Singapore REITs

Still awaiting the elusive 2016 rate hike

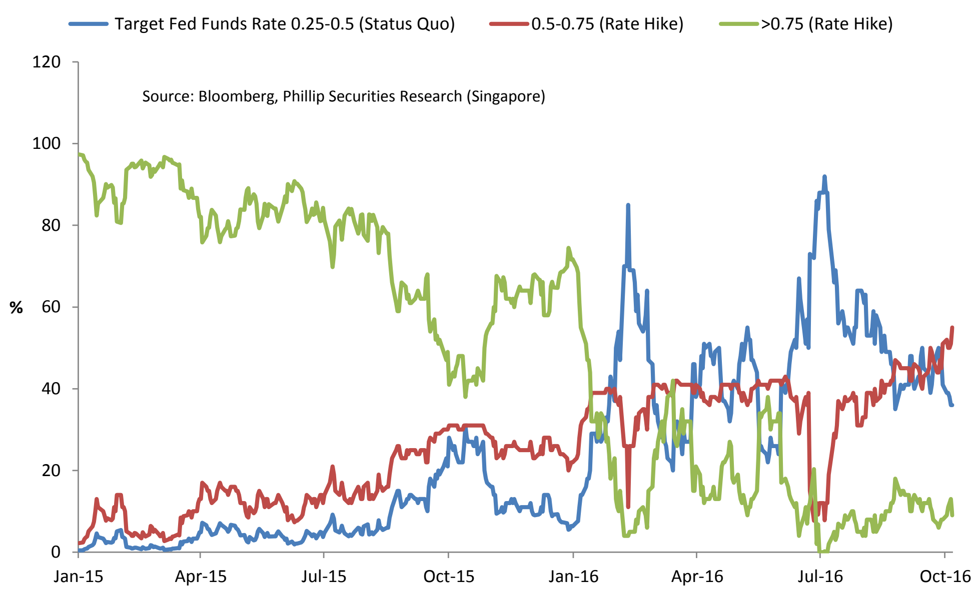
SINGAPORE | REAL ESTATE (REIT) | UPDATE

14 October 2016

What is the news?

- **Expectations have been rising in recent months for Fed rate hike in December**
  Rising expectations in recent months for a December rate hike by the Federal Reserve may have gotten investors jittery about the knee-jerk reaction that might be caused to the REIT markets. Current polled odds from Bloomberg for a December rate hike stand at c.67%, an increase from a mere 7.7% on 27 June 2016, the Monday after the Brexit referendum.

Figure 1: Rate Hike Probabilities Chart for December 2016 Federal Reserve meeting



How do we view this?

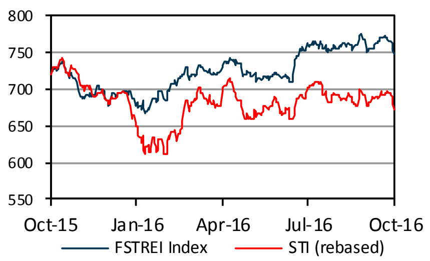
- **Different causes for investors' concerns**
  REIT investors' concerns over rising interest rates are manifested in several ways. Firstly, rising interest rates impact REITs in a few major ways, most notably in rising credit costs since this represent the biggest cost component for REITs. Traditionally viewed as quasi-yield instruments, rising interest rates also narrows the spread of REIT yields vs the risk-free yield, defined as the country's 10 year government bond yield.

Equal Weight

INDEX PERFORMANCE (%)

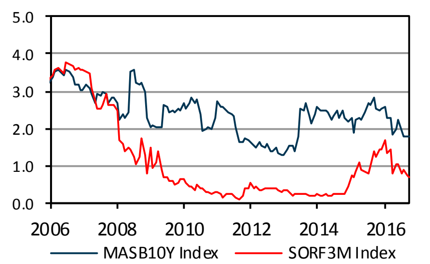
	1MTH	3MTH	1YR
FSTREI RETURN	(2.2)	0.5	11.3
STI RETURN	(2.0)	(1.4)	(3.6)

