Singapore REITs

Fed normalisation of interest rates in 2017/2018 to end 7 year outperformance of S-REITs

6 February 2016

SINGAPORE | REAL ESTATE (REIT) | UPDATE

- **Start of the new rate hike cycle: A comparison with the last rate hike cycle.** Comparing the start of the current rate hike cycle to the last one in 2004-2006, fundamentals of the various property sectors were much stronger back in 2004. We think Technology and Growth are the two key buzzwords which differentiate then and now.

- **S-REITs returned 27% CAGR during last rate hike cycle from 2004-2006. But property and economic fundamentals back then were much stronger.** Singapore's GDP grew an annual average 7.3% from 2004-2006. In contrast, growth was 2% in 2015, 1.8% in 2016 and a projected 1-3% in 2017.

- **Further Fed normalisation of interest rates in 2017/2018 to end 7 year outperformance for S-REITs.** S-REITS have done incredibly well since post Global Financial Crisis (GFC) until now, outperforming the STI every year except in 2013. This could change as Fed further normalises interest rates in the coming years.

- **Why hasn't a recovering US spur growth in Singapore like it did in 2004, given that Singapore is such an open, export-oriented economy?** Structural challenges within Singapore, such as slower labour force growth caused by tighter immigration policies, still enforced property cooling measures and overcapacity problems in China, are current impediments to growth.

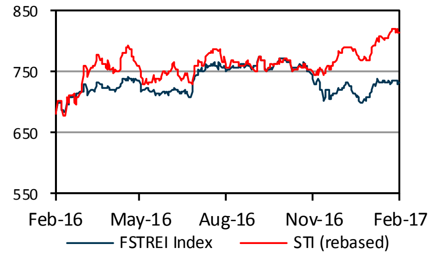
- **Technological advancements also create headwinds for the various property sectors.** The advent of e-commerce, advanced web-conferencing technology allowing employees to work from home, and the increasing digitalisation of information are some trends that could reduce demand for retail or office space.

Underweight (Downgrade from Equal Weight)

INDEX PERFORMANCE (%)

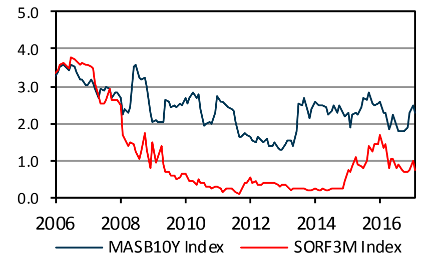
	1MTH	3MTH	1YR
FSTREI RETURN	4.6	(0.1)	13.4
STI RETURN	5.9	9.0	22.7

FSTREI VS. STI



Source: Bloomberg, PSR

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



Source: Bloomberg, PSR

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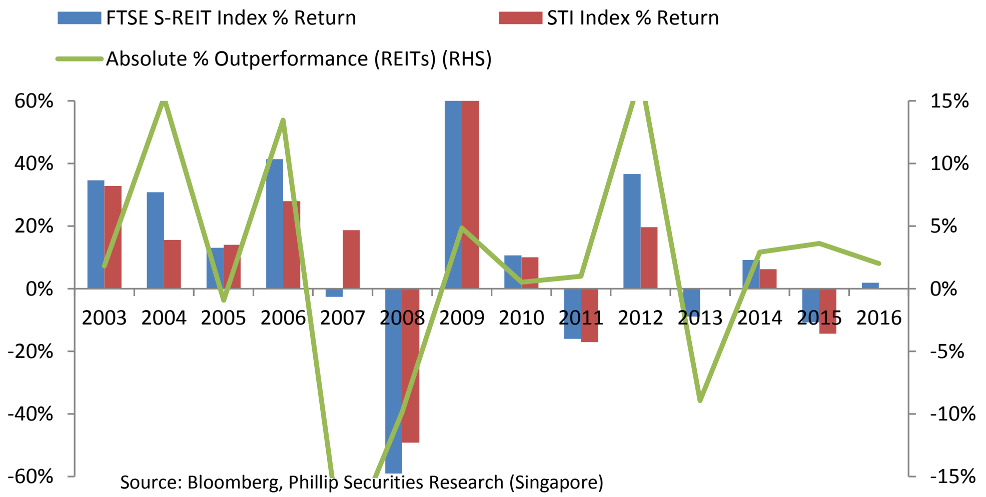
How do we view this?

