OCBC Bank

Asia Credit Research

Industrial REITs: Sector Update

Friday, 24 February 2017

Down but not out

- **Committee on Future Economy ("CFE") reaffirmed that maintaining a globally competitive manufacturing sector with manufacturing-related services is important to Singapore (target ~20% contribution to GDP from 17.9% in 2016)**
- **Manufacturing showing some green shoots, albeit concentrated on some industrial clusters**
- **Perpetuals helped arrest decline in credit of large cap Industrial REITs in 2016. No marked decline observed in headline credit ratios across coverage. Some revaluation losses among smaller players but narrower vs. sector-wide fall**
- **URA, JTC and EDB working together to review land-use policies and planning guidelines to facilitate land use flexibility. This is a right move directionally**
- **Buildings required for higher value-added manufacturing and "servicisation of manufacturing": higher-spec, purpose-built and office-like**
- **We see MINT, AAREIT and SSREIT as most susceptible to additional supply given Singapore-centric and multi-tenanted Industrial B1 and B2 property profiles**
- **Recommendation:** Among large caps, the AREIT'22s provides a 25bps spread pick-up over the CCTSP'22s (an office REIT). Both are rated at similar levels. Within perpetuals, we prefer the AREIT 4.75 '49c20 over the MLT 4.18 '49c21 as we see downside risk on MLT's credit profile. Short term credit profiles for smaller REITs have held up in spite of the downturn in the Industrial space sector (eg: CREIT, SBREIT and VIVA). Within the smaller Industrial REITs, we are Overweight both the SBREIT bonds and see fair value of the SBREIT'18s and '21s at 25 and 60 bps tighter respectively.

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Issuer	Issuer Profile	Issue	Maturity / First Call Date	Outstanding Amount (SGDm)	Ask Price	Ask YTW	I-Spread	Bond Rating
AAREIT	N	AAREIT 3.8 '19	21/05/2019	50	101.37	3.16	149	BBB-/NR/NR (Issuer)
AAREIT	N	AAREIT 4.35 '19	05/12/2019	30	101.90	3.62	184	BBB-/NR/NR (Issuer)
AREIT	N	AREIT 2.5 '19	16/05/2019	95	101.39	1.85	19	NR/A3/NR
AREIT	N	AREIT 2.95 '20	03/08/2020	100	101.70	2.43	52	NR/A3/NR
AREIT	N	AREIT 4 '22	03/02/2022	200	105.35	2.83	69	NR/A3/NR
AREIT	N	AREIT 3.2 '22	03/06/2022	150	101.50	2.89	71	NR/A3/NR
AREIT	N	AREIT 4.75 '49c20	14/10/2020	300	105.00	3.28	133	NR/Baa2/NR
CREIT	N	CREISP 3.5 '18	05/11/2018	155	101.40	2.64	110	NR/Baa3/NR
CREIT	N	CREISP 4.1 '20	29/04/2020	30	102.35	3.31	145	NR/Baa3/NR
CREIT	N	CREISP 3.95 '20	21/05/2020	130	102.00	3.29	142	NR/Baa3/NR
CREIT	N	CREISP 3.95 '23	09/05/2023	50	100.57	3.84	155	NR/Baa3/NR
MINT	N	MINTSP 3.75 '19	08/03/2019	125	103.55	1.95	32	NR/NR/BBB+
MINT	N	MINTSP 3.65 '22	07/09/2022	45	103.49	2.96	75	NR/NR/BBB+
MINT	N	MINTSP 3.79 '26	02/03/2026	60	101.87	3.55	100	NR/NR/BBB+

SSREIT	Neg	SSREIT 4.00 '18	19/03/2018	90	99.05	5.00	362	NR/NR/NR
SSREIT	Neg	SSREIT 4.25 '19	03/04/2019	100	93.50	7.67	603	NR/NR/NR
SBREIT	N	SBREIT 3.45 '18	21/05/2018	100	99.70	3.73	231	NR/Baa3/NR (Issuer)
SBREIT	N	SBREIT 3.6 '21	08/04/2021	100	96.00	4.68	265	NR/Baa3/NR
VIVA	N	VITSP 4.15 '18	19/09/2018	100	100.20	4.05	254	NR/Ba2/NR
MLT	Neg	MLTSP 5.375 '49c17	19/09/2017	350	101.95	1.85	61	NR/Baa3/NR
MLT	Neg	MLTSP 4.18 '49c21	25/11/2021	250	102.22	3.67	155	NR/Baa1/NR (Issuer)