FSTREI VS. STI



Source: Bloomberg, PSR

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



Source: Bloomberg, PSR

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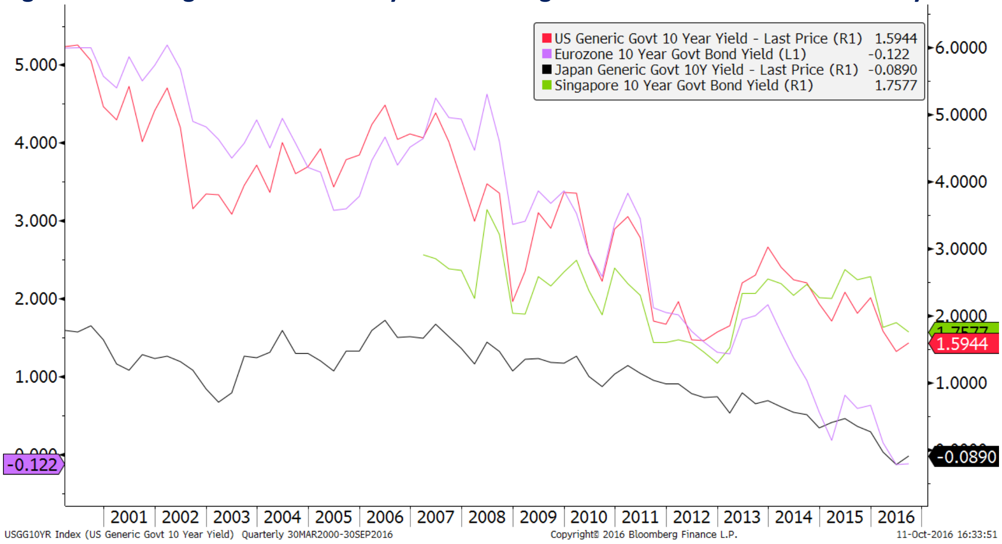
- **Global interest rates on a downtrend**
  While the Federal Reserve prepares to hike rates for only the second time since the Global Financial Crisis (GFC), other major central banks such as the European Central Bank (ECB) and Bank of Japan (BOJ) continue to adopt loose monetary policies. Global interest rates have generally trended down, with the Eurozone and Japanese 10 year bond yields hitting negative territory. The downward trend in long term government bond yields has enhanced the attractiveness of REITs.

Figure 2: Global government bond yields trending down in a decades-old bond rally



Source: Bloomberg, Phillip Securities Research (Singapore)

- **REITs do perform in a rising interest rate environment. Even outperformed mainboard index**
  During the last rate hike cycle from November 2004-2007, Federal Fund rates moved up from less than 2% to around 5% in three years. In that same period, the major REIT indices correspondingly improved. The US, Australian and Singapore REIT indices gained 32%*, 42% and 67% respectively. US and Singapore REITs indices also outperformed their mainboard indices' gains of 26% and 53% respectively. Outside of the US, Japan, Australia and Singapore are the three largest REIT markets by market capitalization in Asia.

Figure 3: Major Regional REIT markets

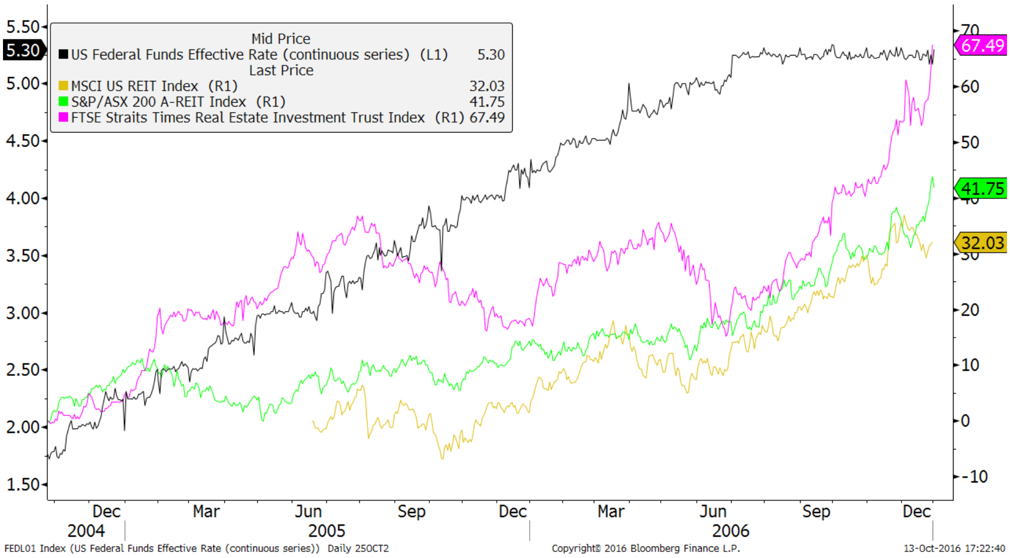
Market	Number of REITs	Market Cap (US$b)
US	249	1107
UK	42	63
Japan	54	111
Australia	47	108
Singapore	38	50
Hong Kong	11	30

