

Earnings Review: ESR-REIT (“EREIT”)

Recommendation

- EREIT is currently undergoing operational integration with VIVA Industrial Trust (“VIT”), having successfully completed the scheme of arrangement to merge with VIT in October 2018. We expect consolidated financials to be made available from 4Q2018. While the combination of EREIT and VIT is likely to have led to an increase in aggregate leverage (we estimate to 41%), we view the merger as credit positive for EREIT.
- We expect the enlarged EREIT to see scale benefits and a gradual compression in its cost of debt. Our base case in maintaining EREIT’s issuer profile at Neutral (4) does not factor in further REIT acquisitions by EREIT.
- We like the EREIT curve at current prices. The curve is trading wide against other Neutral (4) REIT names, indicating potential for tightening. At the short end, we prefer the EREIT 3.95% ‘20s which is trading at similar spread levels as SBREIT 3.6% ‘21s though the EREIT 3.95% ‘20s mature 11 months earlier. We see the EREIT 3.95% ‘23s as trading at fair value against its own curve. Within the perpetual space, we prefer the EREIT 4.6%-PERP over the CACHE 5.5%-PERP. The EREIT 4.6%-PERP provides a 55bps pick-up and a first call date that is 3 months earlier.

Issuer Profile: Neutral (4)

Ticker: **EREIT**

Background

EREIT has completed its merger with VIVA Industrial Trust on 22 October 2018 with a proforma total asset base of SGD3.1bn. EREIT invests primarily in industrial assets. All properties are in Singapore. Mr. Tong Jinqun is now EREIT’s largest unitholder with a ~34%-stake while ESR is the second largest unitholder with a ~9%-stake. The EREIT REIT Manager is now owned by ESR (67.3%), Mr. Tong (25.0%) and Mitsui (7.7%).

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Relative Value:

Bond	Maturity/Call date	Aggregate leverage	Ask Yield	Spread
EREIT 3.95% ‘20	21/05/2020	30.3%	3.81%	172bps
EREIT 4.6%-PERP	03/11/2022	30.3%	6.16%	386bps
EREIT 3.95% ‘23	09/05/2023	30.3%	4.20%	187bps
CACHE 5.5%-PERP	01/02/2023	35.6%	5.62%	331bps
SBREIT 3.6% ‘21	08/04/2021	39.2%	3.88%	170bps
SUNSP 3.0% ‘21	16/07/2021	38.2%	3.13%	93bps
SUNSP 3.4% ‘23	10/05/2023	38.2%	3.33%	101bps

Note: (1) Indicative prices as at 13 November 2018 Source: Bloomberg
(2) Aggregate leverage based on latest available quarter

Key Considerations

- Standalone interest coverage has weakened:** In 3Q2018, gross revenue was up 19.4% y/y to SGD32.4mn while net property income (“NPI”) was up 15.0% y/y to SGD22.5mn. This was attributable to the two properties acquired in December 2017 although partly offset by two property conversions into multi-tenanted buildings and the absence of revenue from one divested property. On a q/q basis (which removes the impact of the acquisitions), we find that gross revenue had declined 0.6% while NPI had declined 3.8%. Assuming that EREIT pays out 4.6% p.a as perpetual distribution, EBITDA/(Interest plus 50% of perpetual distribution) was 3.2x in 3Q2018. In 3Q2018, 6.9% of rental income is attributable to Hyflux, while this tenant has not defaulted on its payments to EREIT, reportedly this tenant has been delaying rents to its other landlord, Ascendas REIT (Issuer Profile: Neutral (3)). Taking away rents from Hyflux, we estimate EBITDA/ (Interest plus 50% of perpetual distribution) at 3.0x.
- Aggregate leverage high versus REIT peers:** As at 30 September 2018, EREIT’s standalone unadjusted aggregate leverage was low at 30.3% (30 June 2018: 30.5%) though this was temporary. Post quarter end on 25 October 2018, EREIT had bought 15 Greenwich Drive within the Paya Lebar Airbase vicinity for a total acquisition cost (including transaction cost) of SGD99.9mn. The fully occupied property was 100% bank debt funded. Additionally, EREIT is in the midst of an asset enhancement initiative of 30 Marsiling Industrial Estate Road 8 which is estimated to cost SGD12.0mn (targeted completion in 1Q2019). Adding this capex, we estimate EREIT’s unadjusted aggregate leverage at ~34%.

