OCBC Bank

Asia Credit Research

VIVA Industrial Trust / ESR-REIT: Credit Update

Tuesday, 30 January 2018

Stars aligning

- **ESR-REIT's REIT Manager ("EREITM") announced that it has submitted a proposal on a proposed merger of EREIT with Viva Industrial Trust, the stapled group.**
- **As at 31 December 2017, EREIT and VIT total assets were SGD1.7bn and SGD1.3bn respectively. A combination of the two will create the 4th largest Industrial REIT (by total asset) listed in Singapore.**
- **The parties are currently in exclusive discussions, though no definitive agreements are in place yet and there is no certainty of a deal. While details still need to be panned out, we view the likelihood of a deal happening to be high.**
- **We like a combination of EREIT and VIT, more so as this is envisaged to be fully funded through issuance of shares. The combined structure will be less levered versus EREIT on a standalone basis and we expect slight improvement to interest coverage.**
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- **The combined structure will be less levered versus EREIT on a standalone basis and we expect slight improvement to interest coverage.**
- **Recommendation:** We are maintaining a **Neutral(4)** issuer profile on EREIT. We are maintaining our **Neutral (5)** issuer profile on VIT and Neutral on the VITSP'18s. Under our base case scenario, our indicative issuer profile of MergeCo is likely to be at Neutral (4). We will only assign a final issuer profile at a later stage when definitive details are provided. We are Overweight the EREIT'18s, EREIT 4.1%'20s and EREIT 3.95%'20s. We recommend a switch from the Suntec REIT's SUNSP'20s into the EREIT'20s which allow a pick-up of 40 bps. The EREIT 4.6%-PERP is providing sufficient pick-up against where the seniors are trading and given the improving credit outlook, we are also Overweight the EREIT 4.6%-PERP.

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OCBC Credit Research
Ezien Hoo, CFA
+65 6722 2215
EzienHoo@ocbc.com

- **Background:** On 29 January 2018, ESR Funds Management (S) Limited ("EREITM"), as REIT Manager of EREIT announced that it has submitted a proposal to the managers of the Viva Industrial Trust ("VIT") for the proposed merger of all the issued and paid-up stapled securities of VIT and units of EREIT. VIT comprises a REIT ("VI-REIT") and Business Trust ("VI-BT") with Viva Industrial Trust Management Pte Ltd ("VIREITM") being the REIT Manager of VI-REIT, while the trustee-manager of VBT is Viva Asset Management Pte. Ltd ("VITM"). VBT is still inactive and does not hold any property. The parties are in exclusive discussions and the exclusivity will expire on the earlier of (1) execution of a definitive implementation agreement and (2) 31 March 2018, or such other date as the VIT Managers and EREITM may agree in writing. It is proposed that EREIT would acquire all of the stapled securities of VIT by way of a trust scheme of arrangement. EREIT is envisaged to issue new EREIT units to VIT's stapled security holders as purchase consideration (ie: effectively a share swap). As of writing, valuation and post-acquisition legal structure details have not been provided. In 2H2017, EREIT had been in talks on a proposed transaction with SSREIT, another industrial REIT peer though discussions fell through in November 2017 (refer to OCBC Asia Credit - SSREIT/EREIT Credit Update).

