Asia Credit Research

First Real Estate Investment Trust ("FIRT") and Lippo Malls Real Estate Retail Trust ("LMRT"): Credit Update

Friday, 15 March 2019

Quest for value

- PT Lippo Karawaci Tbk ("LK") has announced its strategic transformation which includes a significant rights issue of USD730mn, asset divestments of USD280mn to help improve liquidity at LK, senior management and board changes.
- We are maintaining LK-related REITs, LMRT and FIRT's issuer profile at Negative (6) for now. We lowered both from Neutral (5) in May 2018 on account of the high counterparty exposure of the REITs to LK. Notwithstanding our unchanged issuer profiles, we see the positive sentiment surrounding LK as an opportune time to revisit the relative value of FIRT and LMRT perpetuals.
- We started off with the idea that for the same REIT issuer, perpetuals should feature tighter yield in perpetuity versus dividend yields. Based on observations from the SGD REIT perpetual market, LMRT's perpetuals were the only two outliers. This indicates to us three possibilities (1) Common equity holders are pricing the equity wrongly (2) The perpetual prices are too low or both (1) and (2) are in part correct.
- For REIT perpetuals which are more equity-like, we think a perpetual yield in perpetuity-equity to dividend yield spread of 100bps is fair. For those that are more debt-like, we think a larger spread differential is justified, and the more debt-like they are, the larger the spread differential should be.
- **Recommendation:** We see fair value of the FIRTSP 5.68%-PERP at 7.0%-7.5% and continue to underweight the perpetual. For the LMRTSP 7.0%-PERP and LMRTSP 6.6%-PERP we think the bonds are trading at fair value versus a stabilised equity dividend yield and are interesting for investors seeking stressed plays.

Figure 1: REIT perpetuals

Issue	LMRTSP 7.0%-PERP	LMRTSP 6.6%-PERP	FIRTSP 5.68%-PERP	EREITSP 4.6%-PERP
First call	27 September 2021	19 December 2022	8 July 2021	03 November 2021
Ask Price	89.0	85.0	91.0	94.8
Yield to call	12.21%	11.64%	10.16%	6.23%
Yield in perpetuity	8.53%	8.34%	6.86%	5.15%
Current dividend yield	6.03%	6.03%	8.60%	6.23%
Equity-Perpetual yield in perpetuity spread	250bps	231bps	(174bps)	(108bps)

Note (1): Indicative prices as at 15 March 2019 per Bloomberg

- **Background:** On 12 March 2019, PT Lippo Karawaci Tbk ("LK") (Issuer profile: Unrated) announced a strategic transformation of LK to focus on three core areas: urban housing, lifestyle malls and healthcare. LK has been suffering from a liquidity crunch and is proposing a rights issue to raise USD730mn that will go towards (1) Reducing LK's debt by USD275mn (2) Providing a liquidity buffer for interest payments, rental payments to its Sponsored-REITs until end-2020, working capital and general corporate purposes and (3) Fund on-going property development projects. The rights issue will be underwritten by the controlling shareholders of LK, the Riady family. No sub-underwriters have been named. Apart from the rights issue, LK is also intending to raise USD280mn from asset divestment plans (USD260mn from LMRT's proposed acquisition of Lippo Mall Puri ("Puri", owner of Puri Mall) from LK and USD20mn from an earlier announced transaction to sell its

Treasury Advisory
Corporate FX & Structured Products
Tel: 6349-1888 / 1881
Interest Rate Derivatives
Tel: 6349-1899
Investments & Structured Products
Tel: 6349-1886

GT Institutional Sales
Tel: 6349-1810

OCBC Credit Research

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

stake in two healthcare joint ventures to OUE Lippo Healthcare Limited ("OUE-LH")). OUE-LH is a 64%-owned subsidiary of OUE Ltd, a separate Riady family-controlled entity listed in Singapore. We hold OUE Ltd's issuer profile at Neutral (4).

