CT REIT 2016 Third Quarter Results Conference Call
Wednesday, November 2, 2016 – 8:30 AM ET

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CORPORATE PARTICIPANTS

Ken Silver
Chief Executive Officer

Louis Forbes
Chief Financial Officer

CONFERENCE CALL PARTICIPANTS

Sam Damiani
TD Securities

Pammi Bir
Scotia Capital

Michael Smith
RBC Capital Markets

Alex Avery
CIBC World Markets

Jenny Mah
Canacord Genuity

PRESENTATION

Operator

Good morning. My name is Elena and I will be your Conference Operator today. At this time, I would like to welcome everyone to CT REIT's Third Quarter 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, please 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 2016 MD&A and AIF, which can be found on CT REIT's website and on SEDAR.

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

Ken Silver, Chief Executive Officer

Thank you, Operator. Good morning everyone and welcome to CT REIT's Third Quarter 2016 Investor Conference Call. This call feels special to me as it comes just a week after the third anniversary of our IPO, so if you'll indulge me for a moment, I'd like to make a few comments to mark our anniversary.

CT REIT began with almost every advantage imaginable: a clean piece of paper and 20 years of learning from what makes a best-in-class REIT, a significant national portfolio of well-located recently built or rejuvenated retail properties, and a major tenant with one of the strongest and most recognized brands in the country with a long history of growth and innovation built on a unique positioning and an investment grade credit rating.

With these advantages, we built attributes into the REIT we believed investors would value: long-term leases with annual rent escalations to generate predictable organic growth, a solid balance sheet and investment grade credit rating, and real prospects for driving better than average growth in AFFO per unit. At the time of the IPO, we captured these attributes in the words 'reliable', 'durable', 'growing', which for us then and continues to be today our guiding vision.

One distinguishing competitive advantage we enjoy is the ongoing relationship with Canadian Tire. Working closely with our majority unitholder, we have the benefit of an obvious inside track on fulfilling an anchor tenant space requirement together with the other banners in the family. We leverage the scale of the Corporation to keep our overhead costs low, and perhaps most importantly, we have from a landlord's perspective unique insight into the current thinking of some of the top retailers in the country and real data on markets and trade areas from coast to coast to inform our growth strategy.

I'd like to highlight two announcements from our press release yesterday to illustrate what this all means for investors. Firstly, we announced the acquisition of Totem Mall, a 198,000 square foot shopping centre and four acres of development land in Fort St. John, British Columbia. While Fort St. John may not be on the radar screen of every investor in Toronto, through our relationship with Canadian Tire we know it to be the commercial centre of the growing northeastern region of BC with favourable demographics and limited retail availability. Canadian Tire's banners have performed well there for years and to us the current downturn in the oil and gas sector provides a buying opportunity.

We've acquired the mall, which is 93 percent leased at a 7.6 percent cap rate based on existing income. Our underwriting does not make allowances for the potential impact on the market of the $10-billion Site C Dam project which has commenced construction a few kilometres from town, or the recently approved Pacific LNG project. Our objective is to manage the mall to grow NOI over time and the development lands we have acquired, located between the mall and Walmart provide us a further option to grow with the market.

Secondly, we announced the CT REIT's distribution rate would increase by 3 percent to $0.70 per unit on an annualized basis beginning with the January 2017 payment. This marks the third increase in our rate of distribution since our IPO and comes as we have continued to reduce our payout ratio.

As we enter our fourth year of operation, you can be assured that the management team of CT REIT—and I can no longer just say Louis and I—remains absolutely focused on executing our strategy. While we have been able to deliver significant growth in our portfolio and in our operating results, we have done so while remaining selective, patient and conservative in all regards and we will continue to operate this way going forward.

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

Louis Forbes, Chief Financial Officer

Thanks, Ken. Our third quarter results represent solid growth in AFFO per unit over the reported results for Q3 2015. In the third quarter of 2016 we reported FFO per unit of 27.3 cents as compared to 26.0 cents per unit in Q3 of 2015. AFFO per unit was 22.2 cents as compared to 20.3 cents in the comparable period, representing a 9.4 percent growth rate.

Net operating income was $72.8 million, a 7.9 percent increase over the $67.5 million of NOI reported for Q3 2015. Our MD&A breaks this headline growth into its component: 1.5 percent growth on a same store basis, 2 percent growth on the 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 1st of this year as well as recovery of capital expenditures and interest earned on previously unrecoverable balances, with a partial offset from a decrease in recovery of operating expenses and property taxes. The same property growth layers in the effect of intensification on our results.

