Singapore Industrial REITs

Buying opportunities still exist, despite sector weakness

SINGAPORE | REAL ESTATE (REIT) | UPDATE

- Maintain **Equal Weight** view on Industrial REITs sub-sector.
- Oversupply situation abating, and we believe rents to bottom by end-2018.
- Occupancy has not picked up, despite higher industrial activity.
- Top-down strategy of buying REITs that are positioned to benefit from the shift towards higher value-added manufacturing: A-REIT and MINT are our favourites.
- Bottom-up / special situation play: Trading Buy on Sabana REIT.

What is the news?

- JTC recently released its Quarterly Market Report of Industrial Properties for 2Q 2017.

Summary of Rental & Occupancy rate, as at 2Q 2017

		1Q 2017	2Q 2017	QoQ %	YoY %
Rental	All Industrial	93.0	92.3	(0.8)	(5.0)
	Multiple-User Factory	90.7	89.9	(0.9)	(5.2)
	Single-User Factory	99.9	100.1	0.2	(5.7)
	Business Park	104.3	106.5	2.1	0.4
	Warehouse	90.5	88.5	(2.2)	(6.1)
Occupancy	All Industrial	89.4%	88.7%	(0.7)	(0.7)
	Multiple-User Factory	87.0%	86.4%	(0.6)	(0.3)
	Single-User Factory	90.6%	90.2%	(0.4)	(1.3)
	Business Park	84.0%	85.7%	1.7	2.3
	Warehouse	89.9%	88.1%	(1.8)	(0.5)

Source: JTC, PSR

Key takeaways from the quarter

- **Outlook for negative reversions to persist in 2H 2017**
  Our view for negative reversions to persist in the near-term remains unchanged since our last quarterly update (8 May 2017). During this season's results briefings, we repeatedly heard Managers caution for negative reversions in 2H 2017. Ascendas REIT (A-REIT) had +1.1% reversions, but was due to one-off effect from first-cycle renewals at Aperia. Excluding the one-off effect, rental reversion for A-REIT's Singapore portfolio would have been negative. Other casualties with negative reversions were Mapletree Industrial Trust (MINT, -2.0%), Soilbuild Business Space REIT (SBREIT, -9.8%) and an outlier renewal at Cache Logistics Trust (Cache, -20%). Our previous view was for rents to bottom in 2017. We now believe rents to bottom only by the end of 2018.
- **Leasing enquiries have picked up, but it is still a tenant's market**
  Managers generally gave feedback that they are seeing more enquires YoY and QoQ. However, it is still a tenant's market – tenant retention and maintaining occupancy remains the priority for Managers. This will put pressure on rents.
- **Decline in rents in 2017 will negatively impact year-end property valuations**
  Sabana Sharia'ah Compliant REIT's (SSREIT's) portfolio was valued downwards by S$27.9 mn to S$964 mn in 2Q 2017. This resulted in higher QoQ aggregate leverage from 36.1% to 37.0%. REITs with significant exposure to master lease expiries are AIMS AMP Capital Industrial REIT (AA-REIT, 7.5% of rental income) and SSREIT (22.6% of net leasable area). All things held equal, lower YoY rents in 2017 would result in lower end of year valuations. This would have the effect of raising aggregate leverage as the existing debt is across a smaller asset base.
- **Another Oil & Gas tenant defaulted during the quarter**
  Following the default by Technics Offshore Engineering at SBREIT's property (72 Loyang Way) in 2016, Tellus Marine defaulted at ESR-REIT's property (21B Senoko Way) during the quarter and consolidated its operations at its existing SBREIT property (39 Senoko Way), where a new annex block was completed in November 2016.

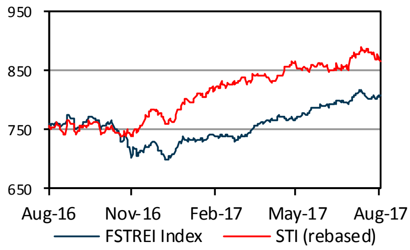
18 August 2017

Equal Weight

INDEX PERFORMANCE (%)

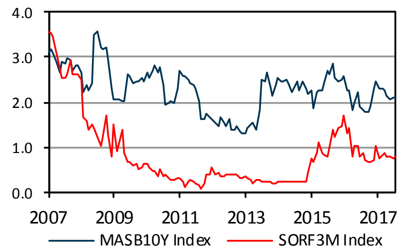
	1MTH	3MTH	1YR
FSTREI RETURN	1.9	6.3	12.8
STI RETURN	0.8	3.0	18.5

FSTREI VS. STI



Source: Bloomberg, PSR

10-year SGS (%) & 3-month SOR (%)



Source: Bloomberg, PSR

Richard Leow, CFTe, FRM (+65 6212 1848)
Investment Analyst
richardleowwt@phillip.com.sg

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Investment Actions

We maintain our "**Equal Weight**" view on the Industrial sub-sector.

