# Singapore REITs

## A speed check in the dash for yield

SINGAPORE | REAL ESTATE (REIT) | UPDATE

18 July 2016

- Prolonged low-interest rate environment is perceived to be favourable for REITs
- Yield spreads have compressed close to the 5-year historical average
- But there is more than meets the eye in the hunt for yield
- Outlook for the individual sub-sectors remain challenging – supply/demand imbalance
- We have an "Equal Weight" view on the S-REITs Sector

As a yield instrument, REITs are favoured in a low-interest rate regime for their predictable distributions arising from rental income on the leases. All other things equal, REITs also reap the benefit of a lower cost of debt under a low-interest rate regime. The S-REITs sector has enjoyed a rally following the Brexit referendum, driving down the yield spread of the FTSE Straits Times REIT Index over the 10-year Singapore Government Securities (SGS) almost to its 5-year historical average. We opine in this report that the outlook for the individual sub-sectors remain challenging. We are holding an "Equal Weight" view on the S-REITs Sector.

### What is the news?

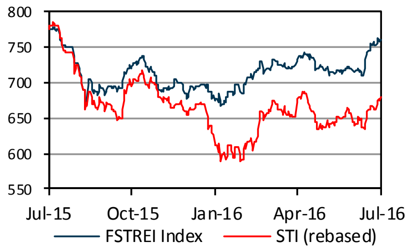
- **Brexit referendum has resulted in lower probability of a Fed rate hike**
  Market participants for the most part of the year had been anticipating further rate hikes by the Fed later this year. On June 23, the day prior to the Brexit referendum, implied probabilities for a Fed rate hike were July/10.0% and September/31.6%. This has now changed to July/8.0% and September/22.7%. (Source: Bloomberg WIRP)
- **Benchmark 3M-SOR had edged higher post-Brexit, but is still lower than six months ago**
  3M-SOR was 0.7282% on June 23 and has edged higher to 0.7505% on July 15, but it is still lower than 1.3221% from six months ago on Jan 31.
- **REITs are withdrawing their corporate credit rating**
  Owing to the new MAS guideline of adopting a single-tier leverage limit of 45%, there has been a trend of REITs requesting for their corporate credit ratings to be withdrawn. Some examples of REITs that have asked for their corporate credit rating to be withdrawn are, OUE Commercial REIT, Cache Logistics Trust, Soilbuild Business Space REIT and Sabana Shari'ah Compliant REIT.
- **REITs continue to include perpetual securities as a source of funding**
  First REIT (5.68%), Mapletree Logistics Trust (4.18%) and Frasers Hospitality Trust (4.45%) tapped on the capital markets this year through the issue of perpetual securities (commonly known as "perps"). They follow after Keppel REIT (4.98%), Ascendas REIT (4.75%) and Ascott Residence Trust (4.68%) having issued perps last year. The allure of issuing perps is that, upon fulfilling certain conditions, they are classified as equity under accounting standards, instead of debt. This has allowed REITs to tap on the capital markets, without increasing their gearing, nor enlarging their Unitholder base.

## Equal Weight

**INDEX PERFORMANCE (%)**

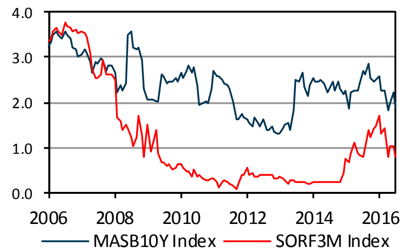
| | 1MTH | 3MTH | 1YR |
|---|---|---|---|
| FSTREI RETURN | 5.7 | 4.9 | 4.1 |
| STI RETURN | 5.0 | 12 | (9.2) |

