

Industrial REITs: Sector Update

Tuesday, 06 September 2016

Getting stoked on Australia

- Overall weakening in the Singapore industrial space sector persists, though sectorial credit profiles remain stable against 1Q2016. Significant new industrial supply coming in for the remaining of 2016 and 2017, though we expect supply-demand imbalances to rectify from 2018 onwards.
- Low risk in business space but other sub-segments will continue to be weak. Landlords are responding more dynamically as bargaining power wrests with tenants.
- Capital allocation will be channeled towards investments in Australia and we see no abating of this trend despite our moderate outlook towards the Australian industrial space sector. We think that due to the shallow nature of the domestic corporate bond market in Australia, Singapore Industrial REITs would continue to raise unsecured financing outside of Australia (including SGD bonds) to fund their Australian activities.
- Among the five key industrial markets in Australia, Sydney is the healthiest, in our view, followed by Melbourne, Adelaide and Brisbane. Perth continues to be challenging following the pressures seen in Australia's resource sectors.
- **Recommendation:** Industrial REITs continue to play a defensive role in a bond portfolio. Our top picks are Cambridge Industrial's Trust's CREITSP'18 and Soilbuild Business Space REIT's SBREIT'18s. Both are similarly rated at Baa3 but trading wider than ARTSP'18 (spread pickup of 40-50 bps). Despite being smaller, both Industrial REITs have a less leveraged profile compared to ARTSP. Within the perpetual universe, we prefer Mapletree Logistics Trust's MLTSP'49c21 over Singapore Post Ltd's SPOST'49c22 (spread pickup of 40bps) and recommend a switch. MLTSP has a corporate credit rating of Baa1 by Moody's while SPOST has a corporate credit rating of A- by S&P.

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Issuer	Issue	Maturity / First Call Date	Outstanding Amount (SGDm)	Ask Price	Ask YTW	I-Spread	Bond Rating
AAREIT	AAREIT 3.8 '19	21/05/2019	50	101.32	3.28	178	BBB-/NR/NR (Issuer)
AAREIT	AAREIT 4.35 '19	05/12/2019	30	102.00	3.69	212	BBB-/NR/NR (Issuer)
AREIT	AREIT 2.5 '19	16/05/2019	95	101.40	1.96	45	NR/A3/NR
AREIT	AREIT 2.95 '20	03/08/2020	100	102.50	2.28	65	NR/A3/NR
AREIT	AREIT 4 '22	03/02/2022	200	106.85	2.63	89	NR/A3/NR
AREIT	AREIT 3.2 '22	03/06/2022	150	103.50	2.54	78	NR/A3/NR
AREIT	AREIT 4.75 '49c20	14/10/2020	300	104.85	3.47	182	NR/Baa2/NR
CREIT	CREISP 3.5 '18	05/11/2018	155	102.00	2.54	109	NR/Baa3/NR
CREIT	CREISP 4.1 '20	29/04/2020	30	103.50	3.08	147	NR/Baa3/NR
CREIT	CREISP 3.95 '20	21/05/2020	130	103.00	3.09	147	NR/Baa3/NR
CREIT	CREISP 3.95 '23	09/05/2023	50	101.92	3.62	181	NR/Baa3/NR
MINT	MINTSP 3.75 '19	08/03/2019	125	103.75	2.20	71	NR/NR/BBB+
MINT	MINTSP 3.65 '22	07/09/2022	45	103.75	2.96	118	NR/NR/BBB+
MINT	MINTSP 3.79 '26	02/03/2026	60	105.31	3.14	117	NR/NR/BBB+
Sabana	SSREIT 4.00 '18	19/03/2018	90	98.15	5.28	390	NR/NR/NR
Sabana	SSREIT 4.25 '19	03/04/2019	100	97.00	5.52	403	NR/NR/NR
SBREIT	SBREIT 3.45 '18	21/05/2018	100	101.35	2.63	123	NR/Baa3/NR (Issuer)
SBREIT	SBREIT 3.6 '21	08/04/2021	100	100.70	3.43	175	NR/Baa3/NR
VIVA	VITSP 4.15 '18	19/09/2018	100	100.35	3.97	254	BB+/NR/NR
MLT	MLTSP 5.375 '49c17	19/09/2017	350	103.05	2.34	102	NR/Baa3/NR
MLT	MLTSP 4.18 '49c21	25/11/2021	250	102.75	3.59	187	NR/Baa1/NR (Issuer)