The tailwinds for the sector are the tapering of supply of Industrial space in 2018 and the uptick in industrial activity in 1H 2017 to expansionary mode. However, occupancy is lower QoQ and YoY in 2Q 2017. The uncertainty is the exact timing of the bottom for rents, but we believe it to be by end-2018. Meanwhile, we expect to negative rental reversions to continue in 2H 2017.

With the recent run up in prices of the Industrial REITs, our view is that positive expectations have been factored in, and there is now a greater probability for disappointment rather than a positive surprise. We would like to see occupancy to improve, in order to upgrade our sector view for Industrial REITs.

Industrial REITs under our coverage

	Rating	Target Price (S$)	Last Close Price (S$)
Ascendas REIT	Accumulate	2.860	2.680
Cache Logistics Trust	Neutral	0.860	0.885
Keppel DC REIT	Neutral	1.280	1.275
Mapletree Industrial Trust	Accumulate	1.980	1.845
Soilbuild Business Space REIT	Neutral	0.730	0.720

Source: PSR

Strategic top-down view

- **Maintain exposure to Business & Science Park properties and Hi-Tech/Hi-Specification buildings**

  Singapore is evolving towards higher value-added manufacturing and there is a push with the Smart Nation initiative. We like REITs that can capture this opportunity with Business & Science Park properties and Hi-Tech/Hi-Specification buildings. Our favourites are:

  - **Ascendas REIT (Accumulate, target price: $2.86).** 57% of A-REIT's Net property income is derived from Business Park and Hi-Specs properties in Singapore. Its Sponsor's pipeline of over S$1 bn of Business & Science Park properties offers growth opportunities. A-REIT has a track-record of DPU growth through its portfolio rebalancing strategy and stability through its diversified portfolio. A-REIT's aggregate leverage of 33.9% is lower than the sector median.
  - **Mapletree Industrial Trust (Accumulate, target price: $1.98)**. MINT's aggregate leverage of 29.8% is one of the lowest within the S-REIT universe, giving it the firepower for inorganic growth. MINT is growing its Hi-Tech Buildings segment. A build to suit (BTS) project for Hewlett-Packard was completed in June 2017. In the pipeline are the development of a 14-storey Hi-Tech Building at Kallang (completion: 1Q2018) and a six-storey data centre in the West Region of Singapore (completion: 2H2018).

Tactical bottom-up view / special situation

- **Consolidation thesis still in play: Sabana REIT (Trading Buy, $0.57)**

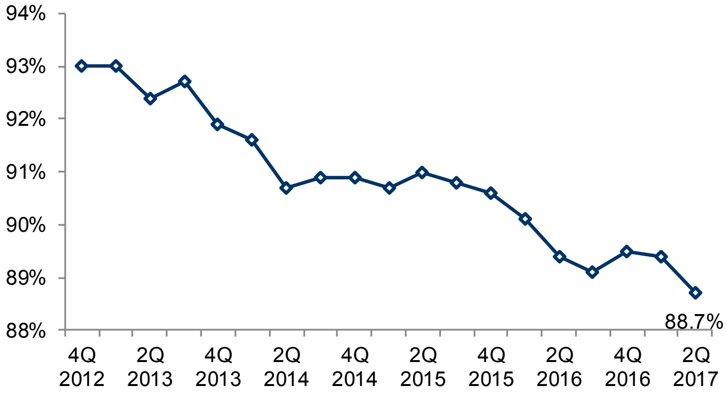
  Our recent report (8 August 2017) outlines our bottom-up view of an acquisition of Sabana REIT's assets, either by e-Shang Redwood (ESR) or ESR-REIT.

  We view SSREIT as a high-yield play that offers a ~7.3% yield (1H17 DPU of 1.69 cents annualised) with a free call option if it gets acquired. There is minimal risk of unitholder dilution this year, as the Manager did not secure a general mandate at the FY16 Annual General Meeting. The key risk to DPU in 2H 2017 is occupancy level, master lease conversions and negative rental reversions. The key risk to our event-driven thesis is that the sale of assets does not materialise.

  - **ESR-REIT appears to be building up its war chest and posturing for an acquisition**
    ESR-REIT announced the proposed divestment of 55 Ubi Avenue 3 in January 2017. ESR-REIT subsequently announced the proposed divestment of two other non-core properties (23 Woodlands Terrace and 87 Defu Lane 10) during 2Q 2017. No further announcement has been made on any proposed property acquisition. At the same time, the Distribution Reinvestment Plan (DRP) was switched on this quarter, after a hiatus of five quarters. The last time the DRP was applied was for the 4Q 2015 distribution.