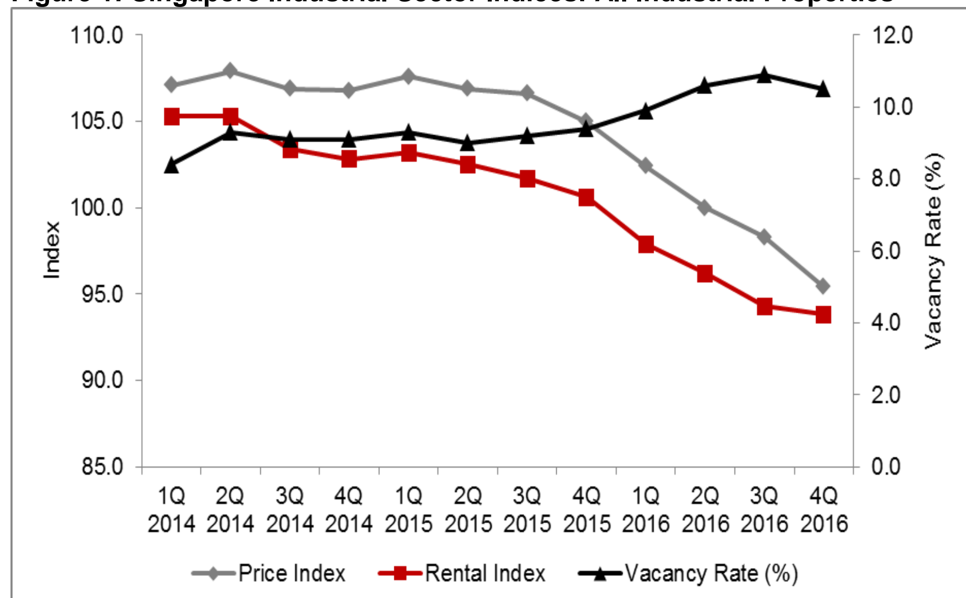
Note: (1) Indicative prices as at 23rd February 2017
(2) Bond Rating is used except where specified
(3) AAREIT: AIMS AMP Capital Industrial REIT, AREIT: Ascendas Real Estate Investment Trust, CREIT: Cambridge Industrial Trust, MINT: Mapletree Industrial Trust, SSREIT: Sabana Shari'ah Compliant Industrial Trust, SBREIT: Soilbuild Business Space REIT, VIVA: VIVA Industrial Trust, MLT: Mapletree Logistics Trust
(4) N: Neutral, Neg: Negative, Pos: Positive as assigned by OCBC Credit Research

A) 4Q2016 Singapore Industrial Update

On n overall basis, the price index of 95.4 as at 4Q2016 represented the 7th consecutive quarter where prices have softened. On a year-on-year (y/y) basis, prices have fallen 9.1%. This has come in wider than the 3% y/y fall in asset values of SBREIT, CREIT, SSREIT and VIT (these REITs have released their annual valuation as at 31 December 2016). The rental index has fallen to 93.8 though at a much smaller quarter-on-quarter (q/q) decline of 0.5% against the 2-3% q/q decline exhibited since the beginning of 2016. By sub-segment, multiple-user factory, single-user factory and warehouse saw narrower q/q declines while business parks saw an uptick in rental index of 1.2%. We think there is still some downside risk on the price index as historically downward pressures in rents have preceded price falls.

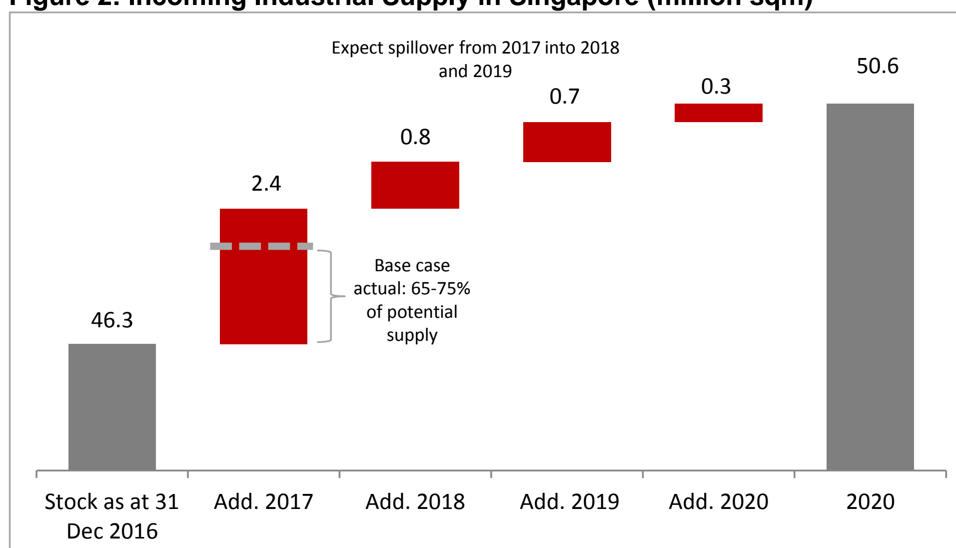
Overall vacancy rate improved slightly to 10.5% against 10.9% in 3Q2016. This was led by improvements in business park vacancies (17.0% against 18.9% in 3Q2016). All the other 3 sub-segments also saw improvements in vacancies of 20-60 bps. Overall transaction volumes (based on numbers of caveats lodged) continue to be low, with less than 200 caveats lodged in 4Q2016. There were around 900 caveats lodged for the full year (falling from ~1,200 in 2015). Annual net change in space occupied (proxy for demand) was 1.1mn sqm, lower than the 1.2-1.4mn sqm exhibited historically. In January 2017, the Purchasing Manager Index had improved to 51, after hovering below that level since end-2014. Business expectations of the manufacturing sector are also somewhat more optimistic, with a net weighted balance of +2% of manufacturers surveyed anticipating business conditions to improve for January to June 2017. While such optimism is not broad based across the manufacturing sector (concentrated in a few industrial clusters), we think demand this year may inch higher.