Note: (1) Indicative prices as at 5th September 2016

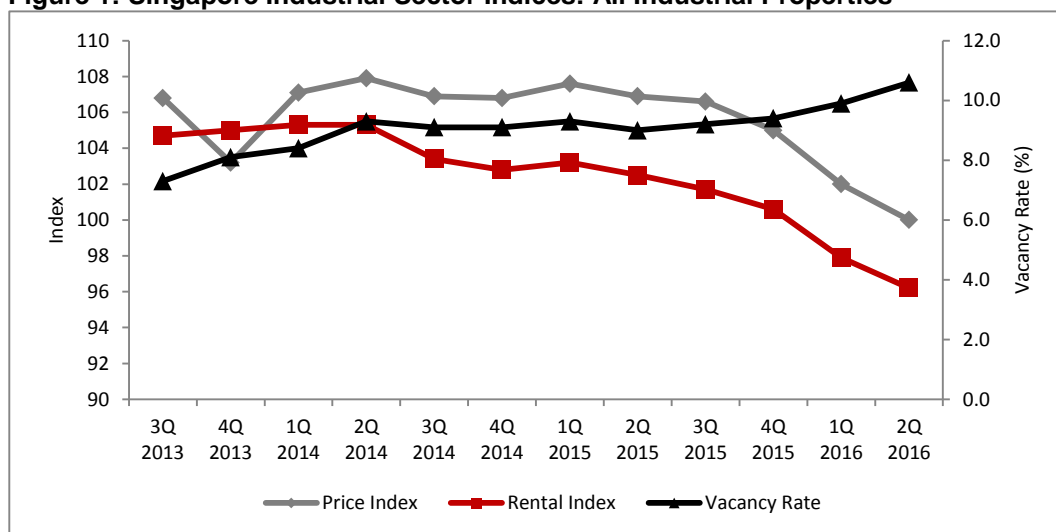
(2) Bond Rating is used except where specified

(3) VIVA corporate credit rating is held at BB by S&P

A) 2Q2016 Singapore Industrial Update

Based on JTC's 2Q2016 quarterly market report for industrial properties, overall all indicators saw a drop from the immediately preceding quarter, with the price index now at levels last seen in 2012 (before the surge in prices seen in 2013 and 2014). Distinction between traditional industrial property segments and business parks is increasingly obvious, with business parks seeing rental increases (104.4 in 2Q2016 against 103.9 in 1Q2016). Although occupancy rates for business parks have declined slightly, this is still relatively stable against its historical trend. We think directionally, business parks will be stable and not susceptible to the impending glut facing the rest of the industrial sub-segments. Over the next few years, the segment will only see 44,000 sqm of space coming online. For other segments, improvements post-2017 should happen as the supply/demand situation becomes more balance. We are likely to see landlords start taking in shorter term tenants both driven by landlords seeking to keep occupancy high (in line with what has been done in the Retail REITs space) and tenants bargaining for shorter leases as they face an uncertain economic environment.

Figure 1: Singapore Industrial Sector Indices: All Industrial Properties

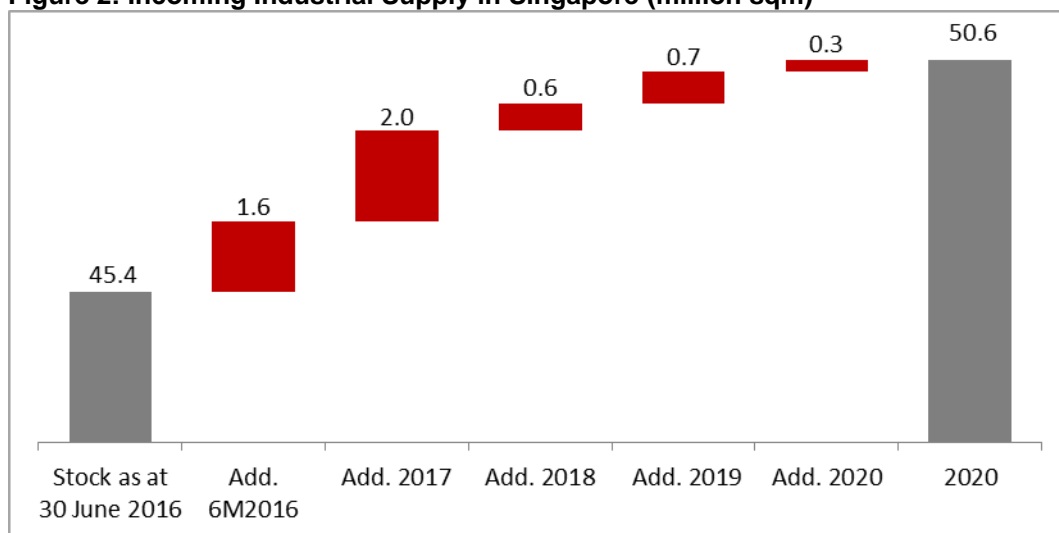


Source: JTC Quarterly Market Report for 2Q2016; price and rental indices

B) Impending Supply Glut but Should taper off post-2017

While Singapore's industrial supply glut has been dominating headlines since the second half of 2015, we expect the sector to start bottoming out towards second half 2017 as landlord's bargaining power should improve by then. Based on JTC data, over the last 3 years, average demand for industrial properties was ~1.2mn sqm (against an annual supply of 1.8mn sqm). Singapore has had an annual surplus of industrial space since 2013. Per JTC, around 1,400 units, totalling about 430,000 sqm in uncompleted strata-titled developments remained unsold as of June 2016. This implies about 307 sqm per unit. We think these remaining unsold units are unlikely to compete head-to-head with single-tenanted properties (those catering to tenants who require larger space) but will continue to pressure lease rates of multi-tenanted buildings. Vacancy rates of multi-tenanted buildings are likely to be compounded by some landlords converting their single-tenanted buildings into multi-tenanted buildings as leases start falling off. Overall, the Singapore industrial property market will continue to be a tenant's market for the remainder of 2016 and into 2017. As of 2Q2016, weighted average lease expiries of our coverage universe remains steady within the 3 – 4 year range but we expect to see lease tenures within Singapore shortening and lease rates soft from now until mid-2017.