- **Start of the new rate hike cycle: A comparison with the last rate hike cycle.**

S-REITS have performed incredibly well since post Global Financial Crisis (GFC) until now, outperforming the STI every year except in 2013 where we had the "taper tantrum" and Treasury yields surged after the Fed announced the "tapering" of monetary stimulus.

Figure 1: FTSE REIT Index Outperformance vs STI



Source: Bloomberg, Phillip Securities Research (Singapore)

Reits have outperformed the STI since post-GFC in every year except in 2013 (Taper Tantrum, where treasury yields surged on the Fed announcement of monetary stimulus tapering)

One of the major contributing factors for the strong performance of S-REITs was the presence of low interest rates and loose monetary policies from major central banks including the Federal Reserve, European Central Bank (ECB) and Bank of Japan (BOJ). This drove funds towards yield investment instruments amidst the low interest rate, low growth environment. Together with a recovering property market across most sectors from 2009, better consumer sentiment driving strong retail sales, and banks and companies rehiring post GFC, these were the perfect fuel for a sustained run in REITs prices.

With the Federal Reserve gradually normalising interest rates, we think that this could mark the start of the reversal of the "yield carry-trade". 2017/2018 will likely see steeper and more frequent Fed rate hikes versus the one rate hike/year in each of 2015 and 2016.

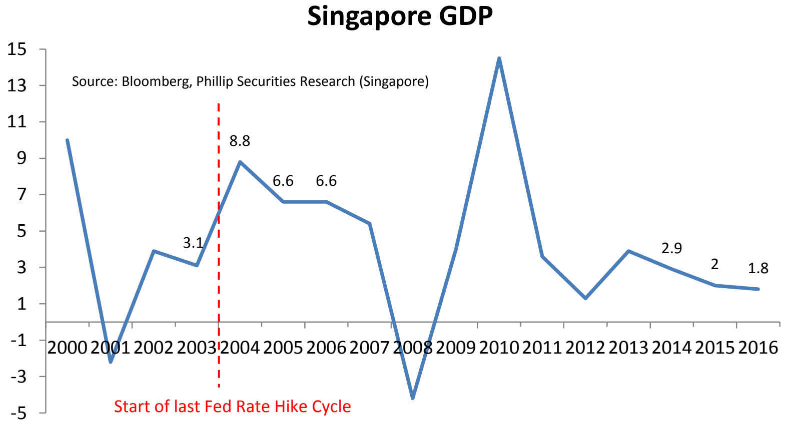
The last time Fed started a rate hike cycle from 2004-2006, the FTSE S-REIT Index returned a CAGR of 26.5% over the 2 years (vs STI's 15.9%). This time though, property and economic fundamentals of Singapore are vastly different. This difference in strength of the underlying economy at a period of rising interest rates, is what we believe would lead to an underperformance of REITs vs the general index over 2017/2018 and potentially bring an end to the S-REIT bull market which started since 2009.

- **S-REITs returned 27% CAGR during last rate hike cycle from 2004-2006. But property and economic fundamentals back then were much stronger.**

<u>2004-2006 vs 2017</u>

In the previous Fed rate hike cycle from 2004-2006, the FTSE S-REIT index chalked up an 85% return in the 3 years, versus the STI's 58%. However, Singapore was going through much stronger growth then as the first rate hike of that cycle occurred in 2004, with also more favourable demand/supply dynamics across all REIT property sectors. From 2004-2006, Singapore's GDP growth grew 8.8% in 2004, 6.6% in 2005, and 6.6% in 2006. More recently, Singapore's latest preliminary GDP figures for 2016 showed an increase of 1.8%. The Ministry of Trade and Industry (MTI) expects a 1-3% growth in 2017. Net property demand tends to be closely correlated to GDP figures.

Figure 2: Singapore GDP Growth (2004-2006 vs current)