Source: Bloomberg, Phillip Securities Research (Singapore)

*US REIT index data from June 2005-2007

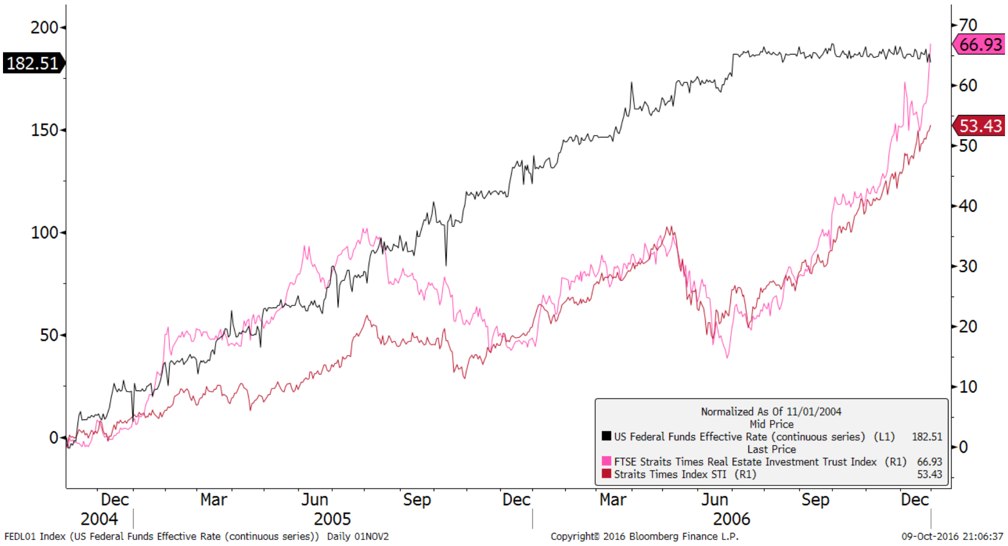
Figure 4: REITs performed during last rate hike cycle 2004-2007

US, Australian and Singapore REITs gained 32%, 42% and 67% respectively in last rate hike cycle.



Source: Bloomberg, Phillip Securities Research (Singapore)

Figure 5: S-REITs outperformed benchmark STI during last rate hike cycle 2004-2007



Source: Bloomberg, Phillip Securities Research (Singapore)

Figure 6: S-REITs, US REITs outperformed

US and Singapore REITs outperformed their respective benchmark indices in the last rate hike cycle

% Appreciation November 2004 - 2007	
S&P 500	**MSCI US REIT Index**
26%	32%
STI	**FTSE Straits Times REIT Index**
53%	67%
S&P/ASX 200	**S&P/ASX 200 A-REIT Index**
50%	42%

Source: Bloomberg, Phillip Securities Research (Singapore)