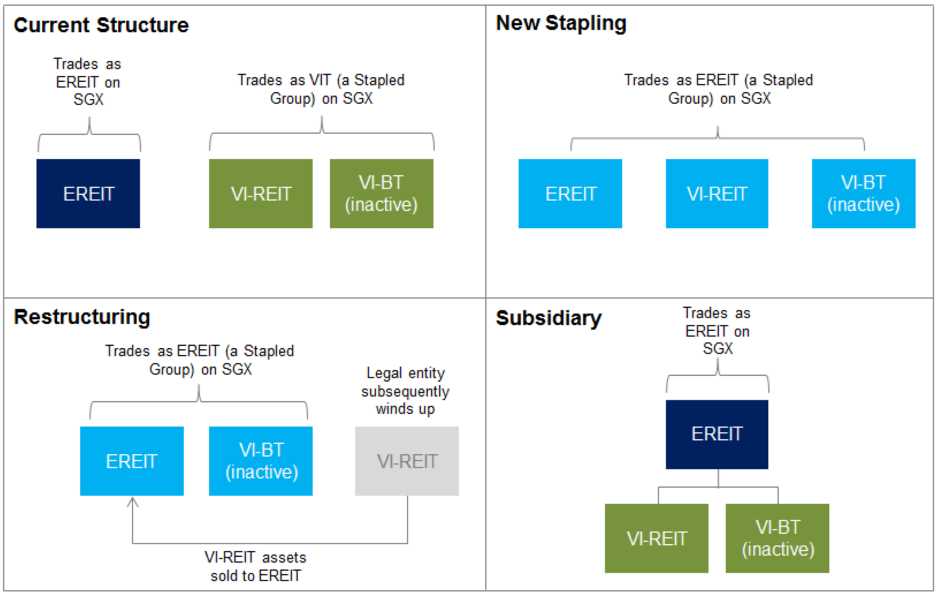
- VIT is listed on the SGX with a market cap of SGD922mn (as at 30 January 2018). VIT has total assets of SGD1.3bn and all investment properties are Singapore-based. The current Sponsors, Ho Lee Group Pte Ltd and Kim Seng Holdings Pte Ltd collectively own 11% in VIT. EREIT is also listed on the SGX with a market cap of SGD769mn (as at 30 January 2018). EREIT has SGD1.7bn in total assets and similarly, all investment properties are Singapore-based. EREIT's current Sponsor, ESR, is a privately held developer and manager of logistics facilities focusing on China, Japan, South Korea and Singapore. Sponsor is owned by Warburg Pincus, the founders and other institutional investors. ESR owns a 12%-stake in EREIT and 80% of EREITM. Post involvement of ESR, there has been a change in senior management team at EREIT and the REIT has taken on an aggressive tilt in expansion, including acquiring ~SGD350mn of Singapore-based properties in 4Q2017 (80%-stake in 7000 Ang Mo Kio (originally under a rights of first refusal to VIT) and 100% of 8 Tuas South Lane from Hyflux). Mr. Tong Jinquan, the major stapled security holder of VIT (with a ~49%-stake in the stapled units) is also the single-largest unitholder of EREIT with 18.5%. VIT managers are owned by Mr. Tong (via entities under his control), the Sponsors and certain members of VIT's senior management team. In November 2017, Mr. Tong was appointed to the board of VIT as a Non-Independent Non-Executive Director.

Our base case assumptions:

A) The VITSP'18s continues to be guaranteed by VI-REIT only, rather than guaranteed by more entities within the combined structure ("MergeCo"). EREIT's existing perpetual and bonds continues to be guaranteed by EREIT only.
B) Post-acquisition, VIT's stapled securities stop trading on the SGX.
C) VI-BT is maintained to keep optionality of operating the hotel component of UE BizHub East.
D) No information on share swap ratio provided. We assume EREIT acquires VIT at SGD922mn (market cap as at 30 January 2018), which represents Price-to-Book of 1.2x.
E) Continuation of externally managed REIT structure, managed by EREITM.
F) We assume it is legally possible for EREIT to buy VIREITM and that the REIT Manager can be bought for SGD95mn in cash. Separate to the proposed merger announcement, EREIT is in the midst of raising up to 263mn in new units to help reduce aggregate leverage which had spiked from 4Q2017 acquisitions. We assume that EREIT raises SGD142mn (at SGD0.54 per unit) in new equity to fund this and no additional debt is required. In a scenario where VIREITM is bought by ESR/EREITM instead, this would improve the credit profile of MergeCo slightly.
G) Existing borrowings at both VIT and EREIT are retained.
H) As yet, we do not know the legal structure that the newly merged entity ("MergeCo") will take. The various permutations may include:
   (1) New Stapling: EREIT/VI-REIT/VI-BT trades as a new stapled group on the SGX (our base case for purpose of this report)
   (2) Restructuring: Post share swap, VI-REIT assets are sold into EREIT and trades as EREIT/VI-BT while VI-REIT winds up as a legal entity post maturity of VITSP'18
   (3) Subsidiary: EREIT substantially buys all the existing stapled securities and holds VI-REIT and VI-BT as non-listed subsidiaries. Trades as EREIT.