**FSTREI VS. STI**




Source: Bloomberg, PSR

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




Source: Bloomberg, PSR

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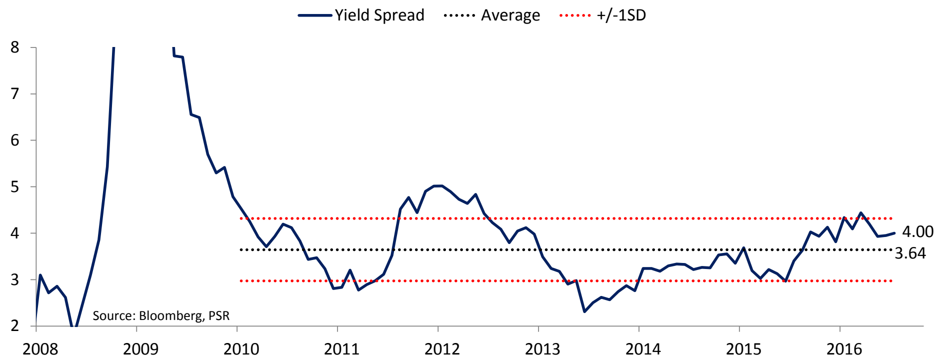
### How do we view this?

- **Not all REITs will benefit equally from the extended low-interest rate environment**
  In anticipation of an imminent rate hike later this year, the REITs had generally been looking to refinance their debt early. Now that expectations of a rate hike later this year have been lowered, and in view of the lower 3M-SOR compared to six months ago, we think that the REITs that had recently refinanced would have locked in a comparably higher rate then, against the rate being offered today.
- **REITs that stand to benefit are those with significant proportion of debt due for refinancing now, or significant proportion of debt on floating-rate**
  In view of the lower rates being offered today, it now appears that the REITs that were slow to refinance, would now be the beneficiaries of the extended low-interest rate environment. Moreover, the REITs that had not refinanced early may now be the unwitting winners if there is a rate cut instead. This also applies to REITs with a significant proportion of debt that had been left unhedged at the floating-rate, instead of fixed-rate debt.
- **Limited cost savings by withdrawing corporate credit rating**
  We understand that the annual cost is in the order of a few tens of thousands, so the reduction in operating cost would be limited.
- **All other things equal, REITs with higher gearing are more likely to raise capital through perpetual securities**
  Our belief is on the basis that the REITs pursuing an acquisition will try to avoid a Unitholder-dilutive equity fund raising exercise. Issuance of preps is perceived to be more palatable to existing Unitholders, as the Unitholder base does not explicitly enlarge.
- **REITs with existing perpetual securities may find themselves on the wrong side of the coin flip if there were to be a rate cut instead of a rate hike**
  Cost of funds from perps are generally at a fixed rate, and a higher cost than vanilla debt, readjusted at regular fixed "reset dates" (usually 5 years). REITs that had issued perps would have locked in their cost of funding, hedging against future interest rate fluctuations (to both the upside and downside).
- **Perps – there is more than meets the eye**
  Unitholders are subordinate to perp holders. As such, perp holders will get paid before Unitholders. So although there is no explicit enlargement of Unitholder base, there will be a reduction in actual cash available to be paid out as distributions to Unitholders. In effect, having perps in the capital structure (instead of vanilla debt) will understate the implicit interest cost of this source of capital.
- **Fed balance sheet stopped expanding since 2014 post withdrawal of QE. But negative interest rates in EU and Japan has provided further impetus for risk assets.**
  Germany last week became the second G-7 nation after Japan to issue 10-year bonds with a negative yield. Negative interest rates adopted in EU and Japan and the subsequent collapse in developed markets borrowing costs means there are now more than $11 trillion of bonds globally with negative yield.
- **Recent REIT rally has driven the yield spread of FTSE REIT Index over the 10-year SGS to near the 5-year historical average.**
  Triggered by lower rate hike expectations caused by the Brexit turmoil, Fed funds futures now imply only a 40% chance of a rate hike this year, from the 4 rate hikes for 2016 that Fed was projecting at the end of 2015. The dovish sentiment meant the Singapore 10-year bond yield has correspondingly fallen from c.2.6% at the start of the year to c.1.7% in July. The recent rally in S-REIT prices has led to a compression in yield spreads too, and while there is room for a further c.35 bps compression to the average yield spread since 2010, we advocate clients be selective in choosing the REITs they invest in instead of indiscriminately chasing yield.

