Asia Credit Research

OCBC Bank

Croesus Retail Trust: New Credit Review

Monday, November 14, 2016

Recommendations Summary

Issuer Profile:	Bond Recommendation:	
Neutral	CROESP 5 '20	**Overweight**
Fundamental Analysis Considerations • Stable asset base • Manageable credit metrics • Mitigated FX risks	Technical Analysis Considerations • 3.4 year paper with decent coupon • Lack of credit rating • Exposure to Japan provides diversification	

S&P: Not rated

Moody's: Not rated

Fitch: Not rated

Ticker: **CROESP**

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Key credit considerations

- **Stable portfolio of assets:** Boasting a long weighted average lease to expiry by NLA of 6.8 years, Croesus Retail Trust ("CRT") offers stability in its portfolio with 85.7% of its gross rental income from pure fixed rent. In the latest 1QFY2017 results, CRT achieved healthy portfolio occupancy of 97.8% despite being weighed down by the acquisition of Feeeal Asahikawa which has only 88.9% occupancy. Meanwhile, the master leases to Aeon Town and Fuji, which comprise 19.5% of the gross rental income, provides income visibility.

- **Double-edged sword from the Japan property wave:** CRT has been recording sizeable revaluation gains from lower cap rates, which drives the debt/asset ratio lower. However, this has made it more costly for CRT to acquire, pushing CRT out of Tokyo/Osaka in a hunt for yield.

- **Manageable credit metrics:** We are comfortable with CRT's debt/asset of 44.6%, which is higher than most S-REITs, due to the low interest environment in Japan. EBITDA/interest is healthy at 4.3x, and comparable to the REITs with stronger credit ratings such as Ascendas REIT (4.4x), CapitaLand Commercial Trust (4.7x) and CapitaLand Mall Trust (4.0x). Cost of debt may fall when the chunky JPY24.4bn (c.SGD320mn) debt in FY2018 is refinanced. We think refinancing is manageable as with higher debt headroom from revaluation gains.

- **FX and interest risks largely mitigated:** The balance sheet is naturally hedged, with assets in Japan matched to the JPY part of the debt. CRT's SGD bonds are swapped to JPY, posing negligible FX risks. Interest rate risk is mitigated with 100% of the debt being hedged.

- **Internalisation of the Trustee-Manager:** Differentiating itself from S-REITs, CRT has internalised the Trustee-Manager on 31 Aug 2016 and will be achieving cost savings for the full quarter from 2QFY2017 onwards. CRT will also save on future acquisition costs paid to the Trustee-Manager, and interest will be better aligned between the Trustee-Manager and unitholders.

- **Technical Factors**: We find CROESP '20s attractive with 4.74% yield for 3.4 year paper, putting it ahead of bonds from comparable S-REITs. Despite the lack of a credit rating and substantially all its assets encumbered, we think that CRT's credit profile is largely stable. We think there is a low supply risk, despite the quick pace of acquisitions, as debt in JPY is cheaper. We also see CROESP '20s providing a diversification play to other SREITs with its exposure to Japan.

I) Company Background

Listed in Singapore on 10 May 2013, Croesus Retail Trust ("CRT") is a business trust with 11 income-generating retail assets in Japan. The portfolio totals 426,314 sqm by NLA, with 5 properties located in the Greater Tokyo region while the remainder are located in Fukuoka, Osaka, Mie, Saga, Hiroshima and Hokkaido.