- **Positive sentiment to FIRT though no structural changes to FIRT credit profile yet:** LK was historically the sole Sponsor of FIRT and currently holds a 10.7%-stake in FIRT. More importantly, 82.4% of FIRT's rental income in 2017 was attributable to LK and its subsidiaries. While the 2018 figures have not been released, this is likely to be similar to 2017. In October 2018, OUE and OUE-LH acquired FIRT's REIT Manager and bought a stake in the REIT itself. Currently OUE's deemed interest in FIRT is 17.6% (largest unitholder of FIRT). We view the knock-on sentiment from LK's 12 March 2019 announcement positively and view OUE's involvement in FIRT as a credit positive. However, we continue to maintain FIRT's issuer profile at Negative (6) on account that structurally, FIRT is still reliant on LK for rental payments. We are maintaining the issuer profile as such until (1) the LK rights issue completes and LK's credit profile improves decisively and/or (2) FIRT structurally de-couples from LK. This can happen if FIRT's earnings become more diversified or end-user PT Siloam International Hospitals Tbk's ("Siloam") credit profile improves and FIRT enters into tenancy agreements directly with Siloam. In 2018 though, Siloam's operating profit-to-total capital (a proxy for returns to capital providers) was 3.0%.

- **LMRT proposed to buy Puri Mall from LK:** LK is the Sponsor of LMRT and holds a 30.7%-stake in the REIT. We estimate that 30% of LMRT revenue comes from the Lippo group of companies, including from Hypermart and Matahari Department stores. LMRT is an important part of LK's liquidity plan with LMRT proposing to buy Puri for IDR3.7bn (SGD354.7mn / USD260mn) from LK, however the total transaction cost will amount to SGD430.0mn, which includes taxes, professional and other fees and asset enhancement initiative cost. Puri Mall, located in Jakarta is the flagship mall of LK. The reported net property income ("NPI") yield of the property is 9.41%, higher than the existing portfolio average of 8.94%. However, the NPI yield includes vendor support from LK. We note that LK has already been falling behind on rental payments to LMRT and the vendor support increases the exposure of LMRT to LK. Similar to FIRT, we continue to hold LMRT at Negative (6) Issuer Profile in the meantime.

- **REIT debt to equity continuum:** We started off with the idea that for the same REIT issuer, perpetuals should (1) Feature tighter yield in perpetuity (ie: perpetuals that are not called though continue paying distributions) versus dividend yields and (2) Perpetuals that are more debt-like should trade at larger spread differentials to dividend yields while those that are more equity-like should trade at smaller spread differentials to dividend yields. In our view, this is grounded in corporate finance theory where seniority matters to required returns and that perpetuals as hybrids can be more debt-like or equity-like at various points of their existence (eg: issuer credit quality, interest rate environment). We also sought to find out if there was a common spread differential between yields-in-perpetuity and dividend yields across various REITs. Based on observations of the SGD REIT perpetuals we cover, we find that in practice, yield in perpetuity for bulk of the REIT perpetuals indeed trade tighter versus dividend yields. However, we find no consensus view on the quantum of spread differential which we think is driven by the lack of overlap between REIT perpetual investors and REIT equity investors. And even more interestingly, we find the only two outliers being LMRT's perpetuals.

- **What's happening to LMRT perpetuals?** Within the curve, we continue to prefer the LMRTSP 4.1% '20s (being senior and trading at 10.1% ask yield to maturity 816 bps spread). The LMRT perpetuals though are trading at yield in perpetuity in excess of current dividend yield of 6.03%. This indicates to us three possibilities (1) Common equity holders are pricing the equity wrongly (2) The perpetual prices are too low or both (1) and (2) are in part correct.

- **LMRT likely need to raise equity to get Puri Mall done:** As at 31 December 2018, aggregate leverage was 34.6%. Given the large scale of Puri Mall, it is likely that both equity and debt would be needed to fund the purchase. The exact funding structure has not been finalised while the acquisition itself is subject to unitholders approval. Currently, LMRT has 2.86bn outstanding shares with a market cap of SGD569mn (20 cts per unit). Given the impending changes at LMRT, it is uncertain what dividend yields would be, although we can put some parameters around it to work backwards towards a fair value view of the perpetuals.

Our base case assumptions:

A) Puri Mall purchase and equity funding approved by unitholders, deal completes.
B) Puri Mall funded via a 58.1% debt and 41.9% equity structure with 1.5bn new units to be issued to raise SGD180mn (per one of LMRT's illustrative scenarios).
C) Dividends per unit of 1.61 cents with a 58.1% debt and 41.9% equity structure (per one of LMRT's illustrative scenario).
D) Given the scale of equity to be raised, we assume that LMRT will fund the equity portion via a rights issue offering at an exercise price of 12 cents per unit (being SGD180mn divided by 1.5bn units)
E) Theoretical ex-rights price of 17 cents