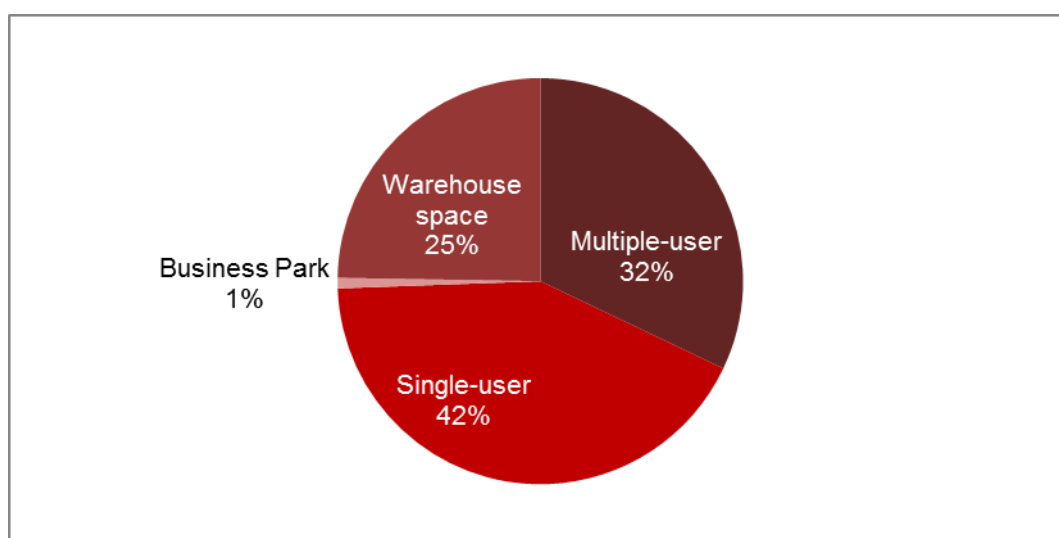
Figure 2: Incoming Industrial Supply in Singapore (million sqm)



Source: JTC Quarterly Market Report for 2Q2016

Note: Assumes no disposal from property stock

Figure 3: Upcoming Supply by Industrial Sub-segment – Singapore



Source: JTC Quarterly Market Report for 2Q2016

Note: Accumulated incoming industrial space from 1 July 2016 and beyond (total of 5.3mn sqm)

C) Credit Ratios Stable Against 1Q2016

Leverage: Compared to the immediately preceding quarter, leverage as measured by total debt-to-total asset declined to 36.5% as at 30 June 2016 (2Q2016) from 37.2% as at 31 March 2016 (1Q2016). This was in part driven by the use of perpetual securities. Rating agencies have tended to be more conservative, only giving a 50% equity credit for S-REIT perpetuals, though we note these securities are being treated as full equity for accounting and MAS purposes. Thus far, two Industrial REITs have issued perpetuals. Adjusting 50% of the outstanding value on the perpetual securities as debt, we find AREIT's adjusted debt-to-total asset to have kept constant at 38.8% against 1Q2016. MLT's adjusted leverage ratio goes beyond 40% at 41.3%, though lower than the 42.8% as at 31 March 2016.

Coverage: Coverage ratios (as measured by EBITDA/Gross interest) for the first half of 2016 declined slightly to 4.1x (1H2015: 4.2x). Nevertheless, this is still safely above covenanted levels of 1.5x which have been stipulated across the smaller-scale Industrial REIT universe. (i) Adjusting for 50% of perpetual distribution, we find that adjusted coverage (EBITDA/Gross interest plus 50% of perpetual distribution) for AREIT to be 4.3x (1H2015: 5.5x). For MLT, this is 4.4x in 1H2016 (1H2015: 5.4x). (ii) Assuming 100% of perpetual distribution within coverage ratios, AREIT's adjusted coverage (EBITDA/Gross interest plus 100% of perpetual distribution) is 4.1x in 1H2016 (1H2015: 5.5x). MLT's will be 3.8x in 1H2016 (1H2015: 4.5x).

Both leverage and coverage has been kept comfortable with the rise of perpetual securities.

Going forward, we expect to see the perpetual securities to be used among smaller Industrial REITs as a means to shore up capital. We continue to hold the view that in practice, REITs (which trade as yield instruments in equity markets) are unlikely to see deferral of distributions on perpetuals unless in distressed situations. Thus far, the use of perpetuals is minimal at AREIT, representing only 3% of total assets. However, perpetuals now represent 11% of MLT's total assets, rising from 7% in March 2016. In our view, this is still manageable but caution a hampering in financial flexibility should MLT's straight debt to total asset creeps back up to ~40%.