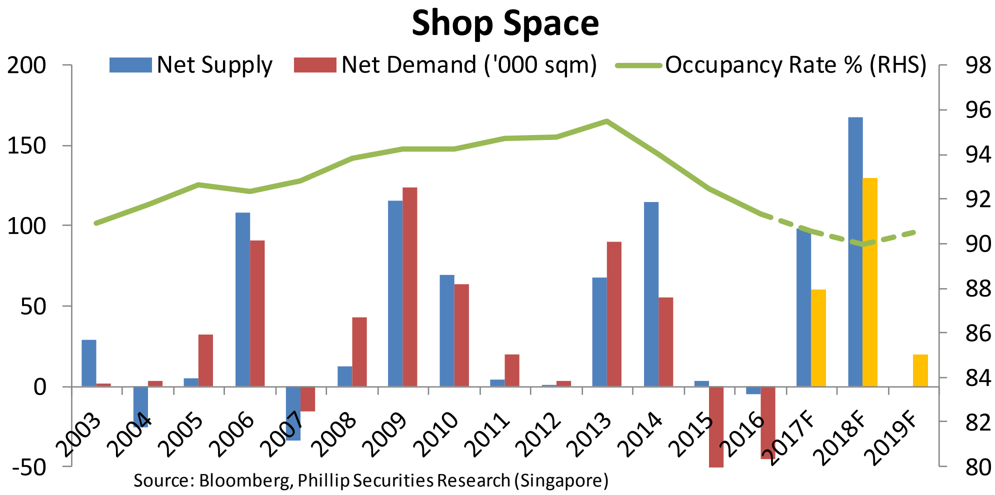


Singapore's GDP was much stronger in the previous rate hike cycle 2004-2006.

Previous rate hike cycle from 2004-2006 coincided with a Singapore economy on much stronger footing and more favourable demand/supply dynamics across all REIT property sectors.

Retail Sector: Comparison with 2004 conditions, Recent Updates and Outlook:

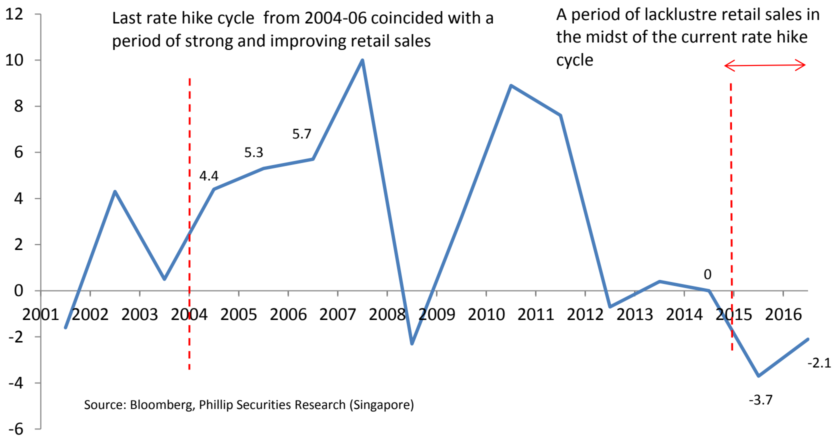
Figure 3: Retail Space Demand and Supply (2004-2006 vs Current)



2004-2006 saw much stronger retail space demand vs supply dynamics. 2016 was second consecutive year of negative net demand post-GFC.

Net absorption of shop space in 2016 hit -45,000 sqm., the second consecutive year where we witnessed a negative net absorption of shop space. This is a phenomenon not seen even during the GFC years. Occupancy has been trending down since hitting 96% in 2013 to 91% in 2016. 2004-2006 though saw periods of increasing net absorption and occupancy. This is hardly surprisingly as Singapore was experiencing strong and improving retail sales growth in the period from 2004-2006 versus the flat to negative growth in the past 5 years. ***YoY Retail sales growth averaged 5.1% in those 3 years. In contrast, retail sales growth has been flat to negative in the last 3 years.***

Figure 4: Retail Sales Y-o-Y Growth (2004-2006 vs Current)



Retail Sales grew at a much stronger average of 5% y-o-y during the previous rate hike cycle. In contrast retail sales languished between flat to negative over the last five years.

