Singapore REITs

Industrial sub-sector: Watch for end-of-year revaluations

SINGAPORE | REAL ESTATE (REIT) | UPDATE

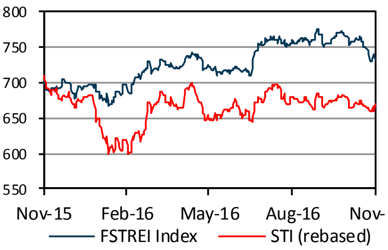
11 November 2016

Equal Weight

INDEX PERFORMANCE (%)

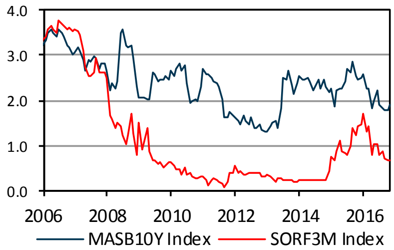
	1MTH	3MTH	1YR
FSTREI RETURN	(2.3)	(1.1)	11.2
STI RETURN	(2.9)	(2.1)	(3.3)

FSTREI VS. STI



Source: Bloomberg, PSR

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



Source: Bloomberg, PSR

- Both sector-wide occupancy and rental fell quarter-on-quarter and year-on-year
- Sector's Rental Index has fallen to 2012 levels, with rental reversions likely to extend into negative double-digits
- Multiple-user Factory and Warehouse rental reversions already at negative double-digits and could worsen with the pipeline of new supply
- Factory space will be hardest hit in 4Q 2016 with an onslaught of new supply
- 2017 going to be worse than 2016 for Warehouse space
- Slight negative bias for Business Park rental reversions are on the cards
- Lower rents could lead to lower end-of-year valuations, resulting in higher gearing
- "**Underweight**" on the Industrial sub-sector due to overwhelming new supply of space
- Maintaining our "**Equal Weight**" view on the overall S-REITs sector

What is the news?

- JTC recently released its Quarterly Market Report of Industrial Properties for 3Q 2016.

Summary of Rental & Occupancy rate, as at 3Q 2016

		2Q 2016	3Q 2016	%qoq	%yoy
Rental	All Industrial	96.2	94.3	(2.0)	(7.3)
	Multiple-User Factory	93.4	92.2	(1.3)	(8.3)
	Single-User Factory	104.0	101.8	(2.1)	(6.9)
	Business Park	104.4	104.2	(0.2)	(0.7)
	Warehouse	95.4	91.2	(4.4)	(7.6)
Occupancy	All Industrial	89.4%	89.1%	(0.3)	(1.7)
	Multiple-User Factory	86.9%	87.1%	0.2	(0.2)
	Single-User Factory	91.4%	90.6%	(0.8)	(1.6)
	Business Park	81.0%	81.1%	0.1	(3.3)
	Warehouse	89.0%	89.1%	0.1	(3.4)

Source: JTC, Phillip Securities Research (Singapore)

Key takeaways from the quarter

- **Leasing market remains soft; even Data Centre segment saw weakness**
  Generally negative reversions across the Industrial REITs, as oversupply condition persists. Even the Data Centre segment was not spared: **Keppel DC REIT** gave a -8% reversion to a large client at Keppel DC Singapore 2. Exceptions of positive *portfolio weighted average* rental reversions during the quarter came from **Ascendas REIT** (+0.9%) with **Mapletree Industrial Trust** (+0.7%) lagging behind.
- **Tenant retention is paramount**
  As with previous quarters, the situation with tenant retention remains unchanged. REIT Managers continue to focus on tenant retention amid the soft leasing environment. One Manager commented that "it is easier to retain a tenant, than to look for a new one".
- **Mindful of downward revaluation of properties**
  Cache Logistics Trust experienced a downward revaluation for its property at 51 Alps Avenue, triggered by a tenancy contractual dispute. The property was revalued downwards by c.31%, losing 4.0 cents in net asset value (NAV) per Unit and pushing gearing to 41.2% from 39.8%. Other ongoing tenant dispute among the Industrial S-REITs is at **Soilbuild Business Space REIT**; bearing in mind that the fiscal year-end revaluation for the REIT's portfolio will be in December. Other obvious candidates for downward revaluation are properties that were converted from a master lease to multi-tenancy lease.