I note that while it is not material, the recovery rate of operating expenses and property taxes is the one area of variability in our operating results on a quarterly basis.

G&A expenses as a percentage of property revenue were lower at 1.9 percent compared to 2.4 percent in Q3 2015. G&A expenses decreased 15.8 percent versus Q3 2015, primarily due to decreased personnel expenses due to the variable component of compensation awards and due to lower legal expenses partially offset by an increase in costs due to timing. We know that G&A expenses can be lumpy throughout the year and we think the amount reported for Q3 2016 is a low point for the year.

With respect to the balance sheet, the financial position is strong and liquid. At September 30, the REIT's indebtedness ratio was 46.6 percent. We also have over $280 million available on our credit facility. Debt as compared to earnings before interest, taxes and fair value adjustment was a solid 7.5 times. Two hundred ninety-seven of the REIT's assets are not encumbered, representing in excess of $4.7 billion of assets, or said another way, approximately 97 percent of our assets.

In addition, interest coverage for the quarter continues to be strong at 3.8 times. The increase in this metric is the result of capitalizing interest on the Bolton DC property starting in June of this year. We expect the metric to return to normal levels next year.

Our AFFO payout ratio was a solid 77 percent, lower than the 82 percent reported for the third quarter of 2015, reflecting the benefits of our investing activity on operating results.

On an operating basis, our portfolio continues to be 99.7 percent occupied. Canadian Tire represents 92 percent of our annualized base minimum rent, and when combined with other CTC banners, represents 94.5 percent of our annualized base minimum rent. All metrics are largely unchanged from a year ago.

Again, I would like to take a minute to speak to the trend in our book value per unit. At September 30, 2016, the book value per unit was $12.38 representing 7.6 percent growth over the book value of $11.51 a year ago. A number of factors contribute 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, and something different this quarter, a $7 million upward revaluation in two assets. In addition, 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.

On a trailing basis, combining distributions and book value per unit growth CT REIT has consistently delivered since IPO a total annual return in excess of 10 percent.

If you look at the results since our IPO, we have established a clear and consistent pattern of strong NOI and EBITDA growth. As we look ahead to 2017, we anticipate results to continue along this path by virtue of the Bolton DC coming online, other development activity as well as the annual 1.5 percent average growth in rent from the Canadian Tire leases.

With that, I'll turn it back to Ken.

Ken Silver, Chief Executive Officer

Thanks, Louis. Before I turn the call over for questions, I'd just like to point out that our pipeline of investments continues to build for 2017. In addition to the Totem Mall acquisition in Fort St. John, we also announced yesterday that we will be acquiring three Canadian Tire-anchored strip plazas from CTC in the first quarter of 2017 and we'll be completing one small intensification project later in the year.

We're pleased with our track record so far and are looking forward to continuing to deliver long-term value to our unitholders.

Now Operator, I'll 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 your handset or step close to your speaker phone system when asking your question to provide maximum audio clarity. We'll pause for just a moment to compile the Q&A roster.

Our first question is from Sam Damiani with TD Securities. Please go ahead.

Sam Damiani, TD Securities

Thank you. Good morning, Ken. Good morning, Louis. Just on the Fort St. John acquisition, is there going to be any meaningful vacancy created in that property to potentially make space for Canadian Tire, or maybe you could talk about the plans for the development land that you bought adjacent to the mall as well.

Ken Silver, Chief Executive Officer

Sure, Sam. It's Ken speaking. The Totem Mall acquisition is not likely to accommodate a new Canadian Tire store. With 93 percent occupancy it doesn't lend itself to the kind of redevelopment we've been doing in some of the other markets where we've bought malls.

Although there is potential repositioning of certain tenants. There is a Mark's store in the mall currently that is looking to expand and that may be a candidate for the development land that we are acquiring, but at the moment we're still assessing the market and our growth plans there.

Sam Damiani, TD Securities

I understand there is another development that has been proposed nearby, a shopping centre development. I'm wondering if you can speak to that, if that is kind of put on hold sort of pending plans at the Totem Mall.

Ken Silver, Chief Executive Officer

Well Sam, I'm impressed. I think you're bucking for a market tour of Fort St. John.

Sam Damiani, TD Securities

I'd love to. In the summer.