Figure 1: Property Portfolio

Property	Location	NLA (sqm)	Property valuation	
			JPY mn	% of Total
Aeon Town Moriya	Ibaraki	68,047	15,200	13.5%
Aeon Town Suzuka	Mie	43,501	9,990	8.9%
Croesus Shinsaibashi	Osaka	2,342	11,900	10.6%
Mallage Shobu	Saitama	68,075	26,400	23.4%
Luz Omori	Tokyo	9,285	4,040	3.6%
Croesus Tachikawa	Tokyo	7,141	13,300	11.8%
One's Mall	Chiba	52,849	12,900	11.5%
Torius	Fukuoka	76,871	8,690	7.7%
Fuji Grand Natalie	Hiroshima	31,065	3,520	3.1%
Mallage Saga	Saga	46,650	4,200	3.7%
Feeeal Asahikawa	Hokkaido	20,490	2,500	2.2%
Total		**426,314**	**112,640**	100.0%

Source: Company

Except for Croesus Shinsaibashi, Luz Omori and Croesus Tachikawa, which are urban or prime retail properties, the remaining properties which comprise 74.0% of property valuation are suburban shopping centres. Aeon Town Moriya, Aeon Town Suzuka, Fuji Grand Natalie are master leased to Aeon Town Co Ltd and Fuji Co Ltd.

Aeon Town Co Ltd is a subsidiary of Aeon Co Ltd (8267 JT). Listed in Japan with a market cap of JPY1,293bn as of 14 Nov 2016, Aeon Co Ltd operates general merchandise stores, supermarkets and convenience stores in Japan. Aeon Co Ltd is rated "BBB+" by S&P. Fuji Co Ltd (8278 JT) is in the general retail business and sells food products, clothing and sundry goods. Fuji also sells and rents books, DVDs, CDs and provides payment services. The market cap of Fuji is JPY77.7bn as of 14 Nov 2016, and is rated "BBB+" by Japan Credit Rating Agency.

CRT has been expanding quickly, with 7 assets acquired after its IPO. We find similarities between CRT and S-REITs, with (1) income producing properties and (2) has committed to paying out more than 90% of distribution income. However, S-REITs have a debt/asset regulatory limit of 45% while CRT has often exceeded this, though the ratio has fallen to 44.6% in 1Q17. CRT has an internal Trustee-Manager, while the Trustee and the Manager roles are separate for S-REITs.

II) Ownership and Management

Figure 2: Major shareholder as at 14/11/16

Investor	Shares	Stake
GKG Investment Holdings Pte Ltd	51,338,285	6.82%
Value Partners Group Ltd	46,318,506	6.16%
DBS Group Holdings Ltd	42,550,020	5.66%
Blackrock	35,771,311	4.76%

Source: Bloomberg

There are no controlling shareholders of CRT. GKG Investment Holdings Pte Ltd provides financial services and holds a controlling stake in GK Goh Holdings and Boardroom Ltd. Value

Partners Group is an asset management company. DBS Group Holdings has a stake in CRT via DBS Bank Ltd. Blackrock is an investment asset manager.

Jim Chang Cheng-Wen is the Executive Director and CEO of CRT. He is also the Chairman and Co-founder of Croesus Merchants International, which was previously the shareholder of a JV which owns the Trustee-Manager. Mr Chang had managed a residential real estate fund in Japan for Citi Property Investors in 2007-2010 and began his career in Taiwan-based Evergreen Group.

III) Company Overview & Analysis

- **Stable asset base:** CRT's portfolio has been performing well since IPO, posting occupancies of 97% and higher. With 85.7% of the portfolio gross rental income on fixed rent and a long WALE by NLA of 3-15 years at its malls, we expect rental income to remain relatively stable. In addition, the upcoming Tokyo Olympics in 2020 is expected to lift retail activity as retailers will seek to target the expected surge in visitors[1]. In the latest 1QFY17 results, gross revenue is higher q/q by 16.8% to JPY3.1bn, mainly from the full quarter recognition of Mallage Saga and Feeeal Asahikawa that were acquired in 27 May 2016.

- **Benefits from internalisation of the Trustee-Manager:** Following the internalisation of the Trustee-Manager (completed on 31 Aug 2016), CRT will be making substantial cost savings, which we estimate at JPY360mn p.a[2]. The cost savings will be more significant as CRT continues to acquire more properties. In addition to cost, we believe that the internalisation better aligns the interest of the Trustee-Manager to CRT, differentiating itself from most S-REITs.

