. With the falling interest rates and changing valuation metrics, is it fair to assume, or reasonable to assume that you're getting close to that $40 million threshold?

Louis Forbes, Chief Financial Officer, CT REIT

No, Michael, we're not on the cusp of it. We were getting closer to it and then the Q4, what we call market letter cap rates from our appraisal advisors show that certain cap rates in the country had gone up, and so certain values came down, and that clawed back a bit of the deferred gain.

Michael Smith, RBC Capital Markets

From Alberta, no doubt.

Louis Forbes, Chief Financial Officer, CT REIT

Yeah, I would say generally Alberta. You might couch it more broadly as certain western markets, so it might have been including some Saskatchewan markets.

Michael Smith, RBC Capital Markets

Okay. Then, is it reasonable to assume that your $50 million to $60 million run rate for acquisitions, vend-ins, development, intensifications per quarter?

Ken Silver, Chief Executive Officer, CT REIT

Michael, it's Ken. I wouldn't bet the farm on it. It's not something, frankly, that we're particularly focused on from quarter to quarter. We are interested in kind of developing a pipeline, we do advanced planning, we're working with Canadian Tire, but an absolute number from quarter to quarter could vary.

Michael Smith, RBC Capital Markets

Okay, that's fair enough. Thank you.

Operator

Thank you. The following question is from Sam Damiani of TD Securities. Please go ahead.

Sam Damiani, TD Securities

Sorry, I just wanted to follow up on the same property NOI growth. One of the material drivers to the strong result in 2015 was the capex recovery. Do you see that contributing a similar portion to NOI growth year-over-year in 2016, or is that going to level off at all?

Louis Forbes, Chief Financial Officer, CT REIT

Sam, it's Louis. I think, normally, it will contribute the same kind of growth. As long as we're spending approximately $15 million a year, it should contribute that kind of growth for the first 15 years of our life, and then it would flatten off and wouldn't contribute growth, unless the portfolio has grown. I'm speaking in averages. So, one year we might only spend $10 million or we might spend $20 million, and that would change the contribution rate to NOI growth.

Sam Damiani, TD Securities

That's great, very helpful. Thank you.

Operator

Thank you. As there are no further questions at this time, I will turn the call back over to Ken Silver, CEO, for any closing remarks.

Ken Silver, Chief Executive Officer, CT REIT

Thank you, Operator, and thank you all for joining us today. We expect our Q1 results will be released the week of May 9, and we look forward to speaking with you then.

Operator

Thank you. That conference has now ended. Please disconnect your lines at this time. We thank you for your participation.