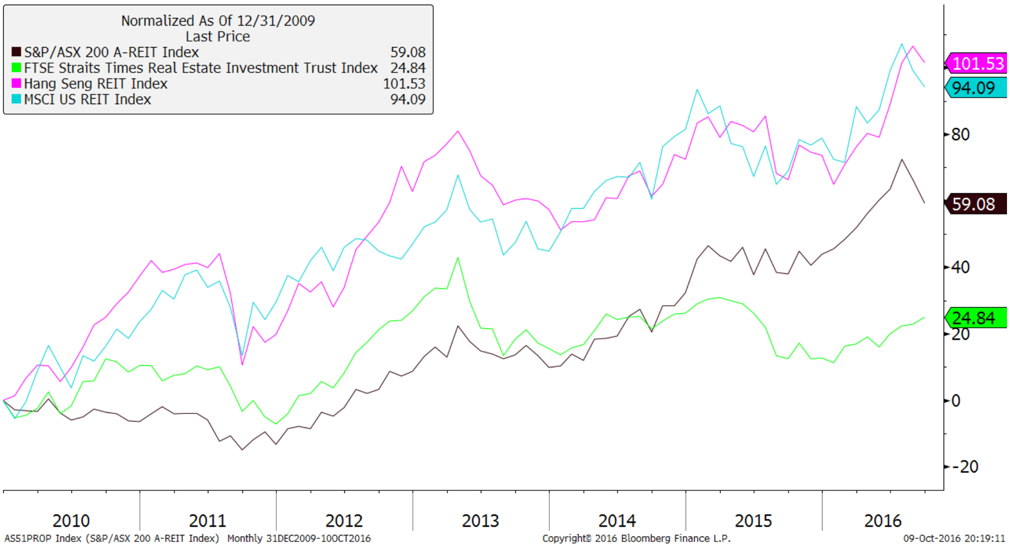
With these statistics, we gather that the more important thing to note about rising interest rates is that rising rates accompanied by strong country growth would actually be beneficial to REITs, with improving corporate earnings and consumer spending power. What is also important is the bigger picture to consider given that Federal Reserve Chair Janet Yellen has repeatedly emphasized that the pace of rate hike will be slow and gradual and most probably "data-dependant".

Measuring the historical performance of major regional REIT markets post GFC

We take a closer look at the performance of the Australia, Singapore and Hong Kong REIT indices post GFC. These are the three largest REIT markets by market capitalization in Asia-ex Japan. From 2010 post GFC until now, Hong Kong REITs have outperformed with a 102% return, followed by Australian REITs 59% and Singapore REITs 25%. Consequently, the stronger appreciation in the REIT prices of Hong Kong and Australian REITs has translated to lower gross forward yields vs S-REITs.

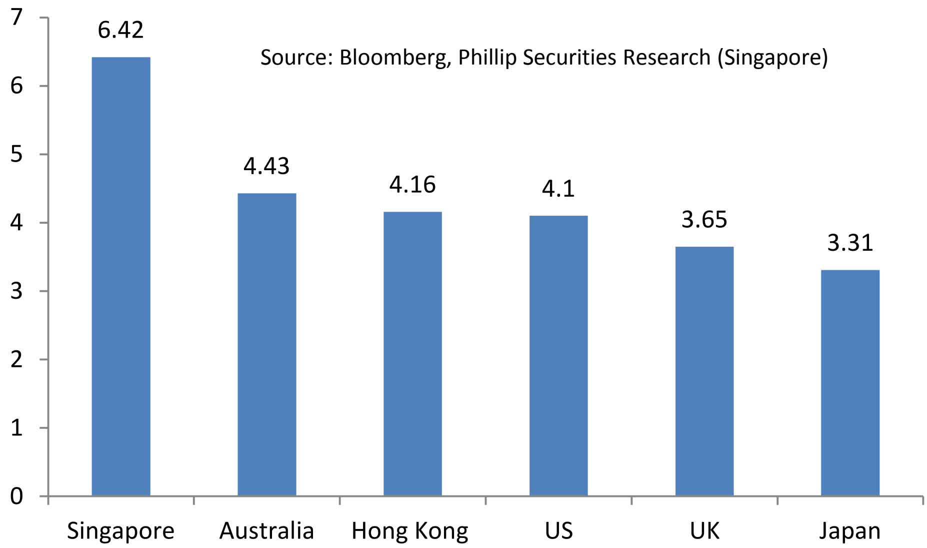
Figure 7: Performance of regional REIT markets (Post GFC to now)

Hong Kong and US REITs outperformed from post GFC 2010 until present.