   While the form of legal structure would have transaction cost implications, this does not materially change our credit view. If the legal structure takes the form of (2), this would trigger the Non-disposal Covenants per VIT's bond documentation and the matter is likely to be put through a bondholders vote. Under scenario (3), financial support from EREIT would be forthcoming under a stressed situation as as VI-REIT would form a significant part of EREIT's value going forward as a subsidiary of EREIT.

Figure 1: Illustration of possible permutations



Source: OCBC Credit Research
Note: Possible permutations are not exhaustive

What does the merger mean to EREIT bond and perpetual holders

Similar to equity unitholders, emergence of a larger REIT is likely to benefit bond and perpetual holders: We do not see the proposed merger as unduly stressing EREIT's credit profile given it is contemplated to be fully equity funded and that VIT is immediately cash generative. Even assuming that VIREITM would need to be bought out in cash, straight equity is being raised at EREIT which can be directed towards acquisition (versus paying down debt as originally intended). Currently, there are nine Industrial REITs listed on the SGX who have significant assets in Singapore. The landscape is dominated by the Big Three Industrial REITs which are ultimately in-part owned by Temasek. The Big Three each have total assets of more than SGD4.0bn while the remaining six are small-to-mid size Industrial REITs with asset base of below SGD2.0bn. By asset size, EREIT is the largest of these small-to-mid size Industrial REITs (total asset as at 31 December 2017 of SGD1.7bn). A combination of EREIT and VIT will see asset base grow to SGD3.0bn and become the fourth largest Industrial REIT in Singapore.

Deal likelihood high: Industrial REITs had been facing limited growth opportunities domestically amidst a weaker industrial space environment. Average daily turnover for the past year for EREIT was only SGD0.5mn (0.1% of market cap) while average daily turnover for the largest Industrial REIT was 0.3% of its market cap. As a larger entity, MergeCo equity units may trade with higher liquidity, leading to higher financial flexibility. Immediately prior to the proposed merger announcement, EREIT was trading at a Price-to-Book ratio of only 0.8x versus median of peers at 1.2x. Though factoring in EREIT's more levered capital structure and lower income generation versus VIT, we think the transaction is immediately yield-accretive for EREIT unitholders. We assume purchase consideration of VIT at SGD922mn and this is fully equity funded. Potential scale benefits post-merger include cost savings from property and facilities management services, higher recurring rents and diversity of tenant profile as MergeCo can more space options.

Resolving the Negative outlook at EREIT: EREIT's standalone rating by Moody's is at Baa3 with a Negative outlook. This implies a one in three probability of a downgrade to non-investment grade. In addition to credit metrics, rating agencies considers scale in determining its credit rating. In the case of EREIT, its small portfolio of industrial assets concentrated in Singapore was a limiting factor to its credit rating, with the Negative outlook premised on weakening of financial metrics and operating cash flow generation. Per our calculation, we think MergeCo's credit metrics are likely to fall within an investment grade rating and adding to that the uplift in scale, we see a strong chance for the Negative outlook on EREIT to be resolved. In our view, as the proposed merger gets seasoned among investors, the debt securities at EREIT and VIT would eventually see a re-rating, leading to lower cost of debt for MergeCo.

What does the proposed merger mean to VIT bondholders

Bondholders protected from non-disposal covenants: We see limited downside for existing VITSP'18s bondholders. Non-disposal covenants at VIT states that as long as bonds are outstanding, the Issuer and Guarantor (namely VI-REIT) shall ensure that none of the respective subsidiaries shall enter into arrangements where a disposal/transfer/sale-and-leaseback is reasonably likely to have a material adverse effect on the Issuer, VI-REIT or the Stapled Group. This means that bondholders have a right to call an Event of Default ("EoD") should the proposed merger result in a highly unfavorable outcome for the financial standing of VIT. We think an EoD is unlikely to be triggered though under a worst case scenario, there are sufficient assets to be paid out to both secured and unsecured lenders. As at 31 December 2017, VIT's aggregate leverage was 39.8%. Assuming a 30% haircut to assets, VIT's asset base can still cover 1.8x of total debt.