- **Forming a basis for comparison:** REIT perpetuals in SGD have standardised structures with no step-up margin and a first call after five years from issuance. Despite not having step-ups, we think REITs may have higher incentive to call if they want to continue accessing the perpetual market, given their aggregate leverage caps. As such we hold the view that cost of funding is only one consideration for REITs. Outside of LMRT and FIRT, we find only one REIT perpetual which in our view has a low probability of call at first call, with the rest having at least a 50:50 probability of a call at first call. ESR-REIT ("EREIT", Issuer Profile: Neutral (4)) priced the EREIT 4.6%-PERP in October 2017 with a first call date in November 2022. Per our estimations, we think a hypothetical replacement perpetual in 3.6 years' time for EREIT may be 80-100bps higher than the 4.6% distribution rate. While we see EREIT's issuer profile as stable, cost advantages are significant enough for us to deem the probability of a call as low.

- **Fair value for the LMRT perpetuals:** In our view, the high cost of a hypothetical replacement perpetual and LMRT's issuer profile increases the probability of non-call at first call; consequently we think the LMRT's perpetuals should trade more equity-like. Our base case dividend yield for LMRT is between 9.4% - 13.4%, with 9.4% on a more stabilised basis and 13.4% at the extremity. The widest dividend yield in the S-REIT space is 9.7% currently; making it less likely that LMRT would breach this. Given the lack of perfect comparables, we take the ~100bps spread differential between EREIT's dividend yield and perpetual yield in perpetuity as the best basis we can have for now. Net-net, we view fair value of the LMRT perpetuals at 8.4% on a stabilised basis.

- **Fair value of FIRT perpetual:** While concerns over FIRT's structural linkages with LK persist, the involvement of OUE as new Sponsor may speed up FIRT's income diversification. FIRT may lever up to buy new properties in the next 12 months though we expect the REIT to fund this optimally and the issuer profile to remain unchanged from current levels. Using the same methodology from LMRT (ie: 100bps less than dividend yield of 8.5%) we see fair value of the FIRTSP 5.68%-PERP's yield in perpetuity at 7.0% - 7.5%. While we deem this perpetual as equity-like, we see the risk of FIRT missing the call at first call as lower than LMRTSP. We are of this view due to the following reason: While FIRT still faces challenges in accessing fixed income markets, this may improve overtime as the change in Sponsor to OUE increases the bankability of FIRT. As a knock-on effect, should FIRT's accessibility to markets improve, a hypothetical replacement perpetual may come in closer to the distribution rate of 5.68%, which encourages FIRT to call.

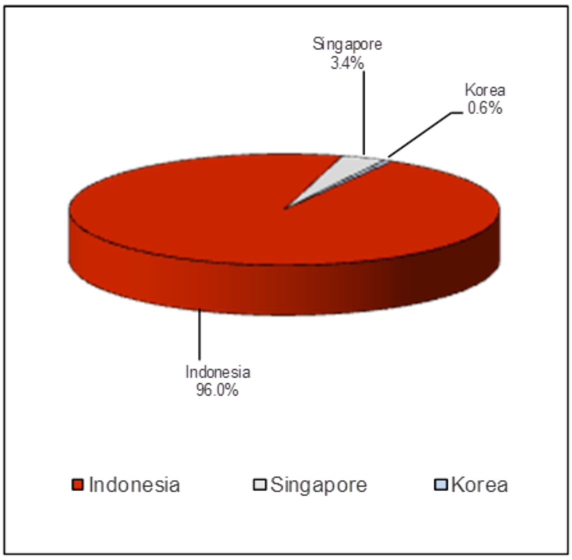
First Real Estate Investment Trust

Table 1: Summary Financials

Year Ended 31st Dec	FY2016	FY2017	FY2018
Income Statement (SGD'mn)			
Revenue	107.0	111.0	116.2
EBITDA	94.9	98.2	102.5
EBIT	94.9	98.2	102.5
Gross interest expense	17.8	17.8	21.6
Profit Before Tax	64.2	93.6	74.8
Net profit	40.3	73.4	75.9
Balance Sheet (SGD'mn)			
Cash and bank deposits	33.6	15.7	27.8
Total assets	1,341.2	1,423.8	1,438.8
Short term debt	142.0	198.3	109.7
Gross debt	413.6	476.4	496.4
Net debt	380.0	460.7	468.7
Shareholders' equity	838.6	852.3	869.2
Cash Flow (SGD'mn)			
CFO	81.5	72.7	73.3
Capex	0.0	0.0	0.1
Acquisitions	39.2	72.5	1.2
Disposals	8.2	0.0	0.0
Dividends	56.7	66.4	68.8
Interest paid	16.2	16.1	16.9
Free Cash Flow (FCF)	81.5	72.7	73.3
Key Ratios			
EBITDA margin (%)	88.63	88.47	88.24
Net margin (%)	37.70	66.16	65.30
Gross debt to EBITDA (x)	4.36	4.85	4.84
Net debt to EBITDA (x)	4.01	4.69	4.57
Gross Debt to Equity (x)	0.49	0.56	0.57
Net Debt to Equity (x)	0.45	0.54	0.54
Gross debt/total asset (x)	0.31	0.33	0.35
Net debt/total asset (x)	0.28	0.32	0.33
Cash/current borrowings (x)	0.24	0.08	0.25
EBITDA/Total Interest (x)	5.34	5.51	4.74