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Investment Actions

Our "**Equal Weight**" view on the overall S-REITs sector remains unchanged, and we maintain our "**Underweight**" view on the Industrial sub-sector.

Industrial REITs under our coverage

	Rating	Target Price (S$)	Last Close Price (S$)
Cache Logistics Trust	Reduce	0.810	0.825
Keppel DC REIT	Accumulate	1.260	1.210
Mapletree Industrial Trust	Neutral	1.740	1.690
Soilbuild Business Space REIT	Neutral	0.720	0.665

Source: Phillip Securities Research (Singapore)

Cache Logistics Trust – Cautious over the possible overhang of Warehouse space.

- Maintain "Reduce" rating from our results report on 24 October
- Our analysis suggests that the situation for Warehouse space in 2017 will be worse than 2016
- Concentrated exposure of 27% of leases by gross rental income (GRI) expiring in FY18, majority from the master lease of CWT Commodity Hub
- Ongoing rental dispute with Schenker Singapore Pte Ltd resulted in downward fair value adjustment of 51 Alps Avenue property from S$116.8 million to S$80.7 million
- Possibility of further downward revaluation if outcome from the Court proceedings is unfavourable
- We forecast 7.58/6.69 cents Distribution per unit (DPU) for FY16e/FY17e, which is 5.3%/14.2% lower than consensus expectations of 8.0/7.8 cents

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

- Maintain "Accumulate" rating from our results report on 12 October
- Completed the acquisition of a shell and core data centre in Cardiff, Wales in October
- Ongoing acquisition of shell and core data centre in Milan, Italy announced in August
- Ongoing acquisition of 90% interest in Keppel DC Singapore 3 (formerly known as T27) from Sponsor, targeted by December
- We forecast 6.96/7.45 cents DPU for FY16e/FY17e, which is 5.4%/2.1% higher than consensus expectations of 6.6/7.3 cents

Mapletree Industrial Trust – DPU growth from pipeline of build-to-suit (BTS) and asset enhancement initiative (AEI) projects.

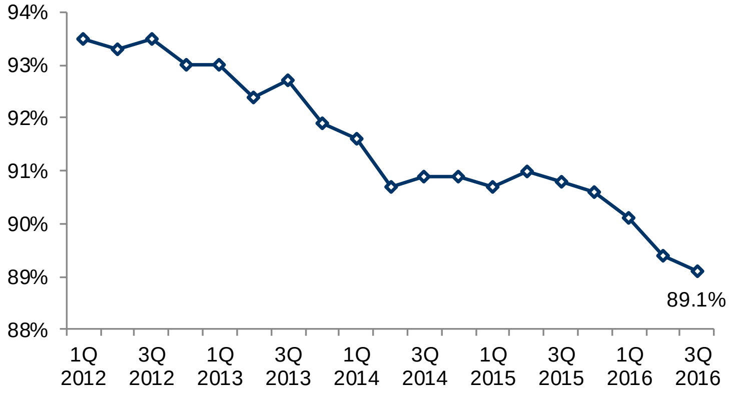
- Maintained "Neutral" rating from our results report on 25 October
- Phase One of Hewlett-Packard BTS has obtained its Temporary Occupation Permit (TOP) in October, with Phase Two TOP expected six months later
- Kallang Basin 4 Cluster AEI due to be completed 1Q 2018; currently 0% pre-committed
- We are mindful of the 32.8% of leases expiring in FY18 in an oversupply landscape; about half of the leases expiring in FY18 come from the Flatted Factories segment
- We forecast 11.14/11.59 cents DPU for FY17e/FY18e, which is in line with consensus expectations of 11.1/11.9 cents

Soilbuild Business Space REIT (SBREIT) – Stability from master leases, but weighed down by concerns from Technics Offshore property

- We maintain our "Neutral" rating from our results report on 13 October
- No master leases expiring in 2017; next master lease expiry will be for Solaris (20% of portfolio by GRI) in August 2018
- Concentration risk as Technics Offshore contributes c.7.6% of portfolio GRI
- Possibility of downward revaluation for the property if it is converted to multi-tenancy lease
- We forecast 6.08/5.95 cents DPU for FY16e/FY17e; this is 0.3%/5.6% lower than consensus expectations of 6.1/6.3 cents