- **Master leases to provide income visibility:** Aeon Town Moriya and Aeon Town Suzuka are master leased to Aeon Town for another 10.7 years, comprising 16.9% of the portfolio's gross rental income, providing stability to CRT's revenue. While Aeon Town has the option to terminate the leases, we think it is highly unlikely for Aeon Town to do so. The notice of termination (one year prior notice is required) has not been served, and we estimate the rental rate paid by Aeon Town on both properties, at below JPY4,000 per tsubo[3] per month, are likely to be significantly below the rent that it collects from its subtenants. The other master lease, by Fuji, contributes 2.6% of the portfolio's gross rental income. The master lease with Fuji will run for another 7.5 years.

- **Double-edged sword from revaluation gains:** Sizeable revaluation gains (FY2016: JPY5.7bn, FY2015: JPY6.3bn) due to decrease in cap rates have driven debt/asset ratio lower. On the other hand, the decrease in cap rates made it more costly for CRT to acquire in Tokyo/Osaka, and CRT has responded by acquiring in less prime and less populous areas (latest acquisitions are in Saga and Hokkaido) in a hunt for yield. On the upside, the acquisition spree has diversified CRT's portfolio across Japan, with CRT in a stronger position to better manage any potential slowdown in Tokyo's rental markets.

- **Income to contribute from Feeeal Asahikawa:** The newly acquired Feeeal Asahikawa is not stabilised, with -0.1% annualised NPI yield as of 1QFY17. We understand from CRT that the property is undergoing asset enhancement and tenant renewal. If the property stabilises at 6.0% annualised NPI yield, the property would contribute an additional JPY150mn to NPI p.a. Meanwhile, Torius is also slated to undergo asset enhancement, though the plan is not concrete yet.

[1] The government has set a goal to attract 40m foreign visitors to Japan with JPY8 trillion in annual tourist spending.
[2] Extrapolated from one month cost savings of JPY29.9mn in 1QFY2017 results.
[3] Japanese unit of measurement for area. 1 tsubo = 3.306 sqm

IV) Financial Analysis

- **Manageable credit metrics:** While the gearing of 44.6% is higher than most S-REITs, we think this is manageable due to the low interest environment in Japan. EBITDA/total interest is decent at 4.3x. Despite the chunky JPY24.4bn debt due in FY2018, we think that CRT will manage this due to higher debt headroom from asset revaluation gains. There is also potential upside, as we expect the cost of debt to fall upon refinancing given the supportive interest rate environment in Japan. Management is assessing options to refinance the debt earlier. However, we understand this will entail significant upfront costs by cancelling the interest rate swaps for the existing debt. 100% of the interest payment is hedged, with all-in cost of debt at 1.93%.

- **FX risks mitigated on the balance sheet:** We like that the balance sheet is naturally hedged, with the JPY assets matched to the JPY part of the debt. Despite issuing bonds in SGD, FX risks are negligible given that these are swapped to JPY. We understand that the SGD bonds are issued, despite higher costs, as CRT typically borrows in Japan with a loan-to-value ratio below 50%. Meanwhile, we believe that substantially all the assets have been mortgaged.

- **Decent access to capital markets:** CRT maintains decent access to funding, demonstrated via the issuance of 70mn shares at SGD0.75 in Apr 2016 and 27.7mn shares at SGD0.797 in Aug 2016. In addition, CRT did a SGD50mn tap on its '20s in Sep 2016, which will likely be used for refinancing its '17s, though the issuance size is likely lower than expected.