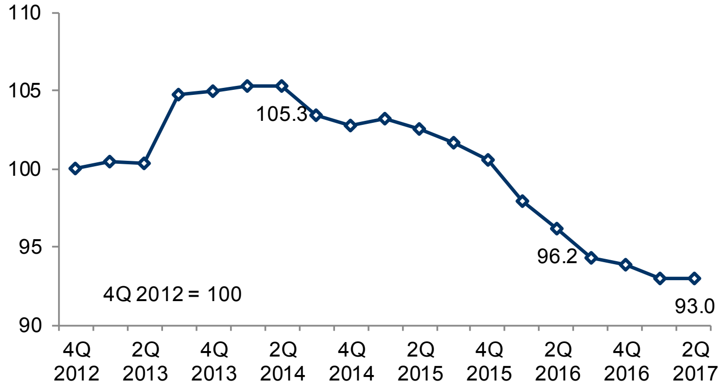
2Q 2017 JTC market data: Occupancy and Rental Index

Figure 1: Industrial sector occupancy



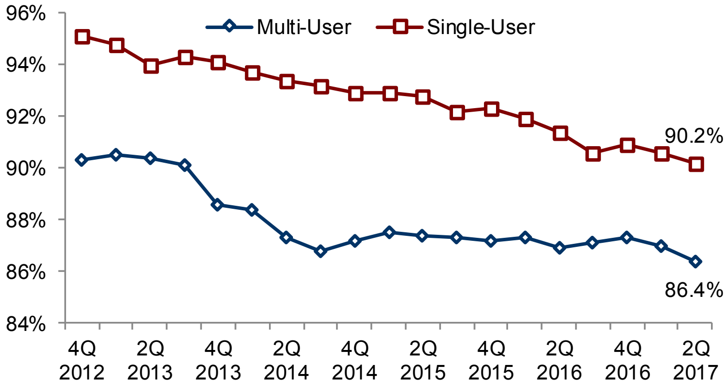
Source: JTC, PSR

Figure 2: Industrial sector Rental Index



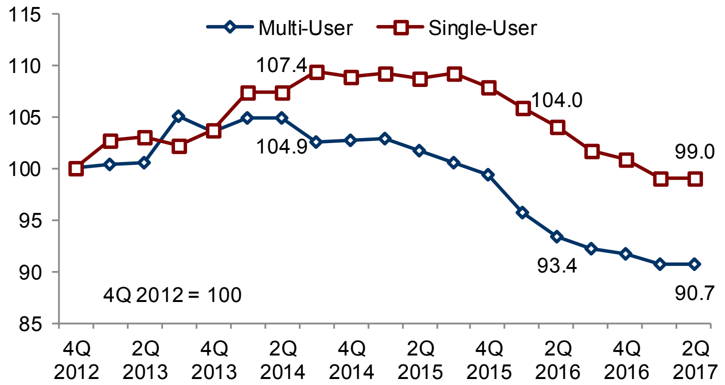
Source: JTC, PSR

Figure 3: Factory occupancy



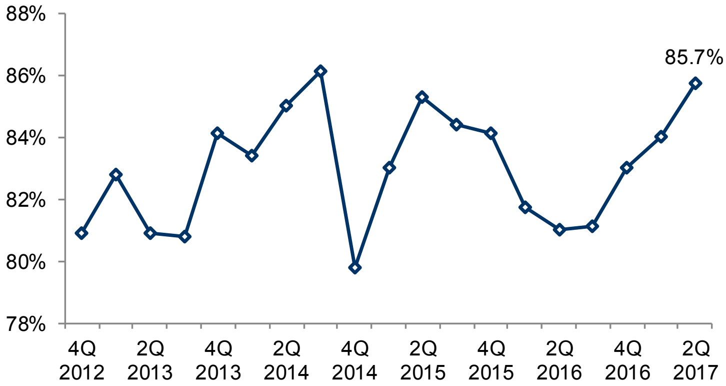
Source: JTC, PSR

Figure 4: Factory Rental Index



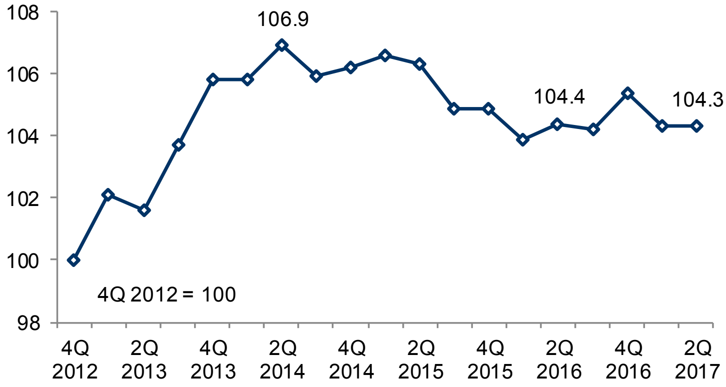
Source: JTC, PSR

Figure 5: Business Park occupancy



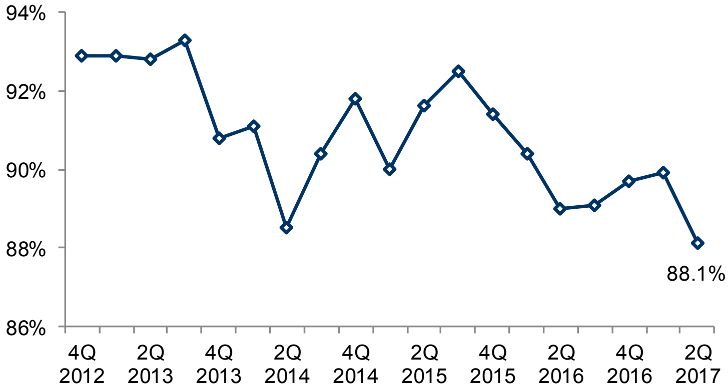
Source: JTC, PSR