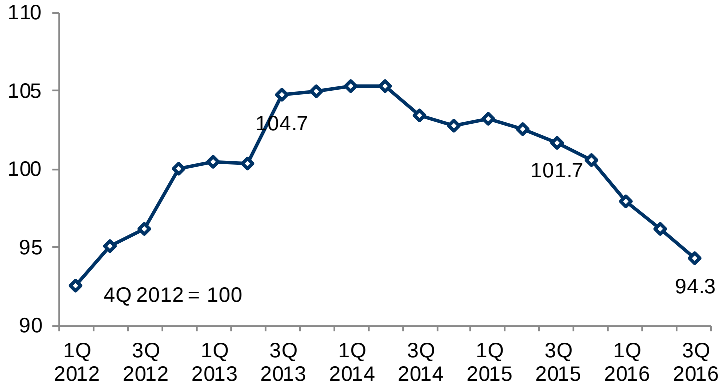
3Q 2016 JTC market data: Occupancy and Rental Index

Figure 1. Industrial sector occupancy



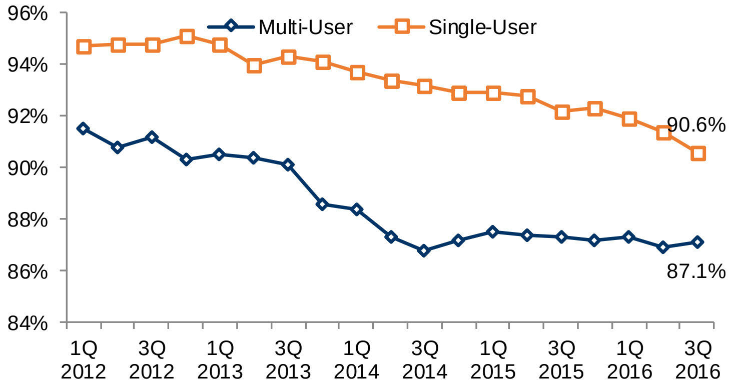
Source: JTC, Phillip Securities Research (Singapore)

Figure 2. Industrial sector Rental Index



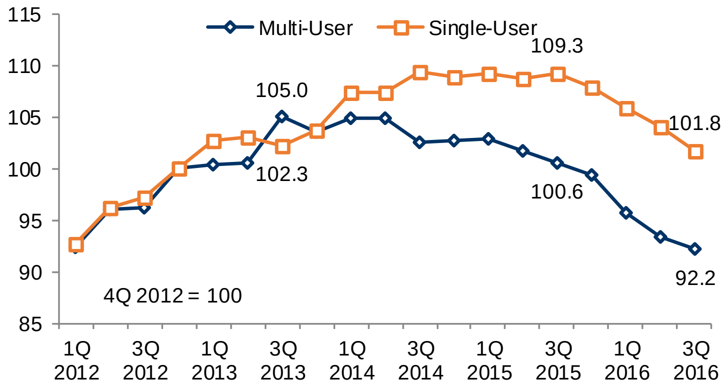
Source: JTC, Phillip Securities Research (Singapore)

Figure 3. Factory occupancy



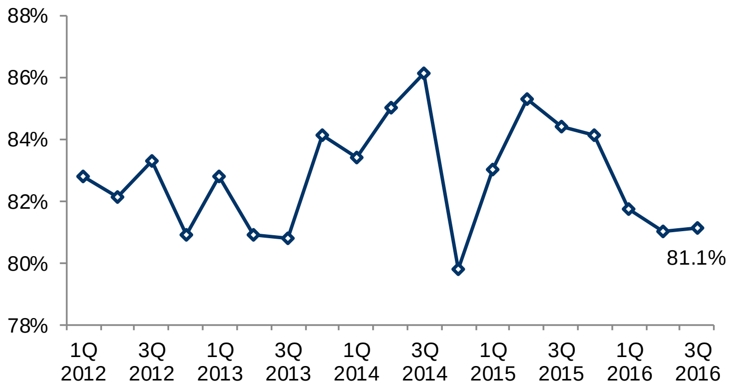
Source: JTC, Phillip Securities Research (Singapore)