V) Technical Considerations

Positives
- 3.4 year paper with decent coupon mitigates interest rate risk
- Low supply risk
- Exposure to Japan as a diversification play to other S-REITs

Negatives
- Lack of credit rating
- High asset encumbrance

Relative Value

Issue	Maturity	Ask Price	Ask YTW	Bond Rating	Debt/Asset
CROESP 5 '20	13/04/2020	100.82	4.74	NR/NR/NR	0.45x
MAGIC 3.2 '21	08/09/2021	101.0	2.98	NR/Baa1/NR	0.40x
FCTSP 3 '20	21/1/2020	100.25	2.92	BBB+/NR/NR	0.28x
LMRTSP 4.1 '20	22/06/2020	98.00	4.71	NR/NR/NR	0.33x

*Indicative spreads based on offer prices from Bloomberg on 11/11/16

We compare CROESP '20s to MAGIC '21s (N). Acknowledging CRT's weaker credit profile due to its encumbered portfolio with a somewhat higher debt/asset ratio, this is more than compensated with 176 bps pickup for 1.4 years shorter in maturity. Under our coverage, for bonds of S-REITs with similar maturity, we are Overweight only on FCTSP '20s and LMRTSP '20s. CROESP '20s offers 182bps and 3bps pickup over the respective bonds.

We also like CROESP '20s for providing diversification play to other S-REITs invested mainly in the Singapore market. Meanwhile, we think there is a low supply risk, despite the quick pace of acquisitions, as debt in JPY is cheaper.

VI) Conclusion & Recommendation

CRT offers a stable credit profile from its portfolio of assets with long 3Y-15Y leases, with fixed rent comprising 85.7% of the portfolio gross rental income. Despite its higher gearing than most S-REITs, we think this is manageable given Japan's low interest rate environment. We initiate coverage on CRT with a **Neutral issuer profile**.

While CRT's credit metrics are somewhat weaker when compared to peers with a higher gearing and asset encumbrance, we are **Overweight on CROESP '20s**, which look attractive for the large yield pickups.

Croesus Retail Trust

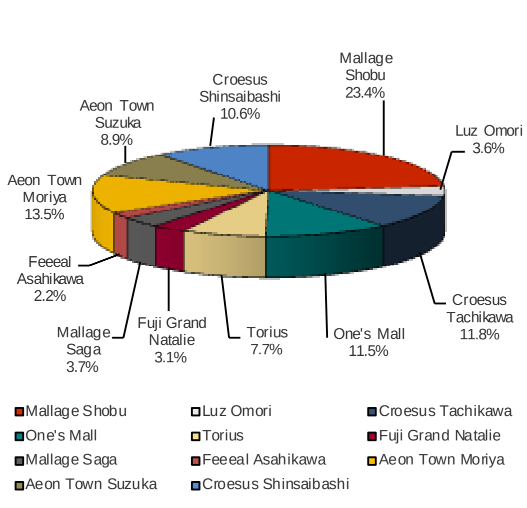
Table 1: Summary Financials

Year Ended 30th June	FY2015	FY2016	1Q2017
Income Statement (JPY'mn)			
Revenue	7,635.4	9,581.2	3,125.7
EBITDA	4,043.2	4,645.3	1,380.0
EBIT	3,988.7	4,615.1	1,380.0
Gross interest expense	1,004.2	1,106.1	318.2
Profit Before Tax	9,666.4	7,786.4	506.9
Net profit	7,579.1	5,946.6	261.9
Balance Sheet (JPY'mn)			
Cash and bank deposits	6,241.9	9,672.2	7,477.5
Total assets	100,401.0	131,174.7	132,687.4
Gross debt	47,487.2	59,394.6	59,247.3
Net debt	41,245.3	49,722.4	51,769.9
Shareholders' equity	43,586.2	55,313.4	56,722.2
Total capitalization	91,073.4	114,708.1	115,969.5
Net capitalization	84,831.5	105,035.8	108,492.0
Cash Flow (JPY'mn)			
Funds from operations (FFO)	7,633.6	5,976.8	261.9
* CFO	3,210.3	2,426.8	634.4
Capex	413.4	408.7	315.7
Acquisitions	11,298.2	18,595.5	4,046.4
Disposals	0.0	0.0	0.0
Dividends	3,100.7	4,652.3	1,017.5
Free Cash Flow (FCF)	2,796.9	2,018.2	318.7
* FCF Adjusted	-11,601.9	-21,229.7	-4,745.2
Key Ratios			
EBITDA margin (%)	53.0	48.5	44.2
Net margin (%)	99.3	62.1	8.4
Gross debt to EBITDA (x)	11.7	12.8	10.7
Net debt to EBITDA (x)	10.2	10.7	9.4
Gross Debt to Equity (x)	1.09	1.07	1.04
Net Debt to Equity (x)	0.95	0.90	0.91
Gross debt/total capitalisation (%)	52.1	51.8	51.1
Net debt/net capitalisation (%)	48.6	47.3	47.7
Cash/current borrowings (x)	9.6	1.2	0.9
EBITDA/Total Interest (x)	4.0	4.2	4.3