Figure 6: Business Park Rental Index



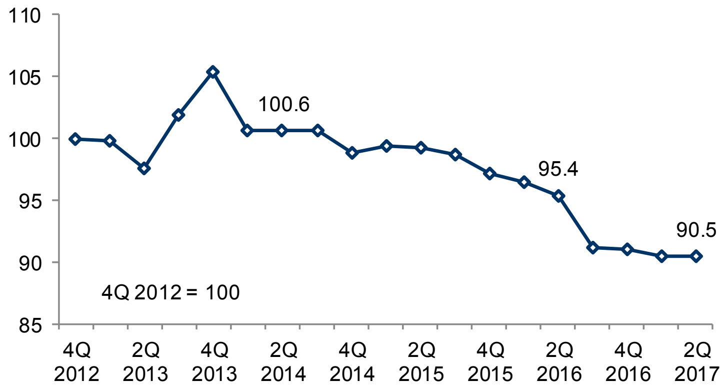
Source: JTC, PSR

Figure 7: Warehouse occupancy



Source: JTC, PSR

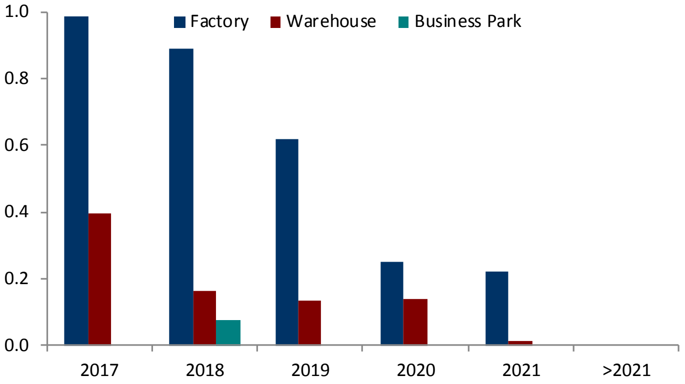
Figure 8: Warehouse Rental Index



Source: JTC, PSR

2Q 2017 JTC market data: Supply pipeline

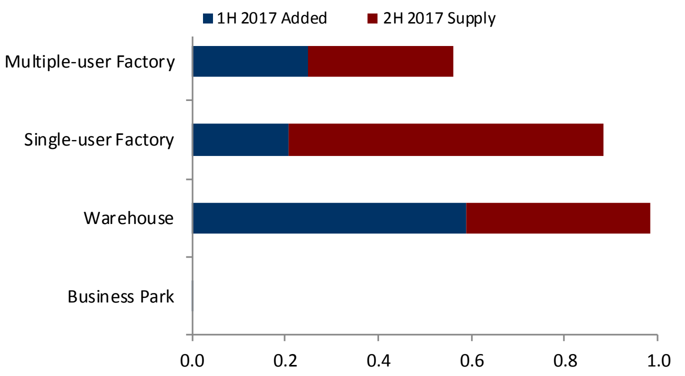
Figure 9: Supply pipeline profile, as at 2Q 2017 (million sqm)



Source: JTC, PSR

- 1.4 million sqm of space coming on-stream in 2H 2017.
- Supply tapering off in 2018 to 1.1 million sqm, after two years of supply that is higher than the historical average.