Figure 4. Factory Rental Index



Source: JTC, Phillip Securities Research (Singapore)

Figure 5. Business Park occupancy

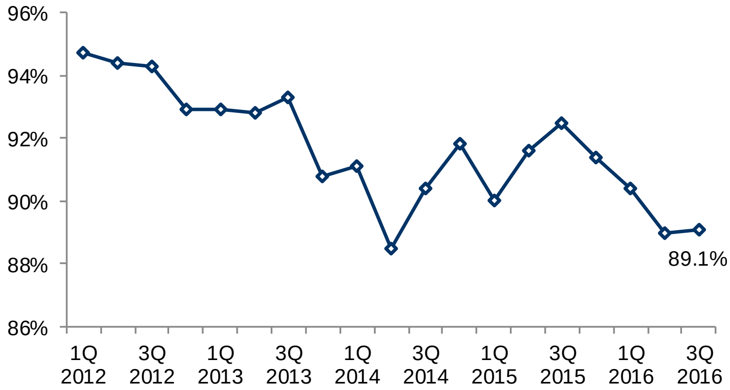


Source: JTC, Phillip Securities Research (Singapore)

Figure 6. Business Park Rental Index

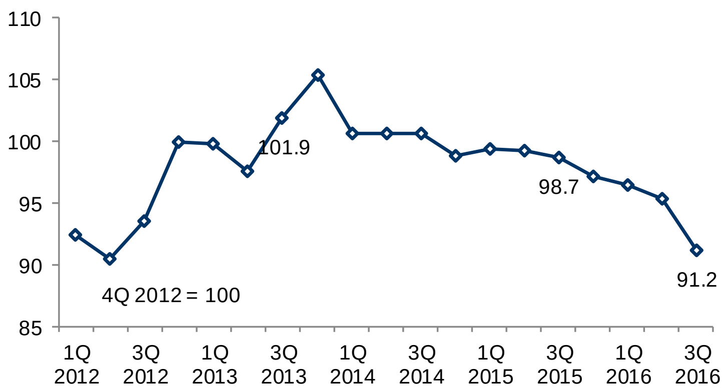
Source: JTC, Phillip Securities Research (Singapore)

Figure 7. Warehouse occupancy



Source: JTC, Phillip Securities Research (Singapore)

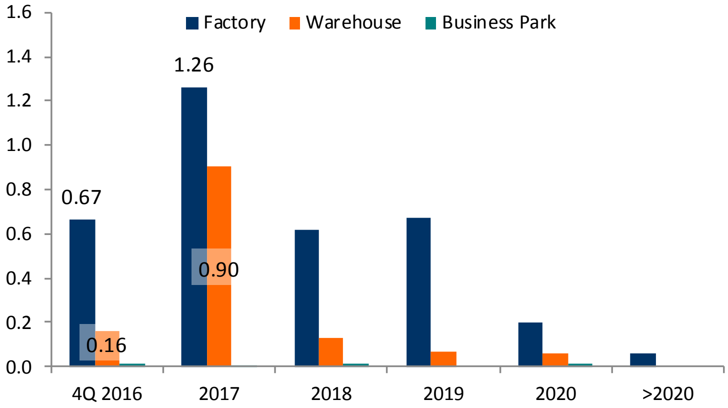
Figure 8. Warehouse Rental Index



Source: JTC, Phillip Securities Research (Singapore)

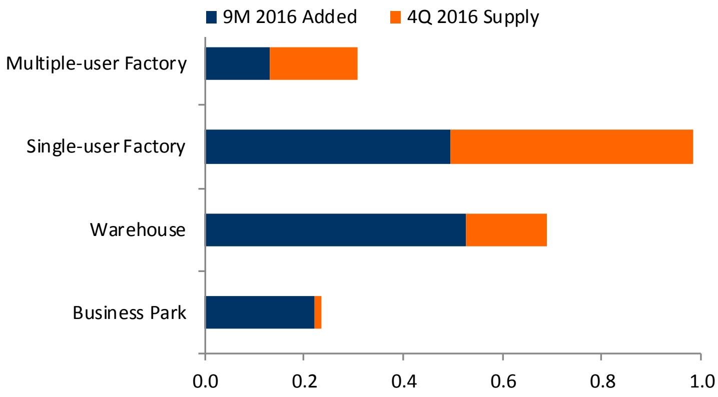
3Q 2016 JTC market data: Supply pipeline