Ken Silver, Chief Executive Officer

Yes, definitely in summer. The only commitment the REIT has made to Fort St. John to this point is the Totem Mall investment. Canadian Tire does own another parcel of land in town that may be developed in the future, and there is work that has begun on that from a planning perspective, and this would present another potential growth opportunity for the REIT.

Sam Damiani, TD Securities

Would you say there's definitely a plan to put a Canadian Tire store, like a newer, larger store, on your—in the set that you're purchasing? Do you know?

Ken Silver, Chief Executive Officer

There is an opportunity to—definitely the Canadian Tire store in this market could be upsized and relocated and that's one of the opportunities that the business is assessing and we're involved in that process.

Sam Damiani, TD Securities

Okay. Just the site that you bought there, I guess is between the Walmart parking lot and the mall? Is that the …

Ken Silver, Chief Executive Officer

That's correct. That's our four-acre development site.

Sam Damiani, TD Securities

Okay. I'm not going to hog the puck too much more but just to confirm, the Bolton DC is on track for the economics that you previously disclosed? The 5.2 cap rate early January?

Ken Silver, Chief Executive Officer

Yes, that's correct.

Sam Damiani, TD Securities

I'll turn it back. Thank you.

Ken Silver, Chief Executive Officer

Thank you.

Operator

Thank you. The next question is from Pammi Bir with Scotia Capital. Please go ahead.

Pammi Bir, Scotia Capital

Thanks. Good morning. Just maybe a couple of quick ones. Looking at the Bolton project again, should we expect a similar level of capitalized interest in Q4? I guess with the income starting in January the capitalization will end this quarter.

Louis Forbes, Chief Financial Officer

Yes, Pammi. It's Louis speaking. The investment amount in Bolton is going to be constant basically through the fourth quarter at the same level as through the Q3. The basis of capitalization really is unchanged and the interest rate being used to capitalize is basically going to be unchanged. What is a little different is that the amount capitalized in the third quarter is a little bit higher than a normal run rate but only a little bit and that's because there had been an undercapitalization for the very short period in Q2 and so that was caught up in Q3. I would say the Q3 capitalization is quite indicative of what you would expect in Q4.

Pammi Bir, Scotia Capital

Okay. Then just maybe on the Arnprior Mall, what was the final cost of that project and I guess the expected yield? Is it fully stabilized at this stage?

Ken Silver, Chief Executive Officer

Pammi, it's Ken. Yes, the project is essentially complete and just as a reminder, the property we bought, the building we bought was 114,000 square feet of GLA and it was 79 percent occupied when we bought it. Today with the renovation complete, the GLA is 133,000 square feet, it's 99 percent occupied and we didn't expand the building per square foot so that's really all converting vacancy and common area to leased space.

Our total yield there is about 8 percent on an investment of about $16 million in total.

Pammi Bir, Scotia Capital

Sorry. The $16 million in total includes the initial purchase and the additional spend on the reno?

Ken Silver, Chief Executive Officer

That's correct.

Pammi Bir, Scotia Capital

Okay. Thanks very much.

Ken Silver, Chief Executive Officer

Thank you.

Operator

Thank you. The next question is from Michael Smith with RBC Capital Markets. Please go ahead.

Michael Smith, RBC Capital Markets

Thank you. I vote for a summer tour of Fort St. John as well.

I just wanted to pick up on a number of Sam's questions. The development lands, that is actually on the other side of 96th Street, so it's right in front of the Walmart parking field?

Ken Silver, Chief Executive Officer

Yes, that's right.

Michael Smith, RBC Capital Markets

Okay. Given it looks like your store in the market is undersized or under-parked anyway, but it sounds like you have other potential areas to grow, so this is just basically an investment? A good investment that you know because you're in the market and really there's nothing much else you could do? Perhaps maybe expand the Mark's but that's pretty much it?

Ken Silver, Chief Executive Officer

I think that's a good summary. We don't see a physical expansion of the existing mall. What we do see is an opportunity to—basically this is a mall where there hasn't been a lot of investment for a number of years, so we think there's opportunities to improve the offering, both to customers and the attractiveness of the mall to tenants. That's what I meant in my comments about growing NOI over time.

This isn't one of those situations like we've done elsewhere where there's a huge vacancy that needs to be redeveloped. This is more a question of actively managing the property.

Michael Smith, RBC Capital Markets

Okay. Just switching gears, so you had a couple of assets, if I heard correctly, that were marked up independently of any changes in income. Could you maybe just give us some colour on those mark-ups?