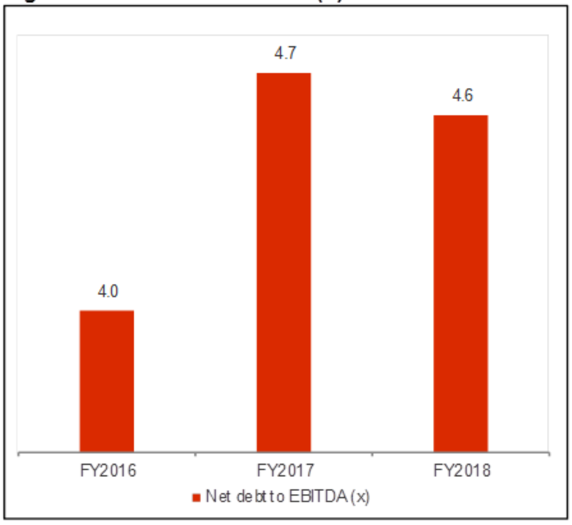
Source: Company, OCBC estimates

Figure 1: Revenue breakdown by Property - FY2018



Source: Company

Figure 2: Net debt to EBITDA (x)



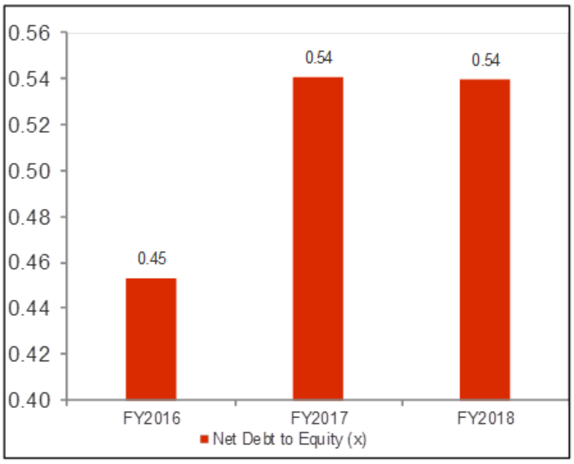
Source: Company

Figure 3: Debt Maturity Profile

Amounts in (SGD'mn)	As at 31/12/2018	% of debt
Amount repayable in one year or less, or on demand		
Secured	386.8	77.9%
Unsecured	0.0	0.0%
	386.8	**77.9%**
Amount repayable after a year		
Secured	0.0	0.0%
Unsecured	109.7	22.1%
	109.7	**22.1%**
Total	**496.4**	**100.0%**

Source: Company

Figure 4: Net Debt to Equity (x)