Figure 9. Supply pipeline profile, as at 3Q 2016 (mn sqm)



Source: JTC, Phillip Securities Research (Singapore)

Figure 10. Space added & Supply for 2016, as at 3Q 2016 (mn sqm)



Source: JTC, Phillip Securities Research (Singapore)

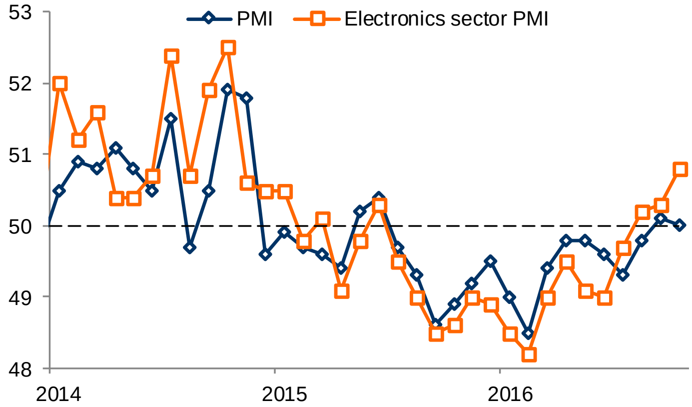
Supply Pipeline as a percentage of existing stock, as at 3Q 2016

(%)	2016	2017	2018	2019	2020	>2020
Factory	1.9	3.7	1.8	2.0	0.6	0.2
Warehouse	1.7	9.6	1.3	0.7	0.6	-
Business Park	0.7	0.2	0.6	-	0.6	-
Industrial sector	**1.8**	**4.7**	**1.6**	**1.6**	**0.6**	**0.1**

Source: JTC, Phillip Securities Research (Singapore)

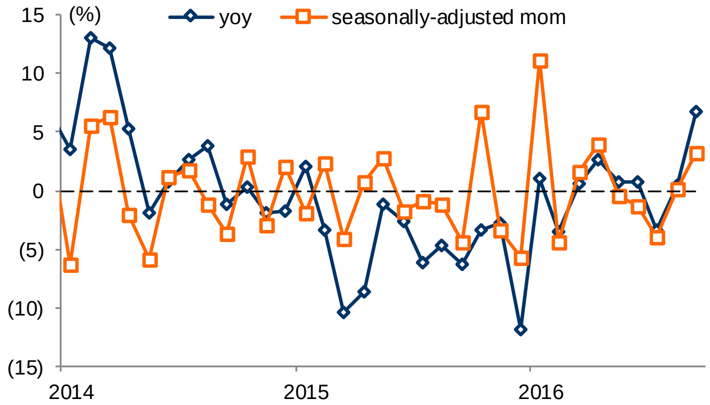
Manufacturing Indicators

Figure 11. Purchasing Managers' Index (PMI), October 2016



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

Figure 12. Industrial Production Index, September 2016



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

How do we view this?

- **Uptick in Industrial activity, but concerns remain on its sustainability**
  The Manufacturing sector has been in contraction for the whole of 2016, as indicated by the Purchasing Managers' Index (PMI), except for September (50.1) and October (50.0). Meanwhile, the Industrial Production Index had a positive surprise, growing 6.7% year-on-year (yoy) and 3.3% on a seasonally adjusted month-on-month (mom) basis in September.
  These two indicators show an uptick in Industrial activity, which could lead to higher demand for Industrial space. However, it remains to be to see if the expansionary activity is sustainable.
- **Continued downward pressure on sector occupancy rates and rentals expected as new supply outstrips historical supply**
  The existing stock of Industrial space is 45.83mn sqm as at 3Q 2016. JTC estimates about 3.0mn sqm of industrial space to come on-stream till the end of 2017 (0.84mn sqm in 4Q 2016 and 2.17mn sqm in 2017). The additional space coming on stream is significantly higher than the average annual supply of around 1.9mn sqm in the past three years. Historical average demand over the past three years was 1.2mn sqm.