Source: Company, OCBC estimates

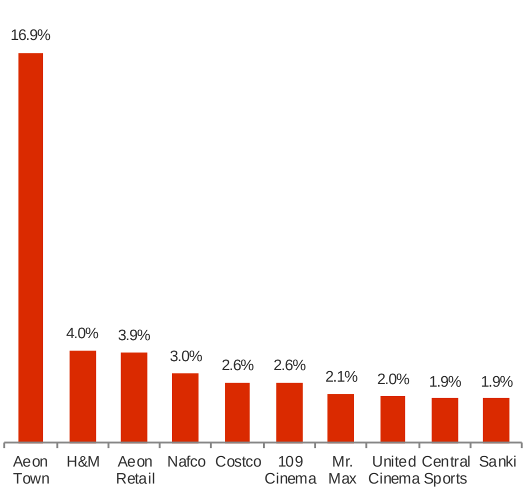
**FCF Adjusted = FCF - Acquisitions - Dividends + Disposals | *CFO after deducting interest expense*

Figure 1: NLA breakdown by Property - 1Q2017



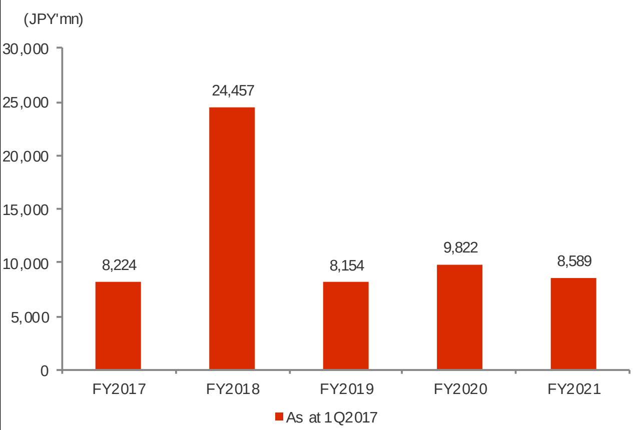
Source: Company

Figure 2: Revenue breakdown by Segment - 1Q2017



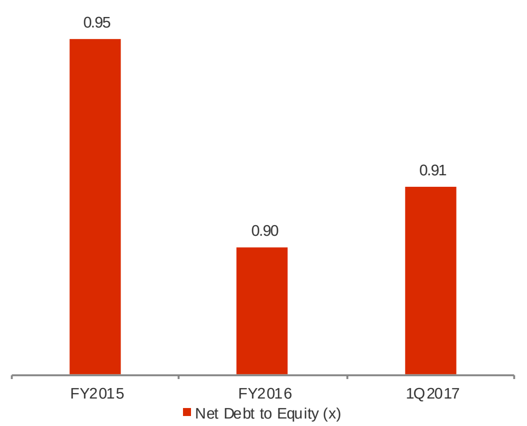
Source: Company

Figure 3: Debt Maturity Profile



Source: Company

Figure 4: Net Debt to Equity (x)



Source: Company, OCBC estimates