Figure 4: Credit Ratios of Industrial REITs Under Coverage

REIT	Aggregate Leverage (%)		EBITDA/Gross Interest (x)		Debt Duration (in years)	
	30-Jun-16	31-Mar-16	1H2016	1H2015	30-Jun-16	31-Mar-16
As at						
AAREIT	33.1	32.4	3.6	3.3	1.9	2.2
AREIT	37.0	37.2	4.6	5.4	3.3	3.4
CREIT	37.4	37.1	3.6	3.2	3.1	2.9
MINT	28.2	28.2	8.6	8.3	3.7	4.0
MLT	35.7	39.6	5.4	6.8	3.6	3.5
Sabana	41.2	39.6	2.5	3.1	1.6	1.8
SBREIT	35.9	36.0	4.5	4.4	3.4	3.0
VIVA	40.0	37.6	3.0	3.9	3.7	4.0
Median	36.5	37.2	4.1	4.2	3.4	3.2

Source: REIT financial statements and company presentations for the quarter ended 30 June 2016

Note: (1) Gross interest for AREIT excludes loss of fair value from Exchangeable Collateralised Securities

(2) Post refinancing in August 2016, debt duration for AAREIT and Sabana has extended beyond 2 years

D) Credit Rating Agency Actions in 1H2016

Of the 8 Industrial REITs we cover, 7 are rated by international rating agencies. In June 2016, Sabana withdrew its rating. This came around the time of a rating downgrade by S&P from BBB- to BB+ with a Stable outlook. In August 2016, SBREIT's outlook was put on Negative from Stable, though the rating itself was reaffirmed at Baa3. Despite the overall weaker industrial property sector outlook, we see such actions as confined to the specific REITs and not a reflection of a possible contagion. We continue to see SBREIT's credit profile as defensive. SBREIT is undergoing a preferential equity offering which will keep funding of the Bukit Batok asset at ~60:40 debt-equity, an optimal structure in our view. Sabana had saw its property valuations fall following the expiry of some Master Leases which were entered into at the time of IPO. Both REITs continue to provide interesting risk/reward opportunities for investors where rating is not a concern. We maintain SBREIT at Neutral and Sabana at a Negative issuer profile.

E) Looking Under the Hood – Australia

Since 2015, Industrial REITs listed on the SGX have intensified their move into Australia. Sector-wide, Industrial REIT bond issuers in Singapore hold SGD24bn (as at 30 June 2016) worth of property assets. For these issuers, Australia makes up SGD1.5bn or about 6% of the total and this amount could rise to SGD1.9bn by year end (assuming no debut issuers). Going forward, we expect bond issuers to further allocate capital for Australian assets. For example, AREIT's latest equity exercise in August 2016 has been earmarked to partially fund SGD185mn of potential investments in Sydney and Melbourne.

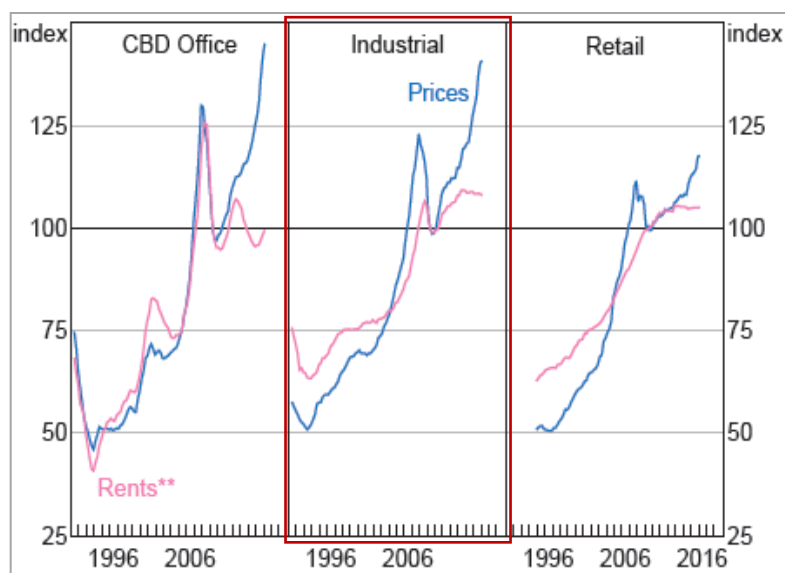
There is one Australian industrial property focused-REIT listed on the SGX (ie: Frasers Logistics & Industrial Trust) and one more possibly on the way (proposed asset injection of Sime Darby's Australian industrial assets into Saizen REIT). In our view, Singapore Industrial REITs are attracted to Australia due to its relatively attractive lease structures (longer leases with built-in rental reversions, freehold status) and lack of acquisition opportunities in Singapore which are accretive on an unleveraged basis vis-à-vis their cost of equity. For now, we expect Singapore REITs to hedge AUD currency exposures, given the general reluctance

of unitholders to bear currency risk.