- **Aggregate reversions were negative and likely to extend to double-digits**
  Industrial leases are typically for a tenure of three years. 3Q 2016 Rental Index (94.3) is lower than three years ago in 3Q 2013 (104.7), and at the levels last seen in 2012. What this means is that lease renewals signed in 3Q 2016 were at lower rents compared to three years ago, and implying negative reversions of -9.9% in aggregate. In view of the ongoing demand-supply imbalance, we expect aggregate reversions to reach negative double-digit territory into 2017.
- **Factory space looking dire; will be hardest hit in 4Q 2016**
  In our previous report, we opined that Factory space will be hardest hit in 2H 2016. Our view remains unchanged, maintaining that Factory space will be hardest hit in 4Q 2016. We highlight that upcoming supply of Factory space in 4Q 2016 is about equal to the Factory space that was added in 9M 2016. For the Multiple-user Factory segment, 57% of 2016's new supply will be coming on stream in 4Q 2016. Similarly for the Single-user Factory segment, 50% of 2016's new supply will be concentrated in 4Q 2016.
  Going by the respective Rental Indices, rents for Single-user Factory was flat in 3Q 2016 (101.8) compared to three years ago in 3Q 2013 (102.3). It was a different picture for Multiple-user Factory, where the Rental Index for 3Q 2016 (92.2) was 12% lower compared to three years ago in 3Q 2013 (105.0). Our view remains unchanged – subsequent leases signed will be on negative reversion terms probably all the way into 2017.
  Planned supply of Factory space of 1.26mn sqm for 2017 is about 3% lower than the supply of 1.30mn sqm for 2016. Despite the lower yoy supply, we still expect double-digit negative reversions possibly up to mid-teens for the Multiple-user segment going into 2017 based on levels observed from the Rental Index.
- **2017 is going to be worse than 2016 for Warehouse**
  Warehouse Rental Index in 3Q 2016 (91.2) was also lower than three years ago in 3Q 2013 (101.4). This implies that Warehouse lease renewals done in 3Q 2016 were on negative reversion terms of about -10%. 77% of new space for Warehouse was added in 9M 2016, with the remaining 23% coming on stream in 4Q 2016. We expect further downward pressure on rents in 4Q 2016 as the oversupply condition persists. Reversions in 4Q 2016 could take a plunge, in view that the peak Rental Index of 105.4 was exactly three years ago in 4Q 2013.
  Total planned supply for 2016 is 0.690mn sqm, with a 31% higher supply of 0.901mn sqm in 2017. The current oversupply condition will be exacerbated in 2017. Planned supply for 2017 represents 9.6% additional space to existing stock as of 3Q 2016.
- **Limited new supply for Business Park, but negative reversions on the cards**
  New supply of Business Park space is limited in 4Q 2016, 2017 and 2018, with only 0.7%, 0.2% and 0.6% increase over current existing stock respectively. Currently no new supply planned for 2019. We are expecting Rental Index to remain stable qoq, but reversions to be flat with a slight negative bias going into 2017.

Strategic top-down view

- **Negative on the Industrial S-REITs sub-sector due to oversupply of space**
  We expect the demand-supply imbalance to persist into 2017. This will result in a tenant's market, with downward pressure applied to both occupancy and rents.
- **Sounding the warning for year-end valuations to be impaired**
  All other things equal, lower rents will result in lower property valuations. Prime candidates would also be properties that were converted from master-lease to multi-tenancy lease in the wake of lower rents and lower occupancy. Downward revaluations would cause gearing to shift upwards. Investors will have to watch out for this.