Source: Bloomberg, Phillip Securities Research (Singapore)

Figure 8: Gross forward dividend yield of major regional REIT markets



Source: Bloomberg, Phillip Securities Research (Singapore)

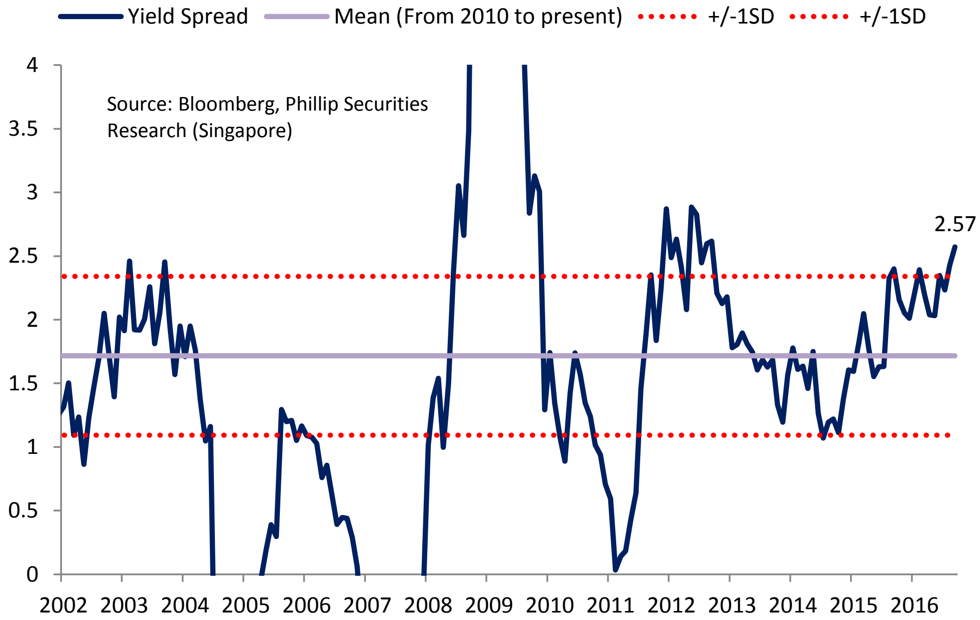
Current Yield Spreads for major REIT markets – ASX, US, Singapore

Despite the lower gross forward dividend yields for US and Australian REITs, yield spreads vs their respective 10 year government bond yields appear to be more "attractively priced" with the Australian and US yield spreads trading at >1s.d. from the mean (2010 to present).

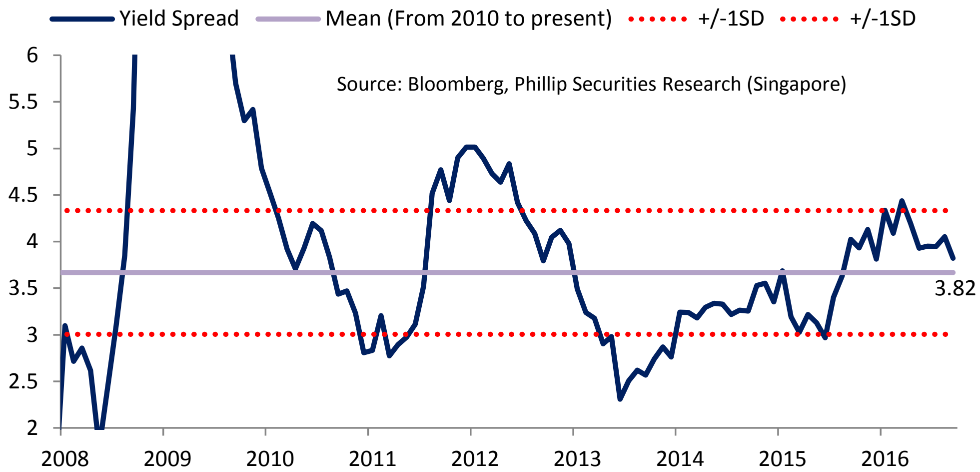
Based on spreads, Australian and US. REITs look "cheaper" vs Singapore REITs. Despite having lower spreads in absolute amounts, Australia and US yield spreads are trading at >1s.d. above the mean.

