Asia Credit Research

Earnings Review: Keppel Real Estate Investment Trust ("KREIT")

Issuer Profile: Neutral (4)

Ticker: **KREITS**

Background

Keppel REIT ("KREIT") focuses on premium office assets and has an AUM of SGD8.1bn. 81.3% of the portfolio in Singapore, with the balance in Australia. Singapore assets are mainly stakes in Grade A office assets in the CBD, such as Ocean Financial Centre ("OFC", 79.9%-stake), Marina Bay Financial Centre ("MBFC", 33%-stake), and One Raffles Quay ("ORQ", 33%-stake). KREIT is 47.4% owned by Keppel Corp ("KEP"), it's Sponsor.

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Recommendation

- KREIT's result has weakened on a year-on-year basis in 4Q2018, even though the outlook on the office market remained largely positive. This was largely due to the lower property income, total return before tax and portfolio occupancy rate recorded over the quarter. Having said that, aggregate leverage improved to 36.3% from a high of 39.1% in the preceding quarter, mainly on the back of the repayment of SGD300mn worth of loans with the proceeds from divesting a 20%-stake in OFC. We **maintain our Neutral (4) Issuer Profile for KREIT**.
- We prefer FHREIT curve to KREIT curve given that the entire FHREIT curve is priced wider despite having a stronger credit profile at Neutral (3) Issuer Profile, a notch higher than KREIT.
- FHREIT 4.45%-PERP offers a 48bps pickup which more than compensates for a 6-month longer first call date. Likewise, we think FHREIT '22s and '24s provide better value than KREITS '22s and '24s.

Relative Value:

Bond	Maturity/Call date	Aggregate leverage	Ask Yield	Spread
KREITS 3.15% '22	**11/02/2022**	**36.3%**	**3.04%**	**104bps**
KREITS 3.275% '24	**08/04/2024**	**36.3%**	**3.32%**	**125bps**
KREITS 4.98%-PERP	**02/11/2020**	**36.3%**	**3.71%**	**172bps**
FHREIT 2.63% '22	06/07/2022	33.6%	3.16%	114bps
FHREIT 3.08% '24	08/11/2024	33.6%	3.37%	126bps
FHREIT 4.45%-PERP	12/05/2021	33.6%	4.34%	234bps

Indicative prices as at 24 January 2018
Source: Bloomberg
Aggregate leverage based on latest available quarter

Key Considerations

- **Lower "Other Income" dragged property income, apart from lower occupancies:** KREIT reported 4Q2018. Property income slipped 14.8% y/y to SGD37.8mn. Likewise, net property income ("NPI") declined in tandem by 15.8% y/y to SGD30.5mn. Lower occupancies at OFC (4Q2018: 96.1%, 4Q2017: 100%), 275 George Street (4Q2018: 99.3%, 4Q2017: 99.7%) and 8 Exhibition Street (4Q2018: 98.7%, 4Q2017: 99.7%) accounted for a 6.5% y/y fall in property income, while the balance 8.1% y/y decline was due to SGD3.6mn lower "Other Income". Unfortunately, there is no disclosure on what comprised "Other Income". We think "Other income" recorded in 4Q2017 is most likely related to OFC, given its property income grew most significantly by 16.8% q/q relative to the other properties which saw a single digit q/q change. Separately, KREIT also saw a jump in "Other Income" in 2Q2018 due to early surrender of leases by Australia & New Zealand Banking Group Ltd at OFC. Excluding 'Other Income', property income would have declined 7.5% y/y in 4Q2018.

- **Weaker bottom line:** Total return before tax fell sharply by 27.4% y/y to SGD60.8mn from SGD83.8mn. This was largely due to the fair value gain on investment properties coming down by 35.9% y/y (i.e. SGD18.6mn) and a lower share of results of associates and joint ventures of SGD3.5mn (-12.6% y/y). The latter was mainly a result of lower dividend income from MBFC, which fell by 25.3% y/y i.e. SGD4.0mn. We note that MBFC been recording lower dividend income year-on-year since the start of 2018 (3Q2018: -26.8% y/y, 2Q2018: -23.4% y/y, 1Q2018: -17.7% y/y, 4Q2017: +10.0% y/y). Given the decline seen at MBFC (NLA: 1.74mn sq ft) coincided with the opening of Marina One (NLA: 1.88mn sq ft) which inaugurated on 15 January 2018 and is located 300 metres away by foot, we believe it could be related expenses incurred to retain tenant. Total contribution from MBFC (i.e. dividend income, rental support and interest income) though fell by a smaller extent of 15.1% y/y (3Q2018: -15.7% y/y, 2Q2018: -14.6% y/y, 1Q2018: -13.4% y/y, 4Q2017: +6.1% y/y). Other assets that have weakened are (1) 275 George Street which saw property income fall by 23.2% y/y and NPI fall by 28.3% y/y though occupancy rate only dipped by 0.4% to 99.3% and (2) ORQ which saw NPI fall by 14.9% y/y while occupancy rate slipped 3.9% from full occupancy to 96.1%.

- **Portfolio statistics has weakened y/y despite q/q improvements:** Overall portfolio committed occupancy stood at 98.4% (4Q2017: 99.7%, 3Q2018: 98.0%). Retention rate for KREIT was 83% in FY2018, down from 95% a year ago. While average signing rent for Singapore offices was higher in FY2018 at ~SGD11.10 psf pm compared to ~SGD9.80 psf pm in FY2017 (CBRE average Grade A office rents – 2018: SGD10.26 psf pm, 2017: SGD9.10 psf pm). We note that this is an industry wide trend since office rental bottomed out in 2Q2017. Given that KREIT has just 4.2% and 0.4% of leases by NLA expiring and due for review respectively in 2019, we think there is little room for KREIT to ride the recovery wave in the office market (in the short term) even though the outlook remains positive. WALE for the portfolio is 5.9 years (4Q2017: 5.5 years).

- **Manageable credit metrics:** Reported aggregate leverage fell to 36.3% (3Q2018: 39.1%) largely due to the repayment of SGD300mn of loans with parts of the proceeds from divesting a 20%-stake in OFC over the quarter. All-in interest rate inched higher to 2.81% from 2.80% in 3Q2018 while interest coverage ratio was 3.9x (3Q2018: 4.0x). KREIT continued its unit buy-backs in 4Q2018 and has purchased and cancelled ~28.3mn issued units in 2018. We think the SGD538mn debt (18% of total debt) coming due within the year is manageable given KREIT has SGD258.9mn of 'Cash and bank balances' and only Bugis Junction Towers out of all its assets is encumbered. 84.0% of total assets remained unencumbered.

- **Making process in Australia:** 8 Exhibition Street, Melbourne, currently 98.7% occupied, will undergo AEI in 1H2019 to improve amenities. Looking further ahead, 311 Spencer Street, Melbourne which KREIT has a 50%-stake, is currently under construction. The commencement of the 30-year lease to the Victoria Police has been pushed back to 1H2020 from the previous estimate - 4Q2019. Management expects this property to contribute a steady income stream given the profile of the tenant. In addition, the lease includes a market rent review at the start of year 16 and options to renew for three additional terms of five year end.

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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.

Underweight ("UW") – The performance of the issuer's specific bond is expected to underperform 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.

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.

Co.Reg.no.:193200032W