Australia is made up of 7 states and the Australian Capital Territory (where the country's capital city Canberra is located). Four states, namely New South Wales ("NSW"), Victoria, Queensland and Western Australia contribute ~90% of the country's GDP. Economic activity for the more diversified states of NSW, Victoria and South Australia is concentrated within their respective capital cities. According to SGS Economics & Planning, Sydney and Adelaide contributes 75% to NSW and South Australia respectively while Melbourne dominates 80% of Victoria's GDP. Queensland and Western Australia, being more resource driven sees a lower representation of economic activity from their capital cities. Brisbane contributes 52% to Queensland while Perth contributes 56% to Western Australia. Broadly, the Australian industrial space market can be evaluated as five distinct markets: Sydney, Melbourne, Brisbane, Perth and Adelaide.

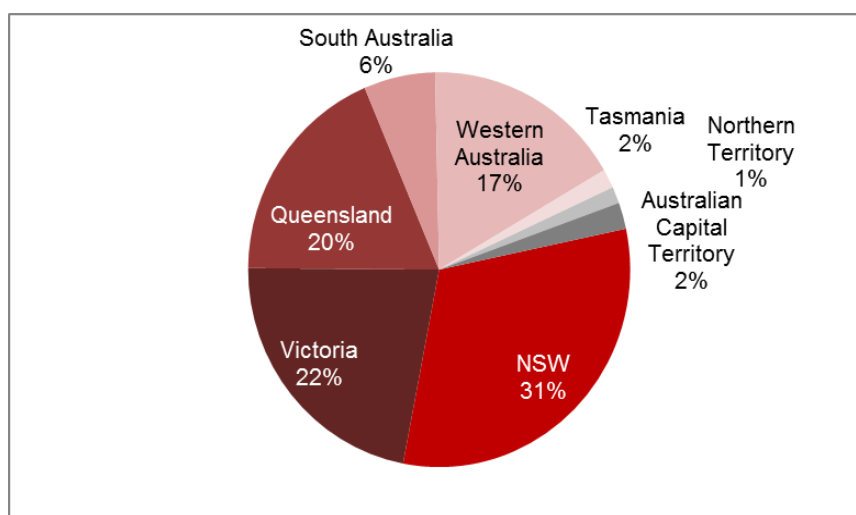
Driven by a lower interest rate environment and increasing investor demand (including strong foreign buyer activity), we have seen significant increases in asset prices and yield compression across all industrial property markets in Australia. Across certain cities, vacancy has been high, signalling indigestion which may lead to falling rents and prices (apart from inner-city industrial properties undergoing gentrification into non-industrial use).

Figure 5: Price Index for Australian Properties (Year 2009 =100)



Source: Australian Bureau of Statistics, Jones Lang LaSalle, Reserve Bank of Australia ("RBA"). Chart extracted from RBA's Financial Stability Review April 2016

Figure 6: Breakdown of Australian GDP by state



Source: Australian National Accounts, State Accounts, SGS Economic & Planning
 Note: 2015 Australia GDP: AUD1,620 bn

Industrial REIT Bond Issuers - Current Australian Exposures

AAREIT	<ul style="list-style-type: none"> Sponsors AIMS Financial Group and AIMS Capital are based in Australia Entered the Australian market via the acquisition of Optus Centre in Macquarie Park, North Sydney in February 2014 Continues to evaluate opportunities in the country Australian portfolio: SGD225mn, represents 16% of portfolio as at 30 June 2016
AREIT	<ul style="list-style-type: none"> Acquired a portfolio of 26 Australian logistics and distribution centres in end-2015 from GIC and Frasers Australia Pty valued at SGD1.0bn. Becomes 8th largest industrial property landlord in Australia Subsequently acquired a property in West Sydney in February 2016 for SGD77mn Completed an overnight equity private placement in August 2016 raising SGD155mn that is intended to partially fund the potential acquisition of two properties in Australia (a logistics property in Melbourne and a business park property in Sydney). Property details have yet to be provided Australian portfolio: SGD1.08bn, represents 12% of portfolio as at 30 June 2016
CREIT	<ul style="list-style-type: none"> The National Australia Bank is part-owner of the REIT manager Entered into an alliance with Adelaide-based Commercial and General, a property group in Australia to co-invest in Australian industrial properties in April 2016
MLT	<ul style="list-style-type: none"> Acquired Coles Chilled Distribution in Sydney in August 2015 for SGD255mn Australian portfolio: SGD255mn represents 5% of portfolio as at 30 June 2016 (increased to ~7% on 31 August 2016) Completed the acquisition of SGD87.4mn of warehouses on 31 August 2016 from a real estate private equity fund
VIVA	<ul style="list-style-type: none"> Reportedly in talks with Abacus Property Group, a Sydney-based diversified property group to either buy Abacus' portfolio of Australian industrial assets valued at AUD100mn (~SGD103mn) and/or a partnership for expansion into Australia

Please refer to "Appendix: Major Industrial Markets of Australia" for market outlook for each of the main industrial property markets.