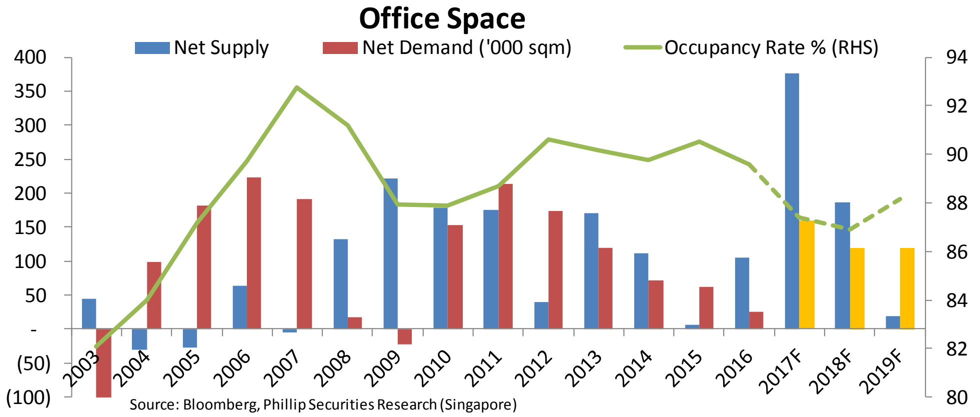
Looking forward, much of the new upcoming supply is concentrated in the city fringe and suburban areas, with limited new supply in the city areas. These include Paya Lebar Quarter (2018), Jewel in Changi (2018) and Northpoint City (2018). We do not foresee a strong recovery for retail sales on the back of expectations for modest wage growth, already low unemployment rate, cautious sentiments amidst rising interest rates, and the growing challenges posed by e-commerce.

The advent of e-commerce and the threat presented by it to brick-and-mortar stores is ever growing. Retailers are forced to re-invent themselves to enhance the shopping experience to consumers who are otherwise flooded with cheaper, more available options online. The imminent entrance of Amazon into Singapore is likely to exacerbate the situation. With quicker, cheaper deliveries made possible by the new local Amazon warehouse at Mapletree Logistics Hub – Toh Guan, shoppers will have added incentives to shop online for cheaper alternatives. The increasing number of startups trying to disrupt the logistics and e-commerce space also serve to improve the shopping experience online for consumers. The increasing popularity of online shopping sites such as Amazon, Lazada (bought by Alibaba in 2016), Qoo10, and the numerous independent online fashion stores such as “Love, Bonito”, Dressabelle, and Zalora will continue to drain retail money into the non brick-and-mortar space. Proliferation of groceries/food delivery services start-ups such as RedMart (bought by Alibaba in Nov 2016), UberEats (launched in 2016) and Deliveroo (launched in 2015) also mean that the perceived more “stable” supermarket anchor tenants and F&B tenants are not immune to the threat of e-commerce.

The main draws of online shopping are lower price points and convenience. What used to be pet peeves for online shoppers were the logistical issues (including long delivery time and shipping difficulties in ordering from certain overseas who may not ship to local shores), which are also increasingly mitigated by the emergence of logistics start-ups such as NinjaVan and Ta-Q-Bin. The setting up of self-collection lockers and better utilisation of delivery fleet also serve to improve the last mile delivery bottleneck problem and shorten delivery waiting time for a better customer online shopping experience.

Office Sector: Comparison with 2004 conditions, Recent Updates and Outlook:

Figure 4: Office Space Demand and Supply (2004-2006 vs Current)



Much stronger office demand was seen during 2004-2006. Huge supply of office space in 2017-2018 on top of already weak net demand.