Figure 10: Space added & Supply for 2017, as at 2Q 2017 (million sqm)



Source: JTC, PSR

- Disproportionate oversupply of new Single-user Factory in 2H 2017 relative to 1H 2017, likely to negatively impact Multiple-user Factory segment in instances where users move to their own developments.
- No new supply of Business Park space for the remainder of 2017.

Supply Pipeline as a percentage of existing stock, as at 2Q 2017

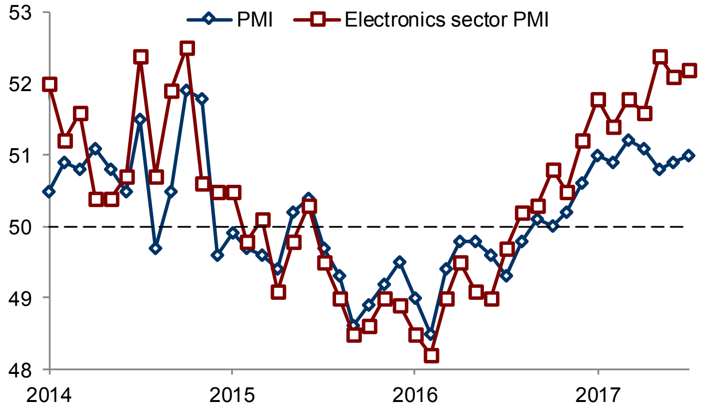
(%)	2017	2018	2019	2020	2021	>2021
Factory	2.8	2.5	1.8	0.7	0.6	0.0
Warehouse	3.9	1.6	1.3	1.4	0.1	-
Business Park	0.0	3.6	-	-	-	-
Industrial sector	**2.9**	**2.4**	**1.6**	**0.8**	**0.5**	**0.0**

Source: JTC, PSR

- Overall supply pipeline is tapering off.
- 3-year average annual supply/ demand of 1.8/1.3 million sqm respectively.

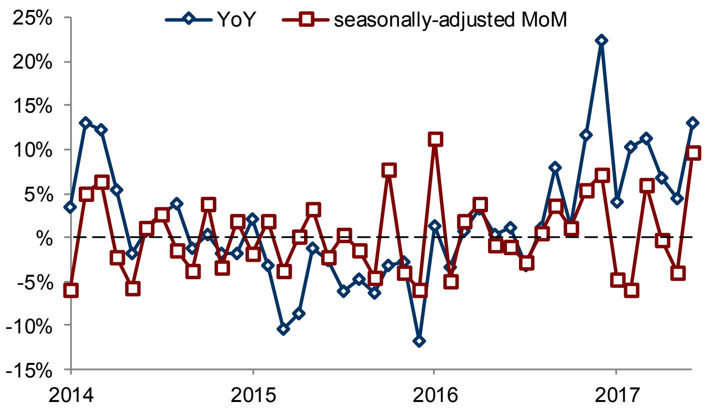
Manufacturing Indicators

Figure 11: Purchasing Managers' Index (PMI), July 2017



Source: Bloomberg, SIPMM, PSR

Figure 12: Industrial Production Index, June 2017



Source: Bloomberg, EDB, PSR

How do we view this?

- **Two-speed PMI while Industrial Production index has moderated**
  PMI remains in expansionary mode, with the electronics sector leading the charge. At current levels, we think there is a higher probability of disappointment rather than positive surprise. At the same time, Industrial Production has moderated and we do not expect to see a repeat of the 22.4% YoY growth seen in December 2016.

- **QoQ lower occupancy not a concern for now, as occupancy usually lags activity**
  QoQ lower occupancy came as a slight negative surprise, in view of robust numbers for industrial production. Higher output has not resulted in higher demand translating to higher occupancy. Upcoming new supply is still higher than historical supply, and demand is still lower than historical demand.
  We are not overly concerned at this time, as occupancy usually lags manufacturing activity by about two quarters to a year. Furthermore, we hear feedback from the managers that there have been more leasing enquiries. Nonetheless would still like to see higher occupancy as evidence of better demand.

- **Multi-User Factory: Oversupply in 2H 2017 worse than in 1H 2017**
  Total planned supply for 2017 represents 5.3% additional space to end-2016 stock, compared to the 2.2% that was added during 2016. Occupancy dipped to a new low during the quarter and would likely worsen as a further 2.9% additional supply over existing stock is added in 2H 2017. The Rental Index appears to have stabilised, but reversions will likely range between negative low-teens to high single-digit for the remainder of 2017.