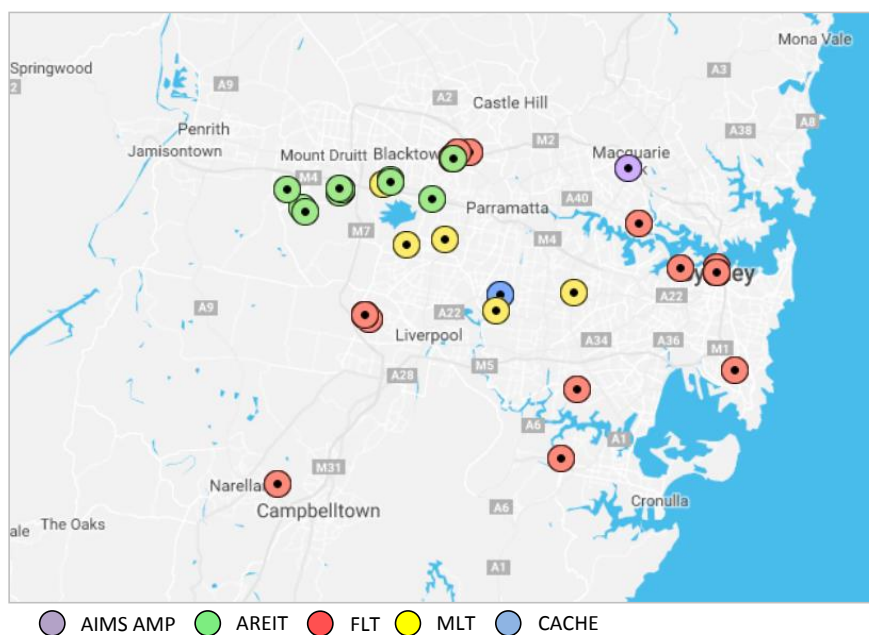
Appendix: Major Industrial Markets of Australia

Sydney – Supply on the Uptrend but Mostly Sunny

Using data from SGS Economics & Planning, Sydney is the largest contributor to Australia by share of GDP (contributing ~23%) with 4.8mn people. The city grew by 3% in 2014-2015, higher than the 2.5% exhibited in the past decade. Financial and professional services are the most important contributors to Sydney's economy (collectively a quarter of gross value added to GDP). Manufacturing contributes less than 6%, of gross value added share of GDP, falling significantly from 1995 when the sector was by far the main economic engine. By value, Sydney is Australia's main industrial city, overtaking Melbourne in recent years. Sydney has focused more on the domestic market and in higher-tech manufacturing such as advanced electronics and biotechnology.

Yield compression has been observed since middle-2013 and according to Knight Frank has declined to 6.7-7.4% as at April 2016. Vacant space¹ was about 478,000 sqm in July 2016, rising 3.7% over the previous quarter but lower than the last few years. Unlike historically observed, prime stock² now makes up 70% of all vacancies (previously, only 47% of vacancy was prime stock). Knight Frank opines that they expect some upward pressure in vacancy rates, with speculative development on the uptrend. Sydney's take-up has been healthy since 2015 but the new impending supply is likely to cap rent upside. Sydney is likely to continue attracting investor demand that will underpin asset price growth and leading to tighter market yields.

Figure 7: Sydney – Singapore Industrial REIT Exposure



Melbourne – Looks toppish

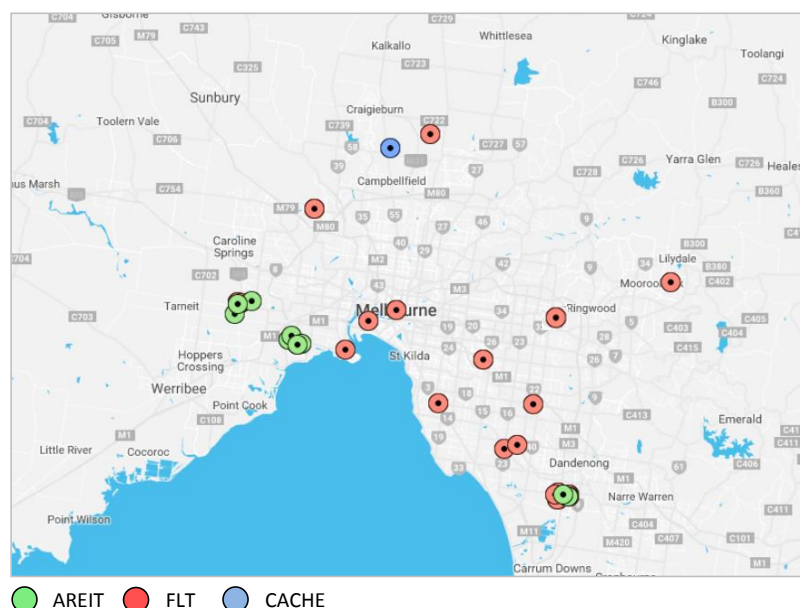
Melbourne is Australia's second largest city by population with 4.5mn people. It is also Australia's largest industrial property market in terms of industrial space and has the largest port in Australia. This makes the city an important logistics, distribution (eg: freight, goods-handling) and warehousing hub of the country. The city grew by 3.1% in 2014-2015, in line with the 3.0% in the past decade. Historically, Melbourne's economic growth was driven by manufacturing (1995: ~18%) using data from SGS Economics & Planning. While the city has managed to transform itself into a more diversified economy (particularly in professional, financial and insurance services), manufacturing remains the third largest contributor to the economy, contributing ~7%. The State of Victoria continues to be committed to investing in infrastructure, announcing AUD22bn to be spent on infrastructure over 4 years in mid-2015. Major projects include a public private partnership ("PPP") to build a subway system, removal of railroad crossings (to decrease transit times), new trains and improving roads.