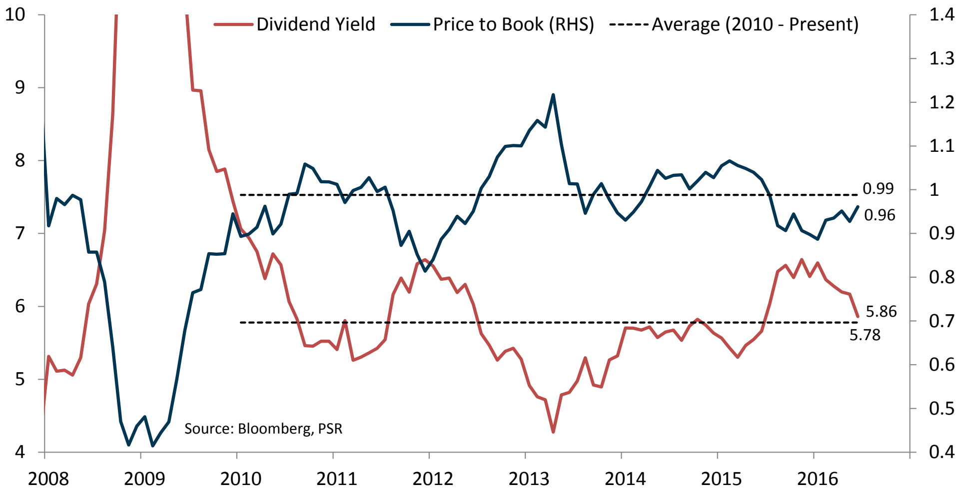
**Figure 1: Yield Spread: FTSE REIT Index vs SGS 10y bond**




***A further c.35 bps compression to average yield spread (from 2010 to present).***

- **Other valuation metrics: FTSE REIT Index yield and P/NAV also close to average levels from post-GFC 2010 to present. S-REITs now trading close to fair value.**
  While interest rate hike expectations have been scaled back, we argue that this dovish sentiment could have already been factored into S-REITs prices with valuations close to average levels taken from 2010 to present. Valuations could also be at risk if market sentiments are overly dovish and the Fed surprises with more frequent rate hikes than expected with improving jobs reports and upward pressure on prices. This could trigger a fresh round of capital flow back into U.S financial markets.