Tactical bottom-up view

- **Maintain exposure to REITs with strong underlying demand drivers and ability to ride out the oversupply situation, or visible pipeline for inorganic growth**
  Keppel DC REIT has a unique asset class of data centres with strong underlying demand drivers. Its portfolio is diversified across Asia, Australia and Europe. Acquisition of Keppel DC Singapore 3 and the Milan data centre is ongoing. Post-

equity raising through a Preferential Offering, gearing is expected to be pared down to 27.7% from 36.1%

Mapletree Industrial Trust has ongoing BTS and AEI projects due to be completed by 2Q 2017 and 1Q 2018, respectively. While its pure-play portfolio bears the full brunt of the demand-supply imbalance of Singapore's industrial space, the low gearing of 29.0% provides the firepower for inorganic growth through acquisitions.

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	**2Q17**	**2Q16**	**yoy (%)**	**2Q17**	**2Q16**	**yoy (%)**	**2Q17**	**2Q16**	**yoy (%)**	**2Q17**	**2Q16**	**yoy (%)**
AIMS AMP Capital Industrial REIT	29.9	31.3	(4.3)	19.3	20.7	(6.9)	17.5	17.8	(1.4)	2.75	2.80	(1.8)
Ascendas REIT	205.4	182.6	12.5	152.4	123.8	23.1	112.5	100.2	12.3	4.030	4.160	(3.1)
Mapletree Industrial Trust	84.2	82.7	1.8	63.6	61.0	4.3	50.6	48.9	3.4	2.83	2.79	1.4
Mapletree Logistics Trust	91.6	87.5	4.7	76.8	73.0	5.3	46.6	46.2	1.0	1.86	1.86	0.0
Y/E Dec	**3Q16**	**3Q15**	**yoy (%)**	**3Q16**	**3Q15**	**yoy (%)**	**3Q16**	**3Q15**	**yoy (%)**	**3Q16**	**3Q15**	**yoy (%)**
Cache Logistics Trust	28.0	23.1	21.2	22.1	18.8	17.5	16.6	16.8	(1.3)	1.847	2.140	(13.7)
Cambridge Industrial Trust	27.6	28.5	(2.9)	19.9	21.7	(8.3)	12.9	15.6	(17.2)	0.987	1.204	(18.0)
Keppel DC REIT	22.7	25.7	(12.0)	22.7	21.4	6.2	16.8	14.5	15.9	1.90	1.64	15.9
Sabana Shari'ah Compliant REIT	23.0	25.5	(9.7)	13.9	18.3	(24.0)	8.9	13.0	(31.7)	1.20	1.77	(32.2)
Soilbuild Business Space REIT	19.7	20.7	(4.7)	17.3	17.8	(2.9)	14.6	15.1	(3.9)	1.399	1.625	(13.9)
Viva Industrial Trust	24.3	18.4	31.9	17.4	12.5	39.2	15.7	11.6	35.2	1.810	1.647	9.9

Source: Various REITs, Phillip Securities Research (Singapore)

- **Gross revenue growth driven by inorganic growth**
  Gross rental income (GRI) across the sub-sector grew mainly due to acquisitions, specifically at **Ascendas REIT**, **Mapletree Logistics Trust**, **Cache Logistics Trust**, and **Viva Industrial Trust**. Negative rental reversions were seen across the board, with the exception of positive reversions from **Ascendas REIT** (+0.9%) and **Mapletree Industrial Trust** (+0.7%).
- **NPI generally outperformed GRI**
  Net property income (NPI) growth was able to outpace GRI growth due to lower property expenses. Even some of the REITs with lower yoy GRI and lower property expenses, were able to mitigate the decline in NPI. **Cache Logistics Trust**, **Cambridge Industrial Trust** and **Sabana Shari'ah Compliant REIT** had higher property expenses due to conversions from master-lease to multi-tenanted leases, thus negatively impacting NPI.
- **Distributable income broadly in line with NPI, but with some exceptions**
  Exceptions came from **Ascendas REIT** (S$3.59mn distribution to perpetual securities holders in 2Q FY17; none in 2Q FY16), **Mapletree Logistics Trust** (2Q FY17 includes S$1.505mn capital distribution; none in 2Q FY16), **Cache Logistics Trust** (S$1.51mn capital distribution in 3Q FY15; none in 3Q FY16), **Cambridge Industrial Trust** (100% of S$1.27mn management fees paid in cash in 3Q FY16; 50% of S$1.78mn management fees paid in cash in 3Q FY15) and **Keppel DC REIT** (S$2.0mn property tax refund in 3Q FY16; none in 3Q FY15).
- **DPU faltered, impacted by dilution from larger Unitholder base**
  Dilutive effect of New Units issued had negatively impacted **Ascendas REIT** (Private Placement and conversion of Exchangeable Collateralised Securities), **Cache Logistics Trust** (Private Placement in 4Q FY15), **Soilbuild Business Space REIT** (Preferential Offering in 3Q FY16) and **Viva Industrial Trust** (Private Placement and Preferential Offering).