Figures 9-11: Yield Spreads for Regional REITs (REIT vs 10 year bond yields)

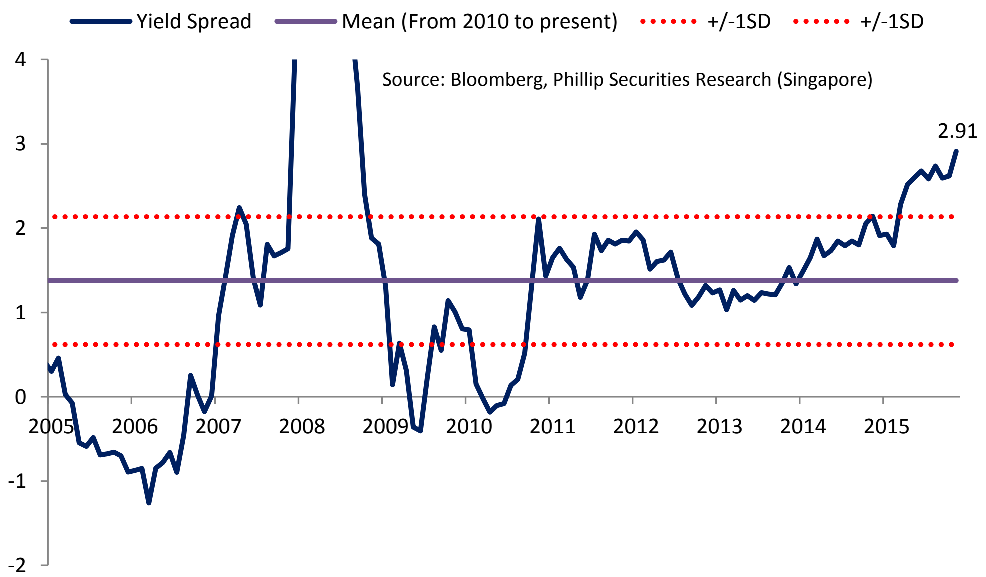
Australian Yield Spreads: at 2.57%, >1s.d. away from the mean (from 2010-present)



Singapore Yield Spreads: at 3.82%, close to the mean (from 2010-present)



US Yield Spreads: at 2.91%, >1s.d. away from the mean (from 2010-present)



US Yield Spreads at levels last seen only during the GFC.

Advantages of investing in REITs vs Physical Properties – Table of returns for different asset classes

Low interest rates amidst the easy monetary policies since the GFC have led to an influx of institutional and private investment capital into properties. Besides offering better liquidity, affordability (board lot size of 100 shares), accessibility to overseas and unique asset classes such as golf courses, hospitals and shopping malls, REITs also offer investors tax savings. While investors in physical properties have to fork out property tax and rental income tax, REIT investors are exempted from both capital gains and dividend taxes. On the REIT end, local REITs with locally sourced rental income are also exempted from tax, provided they pay out 90% of the income as dividends.

REITs also offer investors access to professional management teams who are able to carry out asset enhancement initiatives to achieve higher rental yields on costs, which would be more difficult to achieve on an individual basis. An example will be the acquisition of Iluma Mall by CapitaLand Mall Trust (CMT) in 2011 for S$295m. Within two years of acquisition, after some asset enhancement initiative works, CMT achieved a yield on cost of 7.1% by 2013, a rental yield which outperformed even those of suburban malls at high 5s to 6%.

Index Level	S-REIT index	All Private Resi include EC	Private Residential CCR (Non-Landed)	Private Residential OCR (Non-Landed)	Office Space	Shop Space
2010 Q1	**617**	125.1	122.4	125.7	93.7	107.5
Current	**764**	140	129.4	156.5	136.1	123.9
Change	**24%**	**12%**	**6%**	**25%**	**45%**	**15%**

Source: Bloomberg, REALIS, Phillip Securities Research (Singapore)

Post GFC returns: S-REITs offered better/comparable returns vs most other physical asset classes except for physical office space

Investment Actions

We re-iterate our Equal Weight call on the S-REIT sector.

	Rating	Target Price (S$)	Last Close Price (S$)
Retail			
CapitaLand Retail China Trust	Accumulate	1.62	1.575
Croesus Retail Trust	Accumulate	0.93	0.85
Frasers Centrepoint Trust	Neutral	2.00	2.08
Commercial			
CapitaLand Commercial Trust	Reduce	1.29	1.535
Industrial			
Keppel DC REIT	Accumulate	1.29	1.21
Mapletree Industrial Trust	Neutral	1.72	1.7
Soilbuild Business Space REIT	Neutral	0.72	0.71
Cache Logistics Trust	Reduce	0.81	0.875
Healthcare			
First REIT	Accumulate	1.32	1.35

Source: Bloomberg, Phillip Securities Research (Singapore)

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