**Figure 2: FTSE REIT Index Dividend Yield and Price to NAV**




***REIT Index yield and P/NAV levels close to average levels (from 2010 to present)***

**REITs and Business Trust gearing and near-term debt maturity profile**

| | Gearing | Percentage of debt maturing Current FY | Next FY |
|---|---|---|---|
| **Commercial** | | | |
| CapitaLand Commercial Trust | 30.1% | 26.0% | 8.0% |
| Frasers Commercial Trust | 36.2% | 0.0% | 24.2% |
| IREIT Global | 43.1% | 12.0% | 0.0% |
| Keppel REIT | 39.0% | 0.0% | 15.0% |
| Mapletree Commercial Trust | 35.1% | 12.0% | 3.0% |
| OUE Commercial REIT | 40.5% | 0.0% | 31.6% |
| Suntec REIT | 34.7% | 17.3% | 6.5% |
| **Healthcare** | | | |
| First REIT | 30.0% | 0.0% | 30.9% |
| Parkway Life REIT | 36.4% | 1.1% | 7.8% |
| Religare Health Trust | 14.8% | 2.0% | N.A |
| **Hospitality** | | | |
| Ascendas Hospitality Trust | 32.7% | 4.3% | 30.3% |
| Ascott Residence Trust | 38.9% | 5.0% | 9.1% |
| CDL Hospitality Trusts | 36.7% | 22.7% | 0.0% |
| Far East Hospitality Trust | 32.7% | 4.9% | 30.4% |
| Frasers Hospitality Trust | 39.3% | 0.0% | 0.0% |
| OUE Hospitality Trust | 42.2% | 26.9% | 9.1% |
| **Industrial** | | | |
| AIMS AMP Capital Industrial REIT | 32.4% | 0.0% | 30.9% |
| Ascendas REIT | 37.2% | 17.9% | 9.9% |
| Cache Logistics Trust | 39.6% | 0.0% | 13.9% |
| Cambridge Industrial Trust | 37.1% | 0.0% | 18.8% |
| Keppel DC REIT | 29.6% | 8.8% | 0.0% |
| Mapletree Industrial Trust | 28.2% | 4.6% | 14.9% |
| Mapletree Logistics Trust | 39.6% | 11.0% | 17.0% |
| Sabana Shari'ah Compliant REIT | 39.0% | 22.1% | 26.5% |
| Soilbuild Business Space REIT | 36.0% | 0.0% | 0.0% |
| Viva Industrial Trust | 37.6% | 0.0% | 0.0% |
| **Retail** | | | |
| CapitaLand Mall Trust | 35.5% | 11.1% | 7.7% |
| CapitaLand Retail China Trust | 28.7% | 13.0% | 17.7% |
| Croesus Retail Trust | 46.2% | 0.0% | 18.0% |
| Frasers Centrepoint Trust | 28.5% | 3.2% | 26.1% |
| Mapletree Greater China Commercial Trust | 39.5% | 0.0% | 18.0% |
| SPH REIT | 25.7% | 29.4% | 0.0% |
| Starhill Global REIT | 35.4% | 0.0% | 0.9% |

Source: Various REITs, Phillip Securities Research (Singapore) estimates

## Snapshot of our views on the various sub-sectors

**Commercial**

- **Recent transactions point to bullishness, with highest price psf ever paid for a Singapore office property.** Two huge transactions this year involving Singapore's office properties have set the market abuzz with excitement amidst the recent gloom surrounding Singapore's office buildings as occupancies fall. Asia Square Tower 1 in Marina View (S$3.38b or S$2,700 psf of NLA) and Straits Trading Building in Battery Road (S$560m or S$3,524 psf of NLA) were sold to sovereign wealth fund Qatar Investment Authority (seller: BlackRock) and Indonesian tycoon and philanthropist Tahir (seller: Sun Venture Group) respectively. The $3,524 psf paid for Straits Trading Building in particular set a new record for Singapore office property price on a psf basis.
- **But exuberant transaction prices may not be indicative that we have hit bottom pricing.** We note though that these buyers, unlike traditional institutional investors such as property funds, may have a much longer time horizon as they may not be subject to shorter term investment return targets. We also note that the previous highest record on a psf basis paid for a Singapore office property, $3,125 psf for 71 Robinson Road took place in 2QCY08 in the thick of the sub-prime crisis. Office prices went into five consecutive quarters of contraction thereafter, and the office price index only recovered to where it was three years later in 3QCY11.
- **Corporates are taking advantage of current low office rents offered for new office completions to relocate to new office buildings.** Big potential office leasing deals in recent months involve such relocations. We note however that total occupied office space in downtown core dropped in 4QCY14 (12,000 sqm) for the first time since 4QCY09 and again in 4QCY15 (18,000 sqm), indicating overall downsizing amongst corporates.
- **Landlords are coming up with innovative ways such as entering the co-working space arena to fill the gap left behind by downsizing financial institutions**. CapitaLand for instance, has turned the entire 12$^{th}$ floor at Capital Tower, previously occupied by Japan's Mizuho Bank into co-working space.