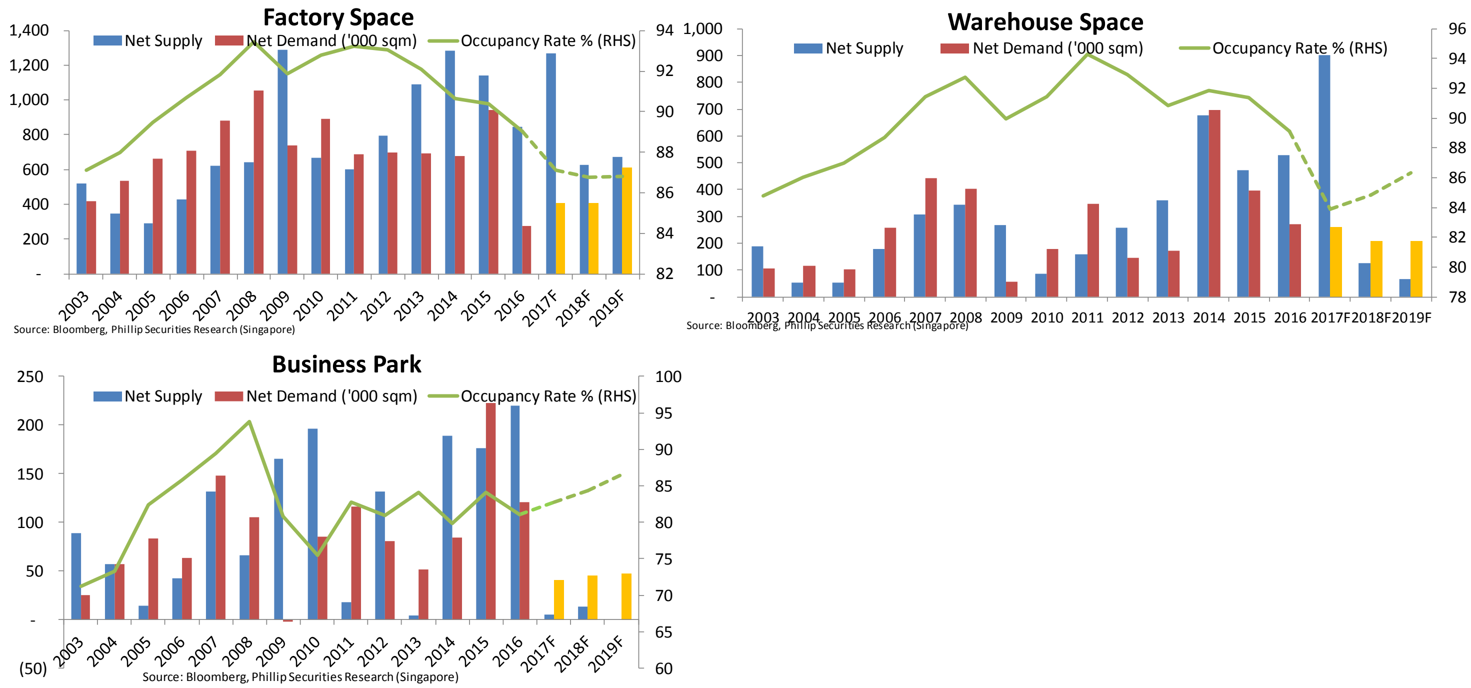
Net office demand saw its fifth consecutive year of contraction in 2016, culminating in net office demand of 26,000 sqm. in 2016. Nonetheless, the limited supply over these few years meant that occupancy stayed relative flat at 90%. Downsizing and relocation of operations overseas by banks, the traditional major occupiers of CBD space, contributed to the declining net demand, notwithstanding increased demand by sectors such as Technology.

In contrast, from 2004-2006, average annual net supply was negligible, versus a strong net demand of 168,000 sqm., causing a 49.4% spike in office rental index. Broad structural developments in recent years could also affect the potential demand of office space in Singapore. Singapore's shift away from a liberal immigration policy which will inevitably lead to slower workforce population growth, increasing trends of decentralization away from city centre to ease the city congestion through setting up of suburban commercial hubs, technological advancements allowing people to work from home, and broader government calls encouraging employers to allow flexible work arrangement schemes, such as allowing employees to work from home initiative to encourage increased participation for labour force all serve to slow down the demand growth for city centre office space.

Industrial Sector: Comparison with 2004 conditions, Recent Updates and Outlook:
Industrial space likewise saw an oversupply in the midst of falling demand in recent years, especially for factory space and warehouse space. As a result of the slowing economy, supply has outstripped demand in most years since 2012. Rental index as a result as fallen 10.7% since its peak in 2013. Business parks was the sole bright spot and the asset class continues to benefit from the relocation of IT companies and back-end operations of financial institutions out of city centre. The low upcoming supply of business parks mean rents should sustain and occupancy should slowly creep up.

The last rate hike cycle though saw totally different dynamics with demand outstripping supply, driving up occupancy and industrial space rents.

Figure 5: Industrial Space Demand and Supply (2004-2006 vs Current)



- **Further Fed normalisation of interest rates in 2017/2018 to end 7 year outperformance for S-REITs.**