¹ Knight Frank Research; sample data includes buildings with a minimum floor area of 5,000 sqm

² Prime grade stocks are assets with modern design, good condition & utility with an office component 10-30%. These are located in established industrial precincts with good access. In contrast, secondary stock are assets with older design, in reasonable/poor condition, inferior to prime stock with a smaller office component

According to Knight Frank, market yields have declined to 6.7 – 7.4% for prime assets as at April 2016, with yields having gradually compressed since 2010 and accelerating in 1H2015. As of July 2016, vacant space³ was 1.06mn sqm and 60% higher than historically observed. Net face rents⁴ have been flat, with some declines observed. In December 2013, Australia's only remaining automakers, Ford, Holden and Toyota announced that they will also be closing plants from end-2016 onwards, with the states of South Australia and Victoria expected to take most of the brunt from such fallout (including those of supporting industries). Colliers estimates that the shutdown of such automakers and suppliers could bring about 665,000 sqm in vacancies, although diversification by auto suppliers into other industries is providing some relief. Despite the imbalance in supply-demand, Melbourne is now yielding around the same levels in Sydney. In our view, rental is likely to remain subdued and at risk of declining.

Figure 8: Melbourne – Singapore Industrial REIT Exposure



Brisbane – Soft leasing activities but investments keep asset market buoyed

Brisbane with a population of 2.3mn contributes slightly more than half of Queensland's economy. Growth has moderated on the back of the decline in the resources boom, leading to a pullback in construction activities. Construction is Brisbane's most important economic sector (around 10.5% to the economy). Financial services contribute around 8.5% while manufacturing and healthcare are important sectors contributing more than 7.5% individually. According to SGS Economics & Planning data, Brisbane economy only grew by 0.9% in 2014-2015, declining from the 4% p.a on average over the past decade.

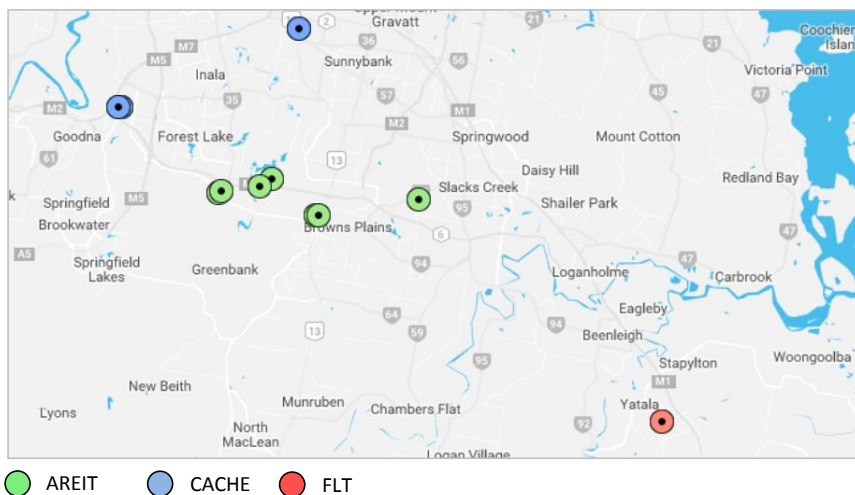
Despite the softer economy, an acceleration of market yield compression was seen since end-2014, driven by investor demand. According to Knight Frank, market yields have declined to 7.0-7.7%. Vacant space⁵ as at July 2016 amounted to around 620,000 sqm, representing 46% above the long term average, but improved from the same time last year where vacancy was ~698,000 sqm. According to Knight Frank, time on market across available space was 17.4 months, (increasing from ~14 months in the same period last year). Average prime rents for existing buildings have fallen 3% for the 12 months to 30 April 2016, and we expect rentals to continue being soft in the next 6-12 months with market rents lower than passing rents. Knight Frank has opined that negative rental reversions are expected as leases fall off. We think that some owners could also see a hit to asset valuation, especially if such assets were bought based on valuation tagged to pre-existing lease terms, rather than the lower prevailing market yield.