**Hospitality**

- **Continued strengthening of the Singapore Dollar (SGD) against key tourist markets such as China, Indonesia and Malaysia likely to erode Singapore's attractiveness as a tourist destination.** Budget conscious visitors are already spending less money and less time in Singapore. International Visitor Arrivals (IVA) in 2015 grew 0.9% y/y to 15.2mn, in contrast to a decline in tourism receipts by 6.8% y/y to S$22.0bn, according to estimates by Singapore Tourism Board (STB). Average length of stay in 2015 was 3.6 days, compared to 3.7 days in 2014.
- **The trend of visitors spending less time in Singapore has continued this year.** Average length of stay for 1QCY16 was 3.4 days, compared to 3.7 days in 1QCY15.
- **We expect the oversupply situation for hotel rooms to persist in 2016.** For 2016, hotel room supply in Singapore is expected to grow between 3.8 and 4.8 percent, while Singapore Tourism Board (STB) is forecasting visitor arrival growth of 0 to 3 percent.
- **Consequently, we expect RevPAR to remain weak, in spite of visitor growth.** 13.3% y/y growth in visitor arrivals for 5MCY16 has supported average occupancy rate (AOR), but we believe hoteliers will have to compromise and lower average daily rate (ADR) – effectively negatively impacting revenue per available room (RevPAR). Sector-wide AOR in 5MCY16 improved 1.4pps y/y to 84.4%, ARR was down 2.3% y/y to S$237.20 and consequently RevPAR was down 0.8% y/y to S$200.30.

**Industrial**

- **As of the end of 1QCY16, new industrial space for the remainder of 2016 and 2017 is equivalent to about 5.4% and 4.0% respectively, of existing available stock.** JTC estimates about 2.43mn sqm and 1.80mn sqm of industrial space to come on-stream in the remainder of 2016 and 2017 respectively. The current existing stock of industrial space is 44.88mn sqm as of 1QCY16.

- **Further downward pressure on sector occupancy rates expected as new supply exceeds new demand.** The additional space coming on stream is significantly higher than the average annual supply of around 1.7mn sqm in the past three years. Historical average demand over the past three years was 1.2mn sqm.
- **We expect demand from the manufacturing sector to remain weak, putting pressure on landlords to lower asking rent.** Singapore Purchasing Manager's Index (PMI) has been less than 50 for twelve consecutive months, indicating a contraction of the manufacturing sector.

**Retail**

- **Sluggish retail sales in Singapore continued into 2016 from 2015.** Retail sales y/y growth figures for 2016 were down every month for the first five months except in January when it grew marginally by 0.6%.
- **Sale of F&B also showed signs of weakness.** Traditionally considered one of the more "staple" categories together with "Medical Goods and Toiletries", food & beverages (F&B) also registered negative y/y growth every single month for the past twelve months. F&B has been touted as one of the more resilient tenant sector in shopping malls as they serve a basic functional need of shoppers. Malls are also gravitating towards becoming "lifestyle malls", bringing in tenants from sectors such as F&B and other services which are more resilient to the threat of e-commerce.
- **Motor vehicle sales was a rare bright spot in an otherwise lacklustre retail sales report these two years, but this does not reflect the whole story.** A closer look at private car ownership statistics though reflect a different state of the consumer, with car ownership numbers falling to a 5-year low in 2015. Motor vehicle sales were buoyed by growth in rental cars caused by the increasing popularity of car-sharing apps such as Uber and GrabCar.
- **We expect the increasing use of technology to facilitate online/mobile sales, which will eventually occupy an increasing portion of total retail sales.** Apart from rising staff and rental costs, we think retailers will be increasingly hit by the rise of e-commerce sales and more B2C and C2C websites and apps in the long-run. Improvements in last mile delivery solutions resulting in more timely deliveries, and higher adoption rates by merchants to online/mobile sales will likely be catalysts for increasing e-commerce sales as a percentage of total retail sales.