  New supply of Hi-Specs/Hi-Tech industrial space is likely to come from asset enhancement initiatives (AEIs) to upgrade existing properties or through BTS projects. Within the sub-cluster of Hi-Specs/Hi-Tech industrial space, demand is expected to rise, in line with the push towards the Smart Nation initiative.

- **Warehouse: Supply pressure with highest percentage stock added in 2H2017**
  Total planned supply for 2017 represents 10% additional space to end-2016 stock, compared to the 6.6% that was added during 2016. Occupancy dipped to a new low during the quarter and would likely worsen as a further 3.9% additional supply over existing stock is added in 2H 2017. The Rental Index appears to have stabilised, but reversions will likely range between negative low-teens to high single-digit for the remainder of 2017.

  New demand for logistics space to come from the e-commerce sector as it continues to entrench itself in Southeast Asia.

- **Business Parks: Most stable sub-segment because of limited supply, but upside in rents is capped**
  We expect Business Parks to be relatively stable compared to the other two types of industrial space, due to limited new supply. However, there has been some change in the supply pipeline profile. Previously there was no new supply from 2019 onwards, but that has changed in this quarter. Some new supply of 51,000 sqm has crept into the pipeline for 2019.

  Consensus favourite has been Business Park assets, but we are less sanguine in terms of rents achievable. We still hold the view for Business Park rents to remain competitive as it is a substitute to traditional Office space and the rental differential has to be maintained. We also view that tenants occupying larger spaces will have better bargaining power during renewal negotiations and have the ability to drive down their rent.

  Overall, we expect reversions to be flat in 2H 2017.

Commentary for quarterly results across the Industrial REITs sub-sector

Summary of quarterly results

	Gross revenue (S$ mn)			Net property income (S$ mn)			Distributable income (S$ mn)			DPU (cents)		
Y/E Mar	1Q18	1Q17	YoY (%)	1Q18	1Q17	YoY (%)	1Q18	1Q17	YoY (%)	1Q18	1Q17	YoY (%)
AIMS AMP Capital Industrial REIT	30.5	29.2	4.3	20.1	20.4	(1.4)	16.0	17.5	(8.7)	2.50	2.75	(9.1)
Ascendas REIT	213	208	2.7	153	149	2.6	118.5	106.9	10.9	4.05	3.88	4.3
Mapletree Industrial Trust	88.8	84.1	5.6	68.2	63.8	6.9	52.9	51.5	2.7	2.92	2.85	2.5
Mapletree Logistics Trust	95.8	89.6	7.0	80.8	75.2	7.5	47.2	46.0	2.5	1.89	1.85	2.0
Y/E Dec	2Q17	2Q16	YoY (%)	2Q17	2Q16	YoY (%)	2Q17	2Q16	YoY (%)	2Q17	2Q16	YoY (%)
Cache Logistics Trust	27.9	28.1	(0.7)	21.7	22.6	(4.0)	16.3	17.8	(8.8)	1.80	1.99	(9.5)
ESR-REIT	27.7	28.3	(2.2)	19.2	21.2	(9.2)	12.5	14.1	(11.4)	0.96	1.08	(11.3)
Keppel DC REIT	34.5	24.9	38.8	31.4	22.1	41.9	20.1	14.7	36.5	1.74	1.67	4.2
Sabana Shari'ah Compliant REIT	22.0	22.6	(2.9)	12.9	14.0	(7.4)	8.6	9.1	(5.5)	0.810	1.230	(34.1)
Soilbuild Business Space REIT	21.6	19.6	10.1	18.7	17.3	8.1	15.4	14.7	4.3	1.466	1.565	(6.3)
Viva Industrial Trust	27.6	23.4	18.0	20.2	17.2	17.5	18.0	15.1	18.9	1.861	1.750	6.3

Source: Various REITs, PSR

- **Gross revenue growth driven by both inorganic and organic growth**
  Inorganic growth in gross revenue was due to acquisitions at **A-REIT**, **Mapletree Logistics Trust (MLT)**, **Keppel DC REIT**, **SBREIT** and **Viva Industrial Trust (VIT)**. Organic growth in gross revenue was due to completion of Phase One of the Hewlett-Packard BTS project at **MINT**, contribution from redeveloped property at 30 Tuas West Road for **AAREIT** and contribution from Viva Business Park at **VIT**.
- **Two REITs had lower YoY DPU despite gross revenue growth**
  AA-REIT was impacted at the Net property income level from higher YoY property operating expenses mainly from three phases of conversions to multi-tenancy leases at 20 Gul Way. **SBREIT** DPU was impacted by 1-for-10 Preferential Offering in 3Q 2016.