Louis Forbes, Chief Financial Officer

First of all, just a brief word about the process for valuing our assets. We have a materiality guideline on the portfolio level of low $40 million. So if we have a total mark-to-market adjustment on the portfolio of less than $40 million, we don't book the entry. At our property level, if our most recent fair value exercise of a property comes up with a fair value that is different by more than $2.5 million on that property than what it's currently on the books for, then we would mark-to-market that asset.

What happened this quarter was there was approximately a 10 basis point decline in cap rate that touched a property level materiality adjustment at two of our Toronto assets—I think Leslie and Sheppard and Leslie and Lakeshore—and probably not a surprise to you that it would be a Toronto large asset that drives this change. So, that's where it's coming from.

Michael Smith, RBC Capital Markets

Is that pretty much the only market where you've seen a little bit of downward pressure on cap rates?

Louis Forbes, Chief Financial Officer

No. I think urban would be a bit of a—large urban would be a bit of a theme for downward pressure in cap rates, just to generalize.

Michael Smith, RBC Capital Markets

In small markets, what's the—any pressure either up or down?

Louis Forbes, Chief Financial Officer

We've not seen a lot of change in small markets at all, although there may be some Alberta markets where there has been a little bit of upward pressure.

Michael Smith, RBC Capital Markets

Okay. Thank you.

Ken Silver, Chief Executive Officer

Thank you.

Operator

Thank you. The next question is from Alex Avery with CIBC. Please go ahead.

Alex Avery, CIBC Capital Markets

Thank you. Just on the acquisition front, can you describe what you're seeing out there in terms of the competition for assets and pricing, and in particular I guess differentiate between sort of secondary tertiary markets and primary urban market.

Ken Silver, Chief Executive Officer

Alex, it's Ken. There certainly seems to be more available this year than certainly last year. Last year seemed to be quiet on the transaction front. We're seeing some assets come to market in secondary locations, more product this year, and I'd say it varies. I think in some cases vendor expectations are somewhat unrealistic and there may be some adjustments there but—and as I said in my comments, we're being selective. We know these markets pretty well and we know values pretty well. Certainly there would appear to be continuing interest in urban markets and the smaller the property obviously the more potential bidders there are. I don't know if that helps any.

Alex Avery, CIBC Capital Markets

Yes, that's helpful. It's just I was sort of observing that this year you bought Fort St. John and last year you bought Arnprior and obviously I mean the lion's share of your acquisitions have come from Canadian Tire but in terms of third party acquisitions in sort of primary lower cap rate markets you haven't been as active.

Ken Silver, Chief Executive Officer

When we look at what's out there is we're really looking for opportunities to create value and we see more of that so far in some of the secondary markets which we have a significant footprint in our urban markets through the balance of the 22 or 23 million square feet that we've got, so we can nibble at the margins at some of these higher yielding plays where we can redevelop or buy well. It doesn't make a great deal of sense for us to get into bidding wars on stabilized assets in urban markets and with some of the additions that we've done, we have been able to do through Canadian Tire like the Bolton acquisition, I mean that's a pretty material acquisition in the GTA, so we feel pretty good about how we're executing from a geographic balance.

Alex Avery, CIBC Capital Markets

Okay and that other property close to the Bolton site that Canadian Tire still owns, any further development on what the redevelopment plan is there?

Ken Silver, Chief Executive Officer

Well, we're continuing to think about what we're going to do with the property. Canadian Tire is not going to move out until 2018. We don't think it's a particularly complicated municipal approval process and as I said in an earlier call, we think that the majority of the site, its highest and best use is still industrial, although there may be an opportunity for some commercial intensification at the western edge of the property across from the GO station.

Alex Avery, CIBC Capital Markets

There's still some time to go before you have to finalize it then.

Ken Silver, Chief Executive Officer

Exactly, but we're certainly thinking about it.

Alex Avery, CIBC Capital Markets

Okay. That's great. Thank you.

Ken Silver, Chief Executive Officer

Thank you.

Operator

Thank you. Our next question is from Jenny Mah with Canaccord Genuity. Please go ahead.

Jenny Mah, Canaccord Genuity

Thanks. Good morning everyone. On the comments that you made about Fort St. John and it was sort of touched upon here and there, what I'm trying to get at is if the downturn in Western Canada has created any interesting opportunities for CT REIT. Could you comment on whether the downturn has produced interesting pricing in certain markets or is the acquisition of Totem Mall in Fort St. John really specific to that market being that pricing was appropriate, it was a value-add opportunity and also the fundamentals there may be a little bit stronger with projects going on. Just general comment about what you're seeing in Western Canada.