³ Knight Frank Research; sample data includes buildings with a minimum floor area of 5,000 sqm

⁴ Quoted rent before taking into account of incentives, excluding building costs

⁵ Knight Frank Research; sample data includes buildings with a minimum floor area of 3,000 sqm

Figure 9: Brisbane – Singapore Industrial REIT Exposure



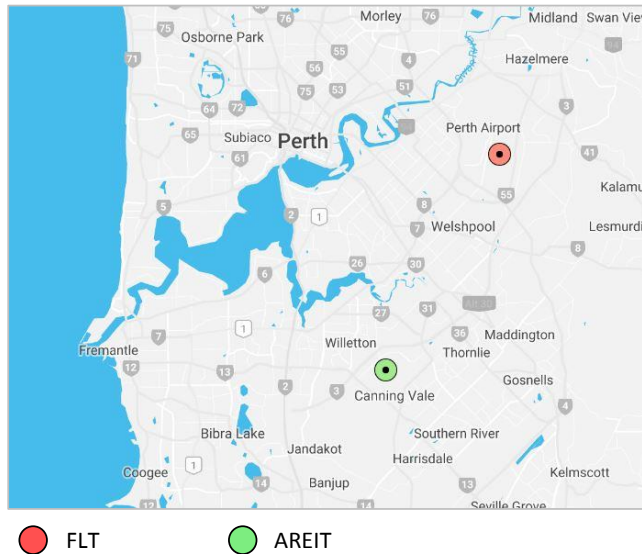
Perth – Still trying to find an anchor in the storm

Perth is a regional capital city with 1.8mn people. With the bursting of the resources boom, the city’s economic environment continues to be challenging. According to data from SGS Economics & Planning, as of June 2015, the construction sector is by far Perth’s most important contributor, making up 16% of Perth’s economy (rising from only 7% in 1995). Professional services, mining and healthcare are important, with each contributing around 7%. Manufacturing makes up slightly less than 6% of GDP. GDP growth has declined to only 0.3% for 2014-2015, marking a steep decline from the 5.3% p.a on average over the past decade where Perth grew faster than the rest of the country.

According to Knight Frank, market yields have declined to 7.0-8.3% for prime assets, with yields gradually declining since early-2014. Vacant space for the quarter ended 31 July 2016 was about 687,000 sqm⁶, more than double the long term average and dominated by secondary grade properties. As a result of supply-demand imbalances, average prime rents have fallen 10.8% for the last 12 months to 30 April 2016. As Perth’s economy continues to be challenged, we do not expect the situation in industrial property space to improve in the near term. Rents are likely to stay stagnant but the lower level of prime stock supply provides some mitigation to further downside for this segment. Tenants may continue to stay away from older, lower spec properties, keeping overall vacancy high and a dichotomy between newbuilds vs. existing properties.

⁶ Knight Frank Research; sample data includes buildings with a minimum floor area of 2,000 sqm

Figure 10: Perth – Singapore Industrial REIT Exposure

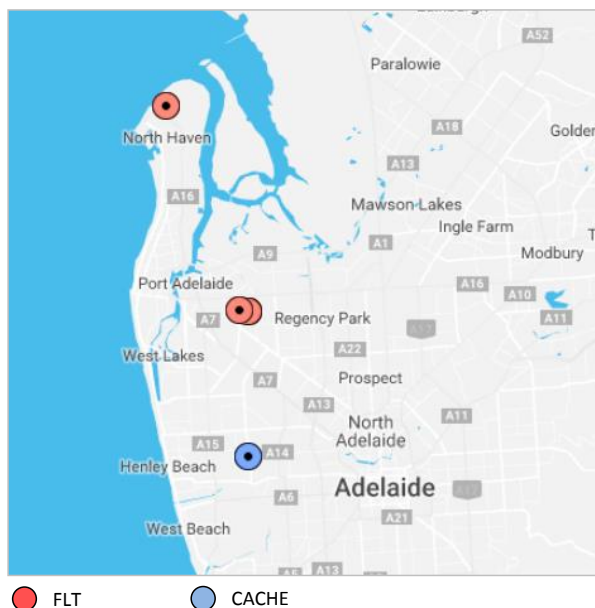


Adelaide – Down but not Out

Adelaide is a smaller city with a population of 1.2mn people and higher unemployment rates versus other cities in the country. Using SGS Economics & Planning, in 2014-2015, Adelaide’s GDP grew by 2.1% and is slightly lower than its historical average over the past decade of 2.4%. Adelaide contributes some 4.6% to Australia’s GDP and its economy is driven by healthcare (contributes 10%), followed by financial services (~8.5%). Manufacturing which was by far the most important sector in 1995 (16% contribution to the economy) now only makes up less than 8%. Adelaide is the hub for the defense industry in Australia. In March 2016, the government announced a AUD230mn national centre for defense; this is envisaged to spur jobs growth in the city. The economic outlook of Adelaide continues to be reliant on state and federal government projects as private investment trails other Australian cities.

Market yields have declined to 7.3-9.8% for prime assets in June 2016 according to JLL,⁷ continuing a gradual decline since 2H2013. Colliers reported that in March 2016, vacancy rate amounted to 4.9%, falling from 6.4% in September 2016 while there have been some signs that building approvals by value have decline. In the last few years, prime rents have remained relatively flat. We think that although there is lower threat from new supply, the impending closure of automakers is likely to induce some uncertainty among market participants.

Figure 11 : Adelaide – Singapore Industrial REIT Exposure



⁷ Colliers; sample data includes buildings with a minimum floor area of 5,000 sqm

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