Review of Performance Measures of Industrial S-REITs

Median occupancy of 92.6% among the Industrial S-REITs was higher than the JTC sector-wide occupancy of 88.7%.

Summary of Performance Measures, as at end of June 2017

	Occupancy (%)	WALE by GRI (years)	WALE by NLA (years)	Gearing (%)	WADM (years)	WACD (%)	Interest coverage (x)
AIMS AMP Capital Industrial REIT	91.0	2.5		36.3	2.0	3.6	4.9
Ascendas REIT	91.6	4.3		33.9	3.1	2.9	5.8
Cache Logistics Trust	98.3	3.4	3.5	43.4	2.3	3.5	4.0
ESR-REIT	95.4	3.4		37.9	2.6	3.7	3.6
Keppel DC REIT	93.1		9.4	27.7	3.3	2.2	10.6
Mapletree Industrial Trust	92.6	3.1		29.8	3.4	2.8	7.2
Mapletree Logistics Trust	95.5		3.9	39.0	4.0	2.3	5.7
Sabana Shari'ah Compliant REIT	87.3	2.4		37.0	1.5	4.0	3.5
Soilbuild Business Space REIT	92.6	3.3		37.9	2.3	3.4	4.8
Viva Industrial Trust	90.6	3.0		39.1	3.0	3.9	4.9
Median	**92.6**	**3.2**	**3.9**	**37.5**	**2.8**	**3.4**	**4.9**

Source: Various REITs, PSR
WALE: Weighted Average Lease Expiry; WADM: Weighted Average Debt Maturity; WACD: Weighted Average Cost of Debt
GRI: Gross rental income; NLA: Net leasable area

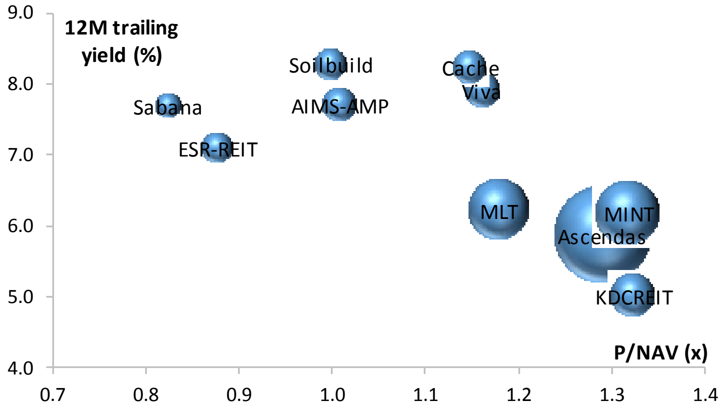
Peer relative valuation

Industrial S-REITs peer relative data (arranged by Mkt. Cap.)

	Mkt. Cap. (S$ mn)	Price (S$)	Trailing P/NAV (x)	12M trailing yield (%)
Ascendas REIT	7,734	2.68	1.29	5.9
Mapletree Industrial Trust	3,335	1.850	1.32	6.2
Mapletree Logistics Trust	3,002	1.200	1.18	6.2
Frasers Logistics & Industrial Trust	1,632	1.080	1.24	N/A
Keppel DC REIT	1,443	1.280	1.32	5.0
AIMS AMP Capital Industrial REIT	896	1.400	1.01	7.7
Viva Industrial Trust	890	0.920	1.16	7.9
Cache Logistics Trust	799	0.885	1.15	8.2
Soilbuild Business Space REIT	751	0.715	1.00	8.3
ESR-REIT	724	0.555	0.88	7.1
Sabana Shari'ah Compliant REIT	495	0.470	0.82	7.7
Average			**1.12**	**7.0**

Source: Bloomberg (Updated: 17 August 2017)

Figure 13: 12M trailing yield (%) vs. P/NAV (x)



Source: Bloomberg (Updated: 17 August 2017), PSR

PhillipCapital

Contact Information (Singapore Research Team)

Head of Research
Paul Chew – paulchewkl@phillip.com.sg

Research Operations Officer
Mohamed Amiruddin - amiruddin@phillip.com.sg

Consumer | Healthcare
Soh Lin Sin - sohls@phillip.com.sg

Property | Infrastructure
Peter Ng - peterngmc@phillip.com.sg

Macro
Pei Sai Teng - peist@phillip.com.sg

Transport | REITs (Industrial)
Richard Leow, CFTe, FRM - richardleowwt@phillip.com.sg

REITs (Commercial, Retail, Healthcare) | Property
Dehong Tan - tandh@phillip.com.sg