No change of control of the VITSP'18s from change in equity ownership of Issuer/VIT/VI-REIT, though downside risk limited: The sole outstanding bond at VIT matures in September 2018 (only six months left). Assuming the proposed merger is intended to be completed prior to September 2018, in our view, it likely for a consent solicitation to be launched for VIT bondholders to waive Event of Defaults ("EoD") clauses that may be triggered as a result of the proposed merger. Additionally, EREIT may simultaneously launch a tender offer to buy back outstanding VITSP'18s. EREIT is reliant on the SGD-denominated debt capital markets for financing. As at 31 December 2016, SGD-denominated bonds amount to SGD365mn (representing 54% of total debt) while perpetuals amounted to SGD150mn. Additionally, investors had penalised SGD-issuers who had offered below-market prices to existing bondholders under change of control situations. Net-net, it is likelier for EREIT to treat VIT bondholders equitably to ensure that markets remain favourable to MergeCo. Given the very short term to maturity, it is also likely for the VITSP'18s to stay at VIT until maturity and be redeemed as per scheduled.

Figure 2: Headline financials

SGDmn	VIT	EREIT	Pro-forma
Gross revenue	112	110	221
EBITDA	73	69	142
Interest expense	21	20	41
Total assets	1,318	1,696	3,014
Gross debt	525	672	1,196
Total equity (including perpetuals)	747	930	1,819
EBITDA/Interest	3.6x	3.4x	3.5x
Aggregate leverage	39.8%	39.6%	39.1%
Adj. Aggregate leverage	39.8%	44.1%	41.5%
Secured debt as a % of total assets	31.9%	All debt unsecured	14.0%
All-in cost of debt	3.9%	3.6%	3.6% or less

Note (1): Excluding transaction cost on the proposed merger and does not take into account any potential synergies
(2): Assumes SGD142mn is raised in new EREIT equity to fund the purchase of EREITM

- **Key risks to our call:**

A) A deal between EREIT and VIT does not transpire: Back to drawing board
B) Valuation for VIREITM higher than SGD140mn and EREIT raises debt to fund this acquisition

Figure 3: VIT SGD Bonds

Issue	Maturity / First Call Date	Outstanding Amount (SGDm)	Ask Price	Ask YTW (%)	I-Spread	Bond Rating
VITSP 4.15% '18	19 September 2018	100	100.5	3.44	228	NR/Ba2/NR

Note: (1) Indicative prices as at 30 January 2018

Figure 4: EREIT SGD Bonds

Issue	Maturity / First Call Date	Outstanding Amount (SGDm)	Ask Price	Ask YTW (%)	I-Spread	Bond Rating
EREIT 3.5% '18	5 Nov 2018	155	100.6	2.71	148	NR/Baa3/NR (Issuer)
EREIT 4.1% '20	29 Apr 2020	30	102.2	3.07	142	NR/Baa3/NR (Issuer)
EREIT 3.95% '20	21 May 2020	130	102.2	2.93	128	NR/Baa3/NR (Issuer)
EREIT 4.6%-PERP	3 Nov 2022	150	99.2	4.79	275	NR/Baa3/NR (Issuer)

Note: (1) Indicative prices as at 29 January 2018

- **Recommendation:** We are maintaining a Neutral(4) issuer profile on EREIT. We are maintaining our Neutral (5) issuer profile on VIT and Neutral the VITSP'18s. Under our base case scenario, our indicative issuer profile of MergeCo is likely to be at Neutral (4). We will only assign a final issuer profile at a later stage when definitive details are provided. We are Overweight the EREIT'18s, EREIT 4.1%'20s and EREIT 3.95%'20s. We recommend a switch from the Suntec REIT's SUNSP'20s into the EREIT'20s which allow a pick-up of 40 bps. The EREIT 4.6%-PERP is providing sufficient pick-up against where the seniors are trading and given the improving credit outlook, we are also Overweight the EREIT 4.6%-PERP.

  We have considered the following:

A) EREIT is unlikely to be geared up beyond 45% for any potential transaction. Under our base case, we expect MergeCo's credit profile to be somewhat stronger over that of EREIT's on a standalone basis.

B) We think the market will come to re-rate MergeCo as having a stronger credit profile versus its small-to-mid size Industrial peers. MergeCo though is unlikely to be viewed in the same bucket as the Big Three and we see MLT's perpetuals as capping the upside gains on EREIT 4.6%-PERP. The MLTSP 3.65%-PERP with a first call date of March 2023 is trading at a YTC of 3.6% while the MLTSP 4.18%-PERP with a first call date of November 2021 is trading at a YTC of 3.3%. We hold MLT's issuer profile at Neutral (4).

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