Ken Silver, Chief Executive Officer

I would say that there is more opportunity than there was a few years ago. I'm not sure pricing has entirely adjusted. Pricing always is sticky but there's definitely conversations that we're having with a variety of folks in Alberta. BC has been a little bit more solid. I think Fort St. John just happened to be an opportunity where—you know I can't speak to the vendor's motivation. It was a pension fund that sold the asset, but obviously as I said in my earlier comments, we know the market well and we quite like it.

Jenny Mah, Canaccord Genuity

For the opportunities you see in Alberta is that focused on the secondary and tertiary markets or are there potential opportunities in Calgary and Edmonton as well?

Ken Silver, Chief Executive Officer

There are opportunities in Calgary and Edmonton as well.

Jenny Mah, Canaccord Genuity

Okay. Then just lastly on that, how do you look at the risk profile given where the economic downturn is? Are you looking at it on a long-term basis and you're willing to ride out what's going on there, or are you looking for specific economic drivers to sort of offset that, like what you're seeing in Fort St. John?

Ken Silver, Chief Executive Officer

I would say generally we're very favourable on Alberta. We do take a long-term view. We know how retailers perform in Alberta. Given the nature of our portfolio, we don't have a lot of lease turnover or risk in our existing Alberta portfolio, so we continue to be interested. If assets were available at what we viewed as the right kind of long-term valuation, we would certainly be interested.

Jenny Mah, Canaccord Genuity

Great. That's good colour. Thanks a lot.

Ken Silver, Chief Executive Officer

Thank you.

Operator

Thank you. As a reminder, please press star, then the number one on your telephone keypad to ask a question. The next question is a follow-up question from Sam Damiani with TD Securities. Please go ahead.

Sam Damiani, TD Securities

Thanks. Just two quick follow-ups. First on the payout ratio, what are you targeting, I guess, a couple of years out? It's been coming down obviously but is there a floor that you see achieving over the next couple of years?

Louis Forbes, Chief Financial Officer

Sam, it's Louis. I wouldn't say there's a floor, to give you a direct answer. I think we started out at 90 percent and sort of pointed to 80 as an interim goal and we've got there, perhaps a little bit faster than we thought we would, which is great. Looking forward we'd say 75 is probably a target; we're not going to get there we don't think really quickly, but that I would say is the next interim goal but can't indicate anything beyond that.

Sam Damiani, TD Securities

Okay. When you look at market rents since the IPO, how would characterize the overall portfolio mark-to-market, if you will, how it's evolved? I mean the rents have obviously gone up by the contractual increases but would you say market rents have moved in line with that or faster, on average?

Ken Silver, Chief Executive Officer

Sam, it's Ken. I'd say it certainly depends on the market. There have been geographic variations. A large part of what drives rent is the underlying cost to develop those properties, and particularly in urban markets. You're not seeing rents going down, that's for sure.

I would say that the average rent that we have in the Canadian Tire portfolio for those kind of assets and the geographic locations is I think still appropriate and on market. We haven't seen much in the way of changes in that regard.

Sam Damiani, TD Securities

Okay. Just finally I think your most recent investor deck stated roughly 40 properties remaining at Canadian Tire available for purchase in the future by the REIT. Would that number have shrunk by 3, I guess, this quarter, or would you say there's materially a different number there at all?

Ken Silver, Chief Executive Officer

Yes, I think a safe conclusion is that as we vend in properties you can deduct from the balance. We continue to work our way through it and as I think I've said in the early occasions, some of the situations in that 40 could be Canadian Tire is moving out of a property and we may be looking at acquiring a redundant store property that is going to be redeveloped. So, it's a little bit of a mix and some of the timing on that remains to be seen.

But yes, that pool of properties is we're just going to keep working our way through over the next number of years.

Sam Damiani, TD Securities

Thank you.

Ken Silver, Chief Executive Officer

Thank you.

Operator

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

Ken Silver, Chief Executive Officer

Thank you, Operator, and thank you all for joining us today. We expect our year-end results will be released the week of February 13th and we look forward to speaking with you then.

Operator

Thank you. The conference has now ended. Please disconnect your lines at this time and we thank you for your participation.