Technical Analysis
Jeremy Ng - jeremyngch@phillip.com.sg

Banking and Finance
Jeremy Teong - jeremyteongfh@phillip.com.sg

US Equity
Ho Kang Wei - hokw@phillip.com.sg

Oil & Gas | Energy
Chen Guangzhi - chengz@phillip.com.sg

Contact Information (Regional Member Companies)

SINGAPORE
Phillip Securities Pte Ltd
Raffles City Tower
250, North Bridge Road #06-00
Singapore 179101
Tel +65 6533 6001
Fax +65 6535 6631
Website: www.poems.com.sg

MALAYSIA
Phillip Capital Management Sdn Bhd
B-3-6 Block B Level 3 Megan Avenue II,
No. 12, Jalan Yap Kwan Seng, 50450
Kuala Lumpur
Tel +603 2162 8841
Fax +603 2166 5099
Website: www.poems.com.my

HONG KONG
Phillip Securities (HK) Ltd
11/F United Centre 95 Queensway
Hong Kong
Tel +852 2277 6600
Fax +852 2868 5307
Websites: www.phillip.com.hk

JAPAN
Phillip Securities Japan, Ltd.
4-2 Nihonbashi Kabuto-cho Chuo-ku,
Tokyo 103-0026
Tel +81-3 3666 2101
Fax +81-3 3666 6090
Website: www.phillip.co.jp

INDONESIA
PT Phillip Securities Indonesia
ANZ Tower Level 23B,
Jl Jend Sudirman Kav 33A
Jakarta 10220 – Indonesia
Tel +62-21 5790 0800
Fax +62-21 5790 0809
Website: www.phillip.co.id

CHINA
Phillip Financial Advisory (Shanghai) Co Ltd
No 550 Yan An East Road,
Ocean Tower Unit 2318,
Postal code 200001
Tel +86-21 5169 9200
Fax +86-21 6351 2940
Website: www.phillip.com.cn

THAILAND
Phillip Securities (Thailand) Public Co. Ltd
15th Floor, Vorawat Building,
849 Silom Road, Silom, Bangrak,
Bangkok 10500 Thailand
Tel +66-2 6351700 / 22680999
Fax +66-2 22680921
Website www.phillip.co.th

FRANCE
King & Shaxson Capital Limited
3rd Floor, 35 Rue de la Bienfaisance 75008
Paris France
Tel +33-1 45633100
Fax +33-1 45636017
Website: www.kingandshaxson.com

UNITED KINGDOM
King & Shaxson Capital Limited
6th Floor, Candlewick House,
120 Cannon Street,
London, EC4N 6AS
Tel +44-20 7426 5950
Fax +44-20 7626 1757
Website: www.kingandshaxson.com

UNITED STATES
Phillip Capital Inc
141 W Jackson Blvd Ste 3050
The Chicago Board of Trade Building
Chicago, IL 60604 USA
Tel +1-312 356 9000
Fax +1-312 356 9005
Website: www.phillipusa.com

AUSTRALIA
Phillip Capital Limited
Level 10, 330 Collins Street
Melbourne, Victoria 3000, Australia
Tel +61-03 9629 8288
Fax +61-03 9629 8882
Website: www.phillipcapital.com.au

SRI LANKA
Asha Phillip Securities Limited
2nd Floor, Lakshmans Building,
No. 321, Galle Road,
Colombo 03, Sri Lanka
Tel: (94) 11 2429 100
Fax: (94) 11 2429 199
Website: www.ashaphillip.net

INDIA
PhillipCapital (India) Private Limited
No.1, 18th Floor, Urmi Estate
95, Ganpatrao Kadam Marg
Lower Parel West, Mumbai 400-013
Maharashtra, India
Tel: +91-22-2300 2999 / Fax: +91-22-2300 2969
Website: www.phillipcapital.in

TURKEY
PhillipCapital Menkul Degerler
Dr. Cemil Bengü Cad. Hak Is Merkezi
No. 2 Kat. 6A Caglayan
34403 Istanbul, Turkey
Tel: 0212 296 84 84
Fax: 0212 233 69 29
Website: www.phillipcapital.com.tr

DUBAI
Phillip Futures DMCC
Member of the Dubai Gold and
Commodities Exchange (DGCX)
Unit No 601, Plot No 58, White Crown Bldg,
Sheikh Zayed Road, P.O.Box 212291
Dubai-UAE
Tel: +971-4-3325052 / Fax: + 971-4-3328895

CAMBODIA
Phillip Bank Plc
Ground Floor of B-Office Centre,#61-64,
Norodom Blvd Corner Street 306,Sangkat
Boeung Keng Kang 1, Khan Chamkamorn,
Phnom Penh, Cambodia
Tel: 855 (0) 7796 6151/855 (0) 1620 0769
Website: www.phillipbank.com.kh

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