## Investment Actions

**REITs and Business Trusts under our coverage**

| | Rating | Target Price (S$) | Last Close Price (S$) |
|---|---|---|---|
| **Commercial** | | | |
| CapitaLand Commercial Trust | Reduce | 1.290 | 1.570 |
| **Healthcare** | | | |
| First REIT | Accumulate | 1.320 | 1.315 |
| **Industrial** | | | |
| Cache Logistics Trust | Reduce | 0.780 | 0.875 |
| Keppel DC REIT | Neutral | 1.130 | 1.160 |
| Mapletree Industrial Trust | Neutral | 1.720 | 1.725 |
| Soilbuild Business Space REIT | Accumulate | 0.790 | 0.705 |
| **Retail** | | | |
| CapitaLand Retail China Trust | Accumulate | 1.550 | 1.610 |
| Croesus Retail Trust | Neutral | 0.930 | 0.845 |
| Frasers Centrepoint Trust | Neutral | 2.00 | 2.12 |

Source: Bloomberg, Phillip Securities Research (Singapore)

**Cache Logistics Trust** – Cautious on the possible overhang of warehouse space going into 2017, stemming from potential overflow of unabsorbed space in 2015 and 2016.

- We forecast 7.68 cents DPU for FY16. This is 6.3% lower than the consensus average of 8.2 cents. Our out-of-consensus view on Cache stems from our pessimism over the two master leases that are expiring in 3QFY16 (Schenker Megahub) and 4QFY16 (Hi-Speed Logistics Centre).
- Cache is currently locked in a dispute between its master-lessee, C&P Land Pte. Ltd. (C&P) and the end-user, Schenker Singapore Pte. Ltd. (Schenker) at the Property located at 51 Alps Avenue, known as Schenker Megahub. Schenker has the intention to exercise an option with C&P to renew its lease at a pre-agreed rate that is below the current market rental rate.
- While this could be evidence of demand for the property, we also view that tenants are driving a hard bargain and are *unwilling* to pay.

*Cache will be announcing 2QFY16 results on 20 July 2016 after market hours.*

**Keppel DC REIT** – Proxy to explosive growth in data requirements.

- We downgraded our rating from "Accumulate" to "Neutral" in a recent report on July 8.
- We forecast 6.62 cents DPU for FY16. This is 4.1% lower than consensus expectations of 6.9 cents. We believe that consensus has not fully factored in the trend of GBP, AUD and MYR depreciating relative to SGD.

*KDCREIT will be announcing 2QFY16 results on 18 July 2016 after market hours.*

**Mapletree Industrial Trust** – Low gearing, with stable income from Flatted Factories segment.

- We downgraded our rating from "Accumulate" to "Neutral" in a recent report on July 8.
- We forecast 10.72 cents DPU for FY17. This is 3.4% lower than consensus expectations of 11.1 cents.

*MINT will be announcing 1QFY17 results on 26 July 2016 after market hours.*

**Soilbuild Business Space REIT** – Stability from master leases, and negligible vacancy risk for the rest of the year.

- SBREIT has recently announced 2QFY16 financial results on July 13 and we have a

report on it.
- We forecast 6.16 cents DPU for FY16. This is in line with consensus expectations of 6.2 cents.

**CapitaLand Commercial Trust** – The worst is yet to come.
- We initiated with a "Reduce" rating in our recent report on May 16.
- Sector demand supply dynamics - Worse than Global Financial Crisis (GFC) 2008-2009.
- Structural issues within Singapore worsen the situation.
- Share prices tend to lead rental rates at major economic turning points as shown in 2007-2009.

*CCT will be announcing 1H16 results on 20 July 2016. We will review our call post results.*

**CapitaLand Retail China Trust** – MAS flattening of S$ band to offset weakening RMB pressure.
- We downgraded from "Buy" to "Accumulate" in a recent report on April 14.
- Retail sales growth in China is slowing.
- RMB weakening since end 2015 but new MAS policy should lessen impact.
- Low gearing provides ammunition for growth as well.

*CRCT will be announcing 1H16 results on 27 July 2016. We will review our call post results.*

**First REIT** – Stable portfolio in times of volatility.
- Maintain "Accumulate", target price of S$1.32 (from S$1.38) in a recent report on July 18.
- 1H Gross Revenue and DPU came in at 48% of our FY16E forecasts.
- S$60m perpetual securities lower gearing from 34.4% to 30%.
- Revise forecasts downwards due to delay in Yogyakarta acquisition and weak CPI data. First REIT's Indonesian hospitals have rental reversions pegged to Singapore's CPI.