Source: Company, OCBC estimates

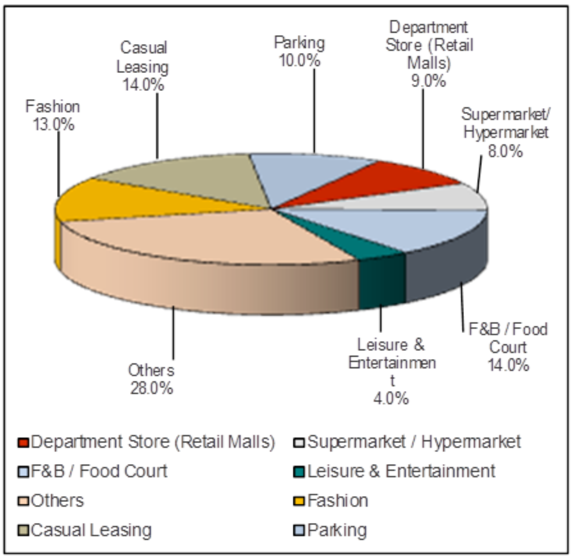
Lippo Mall Indonesia Retail Trust

Table 1: Summary Financials

Year Ended 31st Dec	FY2016	FY2017	FY2018
Income Statement (SGD'mn)			
Revenue	188.1	197.4	230.3
EBITDA	149.4	186.8	158.5
EBIT	159.6	171.3	152.9
Gross interest expense	44.5	40.4	34.7
Profit Before Tax	53.4	88.1	99.6
Net profit	28.8	62.7	60.9
Balance Sheet (SGD'mn)			
Cash and bank deposits	77.8	64.9	52.7
Total assets	2,065.2	2,063.9	1,966.2
Short term debt	124.3	268.5	120.0
Gross debt	640.9	688.3	674.0
Net debt	563.1	623.4	621.3
Shareholders' equity	1,232.6	1,167.9	1,079.2
Cash Flow (SGD'mn)			
CFO	143.7	142.7	138.2
Capex	14.8	51.3	11.8
Acquisitions	88.3	133.4	0.0
Disposals	0.0	0.0	0.0
Dividends	93.8	112.8	89.7
Interest paid	38.8	27.0	31.3
Free Cash Flow (FCF)	128.9	91.5	126.4
Key Ratios			
EBITDA margin (%)	79.46	94.62	68.84
Net margin (%)	15.33	31.77	26.46
Gross debt to EBITDA (x)	4.29	3.69	4.25
Net debt to EBITDA (x)	3.77	3.34	3.92
Gross Debt to Equity (x)	0.52	0.59	0.62
Net Debt to Equity (x)	0.46	0.53	0.58
Gross debt/total asset (x)	0.31	0.33	0.34
Net debt/total asset (x)	0.27	0.30	0.32
Cash/current borrowings (x)	0.63	0.24	0.44
EBITDA/Total Interest (x)	3.36	4.62	4.58

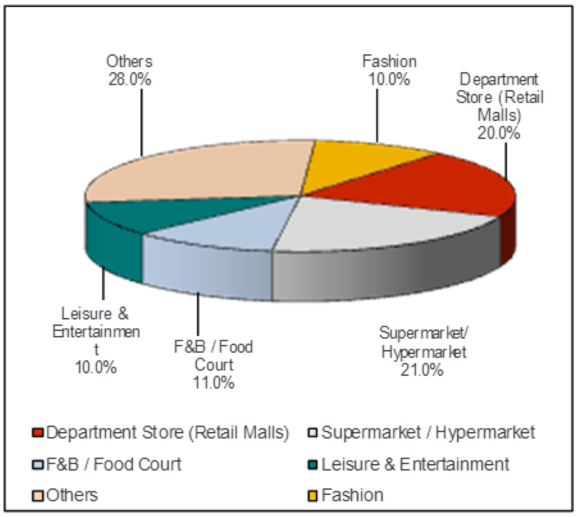
Source: Company, OCBC estimates

Figure 1: Revenue breakdown by Segment - FY2018



Source: Company

Figure 2: NLA breakdown by Segment - FY2018



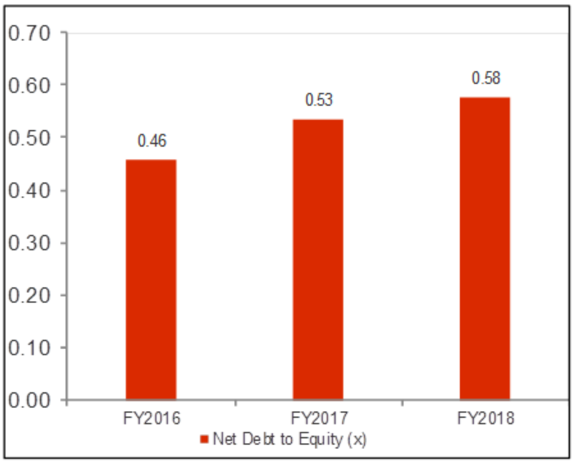
Source: Company

Figure 3: Debt Maturity Profile

Amounts in (SGD'mn)	As at 31/12/2018	% of debt
Amount repayable in one year or less, or on demand		
Secured	0.0	0.0%
Unsecured	0.0	0.0%
	0.0	**0.0%**
Amount repayable after a year		
Secured	120.0	17.8%
Unsecured	554.0	82.2%
	674.0	**100.0%**
Total	**674.0**	**100.0%**

Source: Company

Figure 4: Net Debt to Equity (x)



Source: Company, OCBC estimates

Analyst Declaration

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

Disclaimer for research report

Co.Reg.no.:193200032W