Review of Performance Measures of Industrial S-REITs

Average occupancy of 92.6% among the Industrial S-REITs was higher than the JTC sector-wide occupancy of 89.1%.

Summary of Performance Measures, as at end of September 2016

	Occupancy (%)	WALE by GRI (years)	WALE by NLA (years)	Gearing (%)	WADM (years)	WACD (%)	Interest coverage (x)
AIMS AMP Capital Industrial REIT	92.7	2.6		34.0	2.4	3.9	4.9
Ascendas REIT	89.1	3.7		34.2	3.8	3.0	5.3
Cache Logistics Trust	96.5	3.8	4.0	41.2	2.4	3.7	4.1
Cambridge Industrial Trust	93.6	3.8		36.9	3.4	3.7	3.6
Keppel DC REIT	92.7		8.6	29.4	2.5	2.4	10.1
Mapletree Industrial Trust	92.5	2.8		29.0	3.5	2.6	8.0
Mapletree Logistics Trust	96.4		4.1	37.6	3.5	2.3	5.7
Sabana Shari'ah Compliant REIT	89.2	2.6		41.5	2.1	4.1	3.1
Soilbuild Business Space REIT	94.8	4.7		36.0	3.1	3.4	4.6
Viva Industrial Trust	88.6	3.3		39.8	3.5	3.9	4.2
Average	**92.6**	**3.4**	**5.6**	**36.0**	**3.0**	**3.3**	**5.4**

Source: Various REITs, Phillip Securities Research (Singapore)

WALE: Weighted Average Lease Expiry; WADM: Weighted Average Debt Maturity; WACD: Weighted Average Cost of Debt

GRI: Gross rental income; NLA: Net leasable area

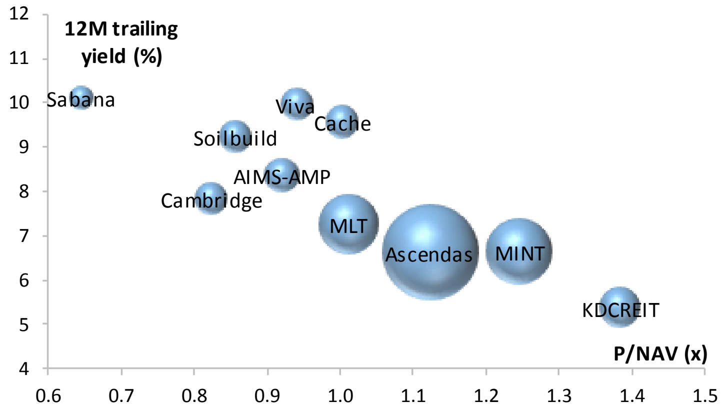
Peer relative valuation

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	6,528	2.30	1.12	6.6
Mapletree Industrial Trust	3,063	1.700	1.25	6.7
Mapletree Logistics Trust	2,537	1.015	1.01	7.3
Keppel DC REIT	1,082	1.210	1.38	5.4
AIMS AMP Capital Industrial REIT	860	1.350	0.92	8.4
Cache Logistics Trust	745	0.830	1.00	9.6
Cambridge Industrial Trust	717	0.550	0.82	7.8
Viva Industrial Trust	701	0.755	0.94	10.0
Soilbuild Business Space REIT	688	0.660	0.86	9.2
Sabana Shari'ah Compliant REIT	385	0.520	0.65	10.1
Average			**0.99**	**8.1**

Source: Bloomberg (Updated: 10 November 2016), Phillip Securities Research (Singapore)

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



Source: Bloomberg (Updated: 10 November 2016), Phillip Securities Research (Singapore)

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