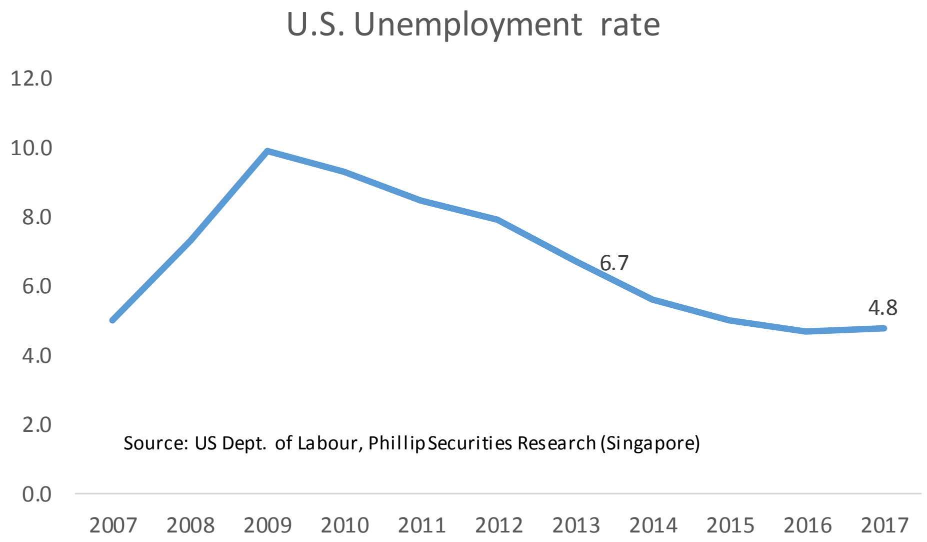
S-REITS have done incredibly well since post Global Financial Crisis (GFC) until now, outperforming the STI every year except in 2013. This could change as the Fed further normalises interest rates in the coming years.

Despite the weak fundamentals over the past few years, S-REITs have done reasonably well due to the low interest rate environment and loose monetary policies. Across most sectors, S-REITs continue to be plagued by weak fundamentals. Further Fed normalization of interest rates in 2017/18 could cause a reversal of the "yield carry" trade.

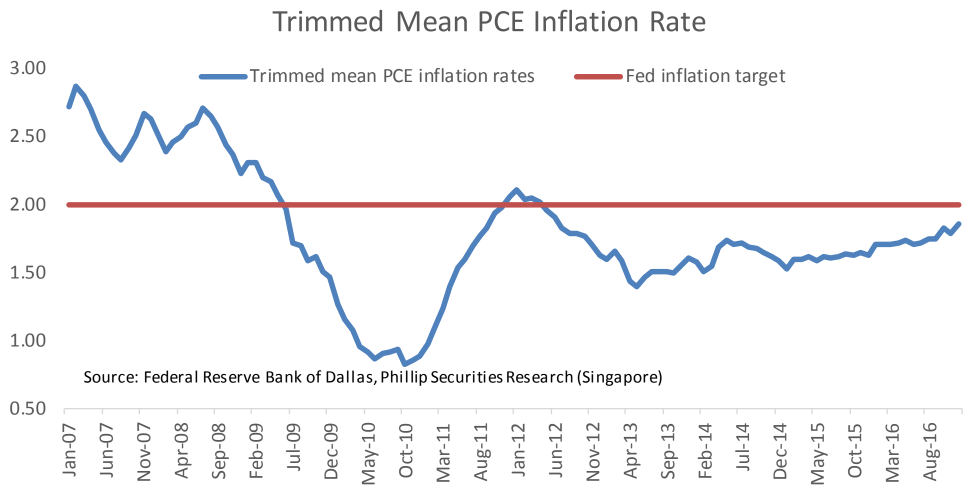
<u>2013 Taper Tantrum vs 2017</u>

Our starting premise arguing for an UNDERWEIGHT rating on REITs is built on the notion that the pace of rate hikes is likely to gather pace from 2017 at a time when the strength of Singapore's economy is far from strong. In the US, unlike the "taper tantrum" period when Singapore's 10 year bond yield spiked in 2013, the Federal Reserve is faced with a stronger US economy now, with lower unemployment rate and higher inflation compared to 2013, the two metrics which greatly affect their decision for future interest rate paths. Unemployment is 4.8% now vs c.7% in 2013, and inflation now stands at 1.85% vs c.1.5% in 2013.

Figures 6 and 7: US unemployment rate/Inflation Rate (2013 Taper Tantrum vs Current)



US employment situation in much better shape now vs in 2013 when Fed announced the gradual tapering of monetary stimulus.



Underlying inflation growing closer to Fed's target rate of 2%.

Thus whereas in 2013 where Singapore's 10 year bond yield spiked to 2.671% post taper tantrum but gradually eased back downwards as the market discounts the probability of fast-paced Fed rate hikes on a still wobbly US economy, we are faced with a stronger US economy now. Expectations are also that President Trump will launch a series of pro-growth reflationary policies which will also likely to fuel further short term growth, stoking further inflation. There is thus a higher probability of interest rates going even higher than where they stand right now. Furthermore, our house view is that the FED is behind the curve in raising rates.