EREIT has SGD150mn in outstanding perpetuals, representing 9% of its total capital. Assuming 50% of this as debt, we estimate its adjusted aggregate leverage at 39% on a standalone basis. As at 30 June 2018, VIT had SGD536.5mn in gross debt against SGD1.3bn in total assets (aggregate leverage of 41.0%) and this should still be relatively constant. The total scheme consideration borne by EREIT for the acquisition of VIT was SGD936.7mn while professional and other fees and expenses was ~SGD24.3mn (2.5% of scheme consideration). 90% of the scheme consideration was paid via new equity issued by EREIT to existing unitholders of VIT though the remaining 10% of cash consideration and transaction costs were funded by debt. Collectively, EREIT would have taken up SGD118mn in new debt. On a combined basis, we estimate that EREIT's unadjusted aggregate leverage will rise to ~41% and ~43% on an adjusted basis (taking 50% of perpetual as debt).

- **No near-term maturities:** As at 30 September 2018, EREIT faced SGD155.0mn in short term debt (the SGD-denominated bond due in November 2018). On 5 November 2018, the bond has been fully redeemed by existing debt facilities. EREIT faces SGD115mn in maturing bank debt in 2019, of which it expects that SGD100mn would be extended to 2023. The remaining SGD15mn relates to debt drawn down from an unsecured revolving credit facility ("RCF"), which in practice is likely to be rolled forward. As at 30 September 2018, EREIT had SGD205mn in undrawn available committed RCF and we think there is at least SGD50mn still available. As at 30 June 2018 (the last available debt for VIT's standalone financials), VIT only faced a SGD100mn bond due in the short term, this has since been redeemed in September 2018 via an unsecured bank loan. No VIT debt is due in 2019. All of EREIT's debt remains unsecured. Prior to the merger, we think VIT had paid down SGD11.8mn in debt using its cash balance and all of VIT's remaining SGD525mn in debt would have also been refinanced into unsecured debt (ie: the full SGD3.1bn in proforma investment properties is unencumbered).
- **Better operating metrics following merger:** In 3Q2018, the top ten tenants at EREIT contributed 41.7% of rental income. Of which, AMS Sensors Singapore Pte Ltd contributed 8.9% while troubled Hyflux contributed 6.9%. Going forward, EREIT's tenant concentration risk will decline, with top ten tenants contributing ~28.7% of rental income, with the largest tenant only contributing 4.9% to rental income. As at 30 September 2018, EREIT's standalone portfolio occupancy was 92.9%, higher than sector portfolio occupancy of 89.1% and rising from 91.4% as at 30 September 2018. For EREIT, only 3.6% of leases by rental income would come due in 4Q2018 while 20% would come due in 2019. Assuming figures are unchanged since June 2018, VIT on a standalone basis has 26% of leases by rental income that will come due in 2019. On a combined basis, we estimate that 23% of rental income will come due, which is not overly lumpy and manageable for the REIT.

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Explanation of Issuer Profile Rating ("IPR") / Issuer Profile Score ("IPS")

Positive ("Pos") – The issuer's credit profile is either strong on an absolute basis, or expected to improve to a strong position over the next six months.

Neutral ("N") – The issuer's credit profile is fair on an absolute basis, or expected to improve / deteriorate to a fair level over the next six months.

Negative ("Neg") – The issuer's credit profile is either weaker or highly geared on an absolute basis, or expected to deteriorate to a weak or highly geared position over the next six months.

To better differentiate relative credit quality of the issuers under our coverage, we have further sub-divided our Issuer Profile Ratings ("IPR") into a 7 point Issuer Profile Score ("IPS") scale.

IPR	Positive		Neutral			Negative	
IPS	1	2	3	4	5	6	7

Explanation of Bond Recommendation

Overweight ("OW") – The performance of the issuer's specific bond is expected to outperform the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Neutral ("N") – The performance of the issuer's specific bond is expected to perform in line with the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

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Other

Suspension – We may suspend our issuer rating and bond level recommendation on specific issuers from time to time when OCBC is engaged in other business activities with the issuer. Examples of such activities include acting as a joint lead manager or book runner in a new issue or as an agent in a consent solicitation exercise. We will resume our coverage once these activities are completed.

Withdrawal ("WD") – We may withdraw our issuer rating and bond level recommendation on specific issuers from time to time when corporate actions are announced but the outcome of these actions are highly uncertain. We will resume our coverage once there is sufficient clarity in our view on the impact of the proposed action.

Analyst Declaration

The analyst(s) who wrote this report and/or her or his respective connected persons did not hold securities in the above-mentioned issuer or company as at the time of the publication of this report.

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