**Frasers Centrepoint Trust** – Resilient amidst the generally lacklustre retail trends.
- Maintain "Neutral", with unchanged target price of S$2 in a recent report on July 18.
- 9M Gross Revenue and DPU at 75% and 77% of our FY16 estimates.
- Portfolio tenant sales generally flat, except at malls undergoing AEI and tenant readjustments.
- Strong rental reversions underpinned by high reversion of 9.3% at Causeway Point.

## Peer relative valuation

**REITs and Business Trusts peer relative data (arranged by sub-sector and Mkt. Cap.)**

| | Mkt. Cap. (S$mn) | Price (S$) | trailing P/NAV (x) | 12M trailing yield (%) |
|---|---|---|---|---|
| **Commercial** | | | | |
| CapitaLand Commercial Trust | 4,641 | 1.570 | 0.90 | 5.5 |
| Suntec REIT | 4,542 | 1.795 | 0.84 | 5.7 |
| Keppel REIT | 3,507 | 1.075 | 0.75 | 6.3 |
| Mapletree Commercial Trust | 3,308 | 1.550 | 1.19 | 5.2 |
| Frasers Commercial Trust | 1,060 | 1.335 | 0.86 | 7.4 |
| OUE Commercial REIT | 879 | 0.680 | 0.74 | 6.4 |
| IREIT Global | 450 | 0.730 | 1.78 | 8.3 |
| **Healthcare** | | | | |
| Parkway Life REIT | 1,555 | 2.57 | 1.53 | 5.1 |
| First REIT | 1,012 | 1.315 | 1.28 | 6.3 |
| Religare Health Trust | 812 | 1.015 | 1.09 | 7.6 |
| **Hospitality** | | | | |
| Ascott Residence Trust | 1,872 | 1.135 | 0.85 | 8.4 |
| CDL Hospitality Trusts | 1,485 | 1.500 | 0.96 | 6.7 |
| OUE Hospitality Trust | 1,266 | 0.710 | 0.80 | 8.0 |
| Far East Hospitality Trust | 1,122 | 0.625 | 0.67 | 7.4 |
| Frasers Hospitality Trust | 1,076 | 0.780 | 0.92 | 8.9 |
| Ascendas Hospitality Trust | 801 | 0.715 | 0.83 | 7.6 |
| **Industrial** | | | | |
| Ascendas REIT | 6,526 | 2.44 | 1.19 | 6.3 |
| Mapletree Industrial Trust | 3,107 | 1.725 | 1.26 | 6.5 |
| Mapletree Logistics Trust | 2,617 | 1.050 | 1.03 | 7.0 |
| Keppel DC REIT | 1,024 | 1.160 | 1.29 | 5.7 |
| AIMS AMP Capital Industrial REIT | 923 | 1.450 | 0.98 | 7.8 |
| Cache Logistics Trust | 783 | 0.875 | 1.00 | 9.6 |
| Cambridge Industrial Trust | 730 | 0.560 | 0.83 | 8.4 |
| Soilbuild Business Space REIT | 663 | 0.705 | 0.89 | 9.1 |
| Viva Industrial Trust | 640 | 0.740 | 0.91 | 9.1 |
| Sabana Shari'ah Compliant REIT | 394 | 0.535 | 0.60 | 12.0 |
| **Retail** | | | | |
| CapitaLand Mall Trust | 7,651 | 2.16 | 1.15 | 5.2 |
| Mapletree Greater China Commercial | 2,910 | 1.050 | 0.85 | 6.9 |
| SPH REIT | 2,402 | 0.945 | 1.01 | 5.8 |
| Frasers Centrepoint Trust | 1,945 | 2.120 | 1.11 | 5.6 |
| Starhill Global REIT | 1,734 | 0.795 | 0.88 | 6.5 |
| CapitaLand Retail China Trust | 1,377 | 1.610 | 0.96 | 6.6 |
| Croesus Retail Trust | 606 | 0.845 | 0.01 | 10.9 |

Source: Bloomberg (Updated: 16 July 2016)

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