- **Why hasn't a recovering US spur growth in Singapore like it did in 2004, given that Singapore is such an open, export-oriented economy?**

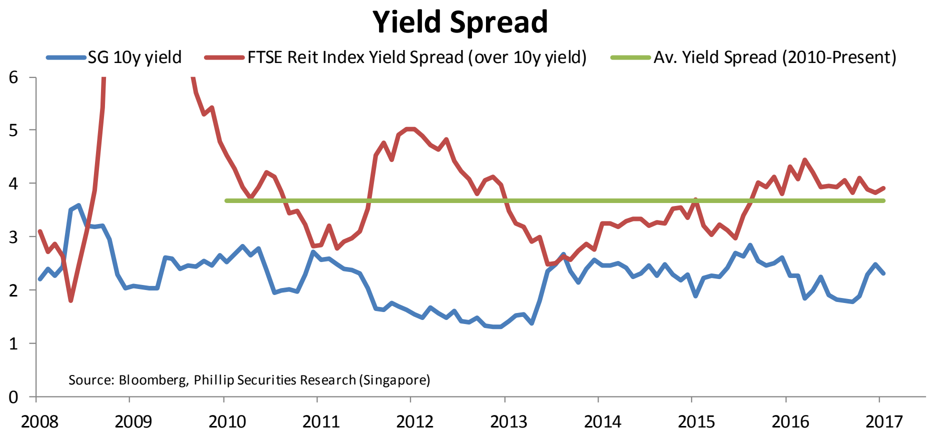
Structural challenges within Singapore, such as slower labour force growth caused by tighter immigration policies, industrial overcapacity problems in China, still enforced property cooling measures, weak oil and gas industry are current impediments to growth.

- **Technological advancements, amongst others, also create long term structural headwinds for the various property sectors.**

The advent of e-commerce, advanced web-conferencing technology allowing employees to work from home, and the increasing digitalisation of information reducing the need for storage space are some trends that could reduce demand for retail or office space. Singapore's increasing trends of decentralization away from city centre to ease the city congestion through setting up of suburban commercial hubs, also affect demand for office space.

Yield Spread Analysis

Figure 8: Historical REIT Index Yield Spread vs 10-year government bond



We expect yield spreads to trade close to or above the 7-year average on the back of 1. deteriorating property fundamentals during the latter part of this 7-year period and 2. rising interest rates decreasing the appeal of yield instruments, especially at this time where technological advancements are adding further headwinds to weak fundamentals.

At a current yield spread of 3.9% (FSTREI Index yield 6.2%-SG 10y bond yield 2.3%), the FSTREI Index trades at close to the 7 year average yield spread of 3.7%. We believe yield spreads should trade close to or above this 7year average because of namely 1. deteriorating property fundamentals during the latter part of this 7year period and 2. decreasing appeal of yield instruments with rising interest rates and tightening monetary conditions. With our belief that the Singapore 10-year government bond yields are set to correspondingly increase with rising interest rates in the US, it is likely REITs yield would likely follow suit to trade higher to maintain a constant spread.

Thus, the S-REIT sector currently faces the double whammy of higher interest rates and weak property fundamentals. We think the repercussions of higher interest rates are likely to be more severe in 2017/2018 than it was in 2004-2007 and in 2013. By extension, we thus think it is unlikely S-REITs will be able to repeat their stellar performance seen over the last few years.

Investment Actions

Based on the above arguments, we downgrade our EQUAL WEIGHT call on the S-REIT sector to UNDERWEIGHT. We have a list of locally listed property-related alternatives that investors can switch to (Figure 10) that we currently have ACCUMULATE/BUY calls on.

Figure 9: REIT Universe and PSR Reit Ratings

Source: Bloomberg (Updated: 6 February 2017)

	Mkt. Cap. (S$mn)	Price (S$)	PSR RATING	PSR TARGET PRICE (S$)	P/NAV (x)	trailing yield (%)	TOTAL RETURNS (%) 1MTH	3MTH	1YR
Healthcare									
PARKWAYLIFE REAL ESTATE	1,470	2.430			1.42	5.0	2.5	(2.7)	15.5
FIRST REAL ESTATE INVT TRUST	1,000	1.295	ACCUMULATE	1.32	1.28	6.5	3.6	(0.7)	19.6
Hospitality									
ASCOTT RESIDENCE TRUST	1,901	1.150			0.86	7.2	3.9	4.8	13.0
CDL HOSPITALITY TRUSTS	1,365	1.375			0.89	7.3	5.9	7.9	17.0
FAR EAST HOSPITALITY TRUST	1,074	0.595			0.64	7.4	(0.8)	0.3	0.6
OUE HOSPITALITY TRUST	1,224	0.680			0.89	6.8	1.2	2.4	8.6
FRASERS HOSPITALITY TRUST	1,221	0.665			0.89	10.4	3.1	(1.0)	4.7
ASCENDAS HOSPITALITY TRUST	838	0.745			0.88	7.3	5.0	5.2	3.8
Retail									
CAPITALAND MALL TRUST	6,944	1.960			1.04	5.7	3.6	(1.3)	3.7
MAPLETREE GREATER CHINA COMM	2,647	0.950			0.78	7.8	1.1	(5.9)	21.0
SPH REIT	2,489	0.975			1.04	5.7	3.0	1.4	12.8
FRASERS CENTREPOINT TRUST	1,886	2.050	NEUTRAL	2.00	1.06	5.7	8.4	1.0	14.5
STARHILL GLOBAL REIT	1,636	0.750			0.81	6.8	3.1	(4.1)	9.6
CAPITALAND RETAIL CHINA TRUS	1,226	1.410	NEUTRAL	1.44	0.86	7.1	6.1	(0.8)	6.7
LIPPO MALLS INDONESIA RETAIL	1,108	0.395			1.01	8.5	6.8	3.6	40.3
CROESUS RETAIL TRUST	652	0.860	ACCUMULATE	0.93	0.91	8.2	1.8	0.6	16.1
Commercial									
CAPITALAND COMMERCIAL TRUST	4,505	1.520	NEUTRAL	1.63	0.85	6.0	5.5	0.1	23.5
SUNTEC REIT	4,389	1.725			0.80	5.8	5.5	4.5	21.2
KEPPEL REIT	3,327	1.005			0.70	6.3	0.5	(5.1)	17.3
MAPLETREE COMMERCIAL TRUST	4,305	1.500			1.12	5.4	8.4	1.5	21.5
FRASERS COMMERCIAL TRUST	1,010	1.265			0.82	7.8	1.2	(3.0)	17.5
OUE COMMERCIAL REAL ESTATE I	905	0.695			0.75	7.5	2.1	2.9	21.9
Industrial									
ASCENDAS REAL ESTATE INV TRT	6,975	2.420			1.16	7.5	6.8	6.8	11.8
MAPLETREE INDUSTRIAL TRUST	2,956	1.640	ACCUMULATE	1.74	1.20	6.9	1.4	(2.5)	14.6
MAPLETREE LOGISTICS TRUST	2,625	1.050			1.02	7.0	4.8	4.8	20.5
KEPPEL DC REIT	1,345	1.195	NEUTRAL	1.15	1.25	5.1	2.4	(1.8)	25.4
AIMS AMP CAPITAL INDUSTRIAL	865	1.355			0.92	8.3	1.9	0.2	10.2
CACHE LOGISTICS TRUST	720	0.800	REDUCE	0.73	1.03	9.7	1.7	(0.8)	4.9
CAMBRIDGE INDUSTRIAL TRUST	724	0.555			0.88	7.5	5.6	2.7	19.7
SOILBUILD BUSINESS SPACE REI	664	0.635	NEUTRAL	0.68	0.88	9.6	(0.7)	(2.2)	(2.9)
SABANA SHARIAH COMP IND REIT	448	0.425			0.71	9.8	17.5	(3.4)	(18.2)
VIVA INDUSTRIAL TRUST	736	0.765			0.97	9.1	3.4	4.1	20.7

Figure 10: Property-related alternatives for investors switching out of REITs

Source: Bloomberg (Updated: 6 February 2017)

	Mkt. Cap. (S$mn)	Price (S$)	PSR RATING	PSR TARGET PRICE (S$)	P/NAV (x)	trailing yield (%)	TOTAL RETURNS (%) 1MTH	3MTH	1YR
PROPERTY RELATED ALTERNATIVES									
CITY DEVELOPMENTS LTD	8,566	9.420	ACCUMULATE	9.98	0.95	1.7	11.3	8.8	37.0
HO BEE LAND	1,525	2.290	ACCUMULATE	2.00	0.55	3.1	12.3	7.5	27.2
UOL GROUP	5,294	6.580	ACCUMULATE	7.05	0.66	2.3	5.9	14.4	20.6
CENTURION	266	0.360	BUY	0.42	0.68	5.6	5.9	5.9	7.0

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