Figure 1: Singapore Industrial Sector Indices: All Industrial Properties



Source: JTC Quarterly Market Report for 4Q2016; price and rental indices

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



Source: JTC Quarterly Market Report for 42016; OCBC Credit Research views that actual supply may come in lower at 65-75% of JTC estimates
Note: Assumes no disposal from property stock

B) The Makeup of Impending Industrial Space Supply

As at 31 December 2016, JTC estimates that 4.4mn sqm in industrial space will be made available over the next few years (of which 60,000 sqm will be made available post-2020). Of these, JTC publicly discloses certain project-specific information for 3.3mn sqm (representing 74% of supply)[1]. Based on the information disclosed, we have attempted to map out the type of supply coming in and come to the view that the Industrial REITs most susceptible to impending supply in Singapore are those who are Singapore-centric and heavily exposed to multi-tenanted B1 and B2 properties (ie: MINT, AAREIT and SSREIT).

Multi-tenanted public projects feature: Multi-tenanted JTC and HDB projects make up about 8% and 10% respectively of the total 4.4mn sqm. JTC's projects aim to integrate the entire value chain of particular industries. For example, JTC Space@Tuas at Tuas Avenue (a SGD277mn project) that is currently being constructed aims to house oil & gas companies together with precision engineering and general manufacturers under one roof. The two HDB projects, namely Bedok Food City and Defu Industrial City, are part of the Industrial Redevelopment Programme[2], catering to Small Medium Enterprises ("SMEs). Both were originally estimated to complete by 2017 but has since been pushed to 2020. We see these public projects directly competing with existing private industrial space.

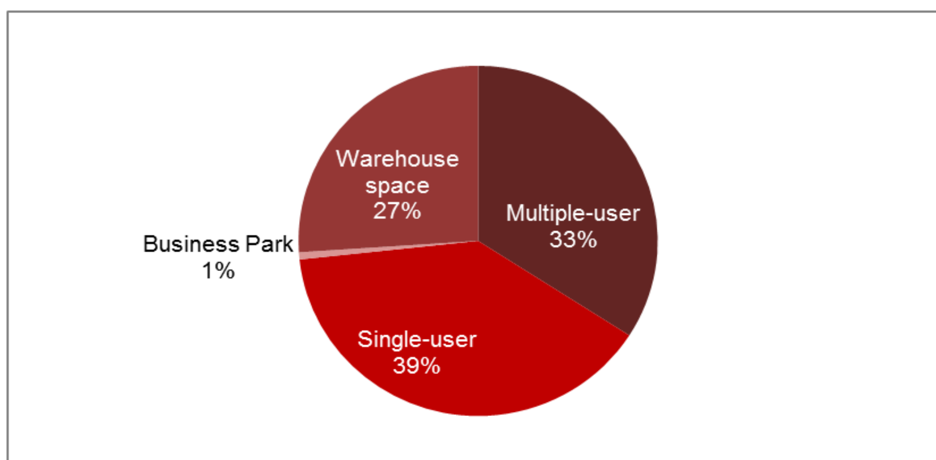
Private projects make up more than half of supply: 2.5mn sqm of projects in the pipeline are being developed by the private sector. Of these, 1.6mn are purpose-built for single-users (largely end-users). Such end-users are unlikely to be new to Singapore. We think some are expanding existing properties or building new properties to consolidate into one location. The impact to the Industrial REITs under our coverage is indirect via sector-wide increase in vacancy rates (and compression in lease rates) as such single-users move out of existing buildings.

Strata-titled investor market under pressure: We estimate that 0.9mn sqm of industrial space are being developed for rental income. The bulk of these are being built by property developers targeting individual investors seeking rental income with purchase quantum kept within reach. Such properties form the most speculative part of the industrial space market in Singapore, in our view. As at 31 December 2016, there were ~1,600 units totalling about 0.4mn sqm (252 sqm per unit on average) in

[1] Upcoming pipeline projects indicated by JTC includes only those with gross floor area of 10,000 sqm and above and have obtained planning approvals for development, includes major mixed use development projects
[2] Launched in 1997 catering to change in land use in URA's Master Plan and increase land productivity. Aims to relocate tenants to modern industrial complexes with better facilities

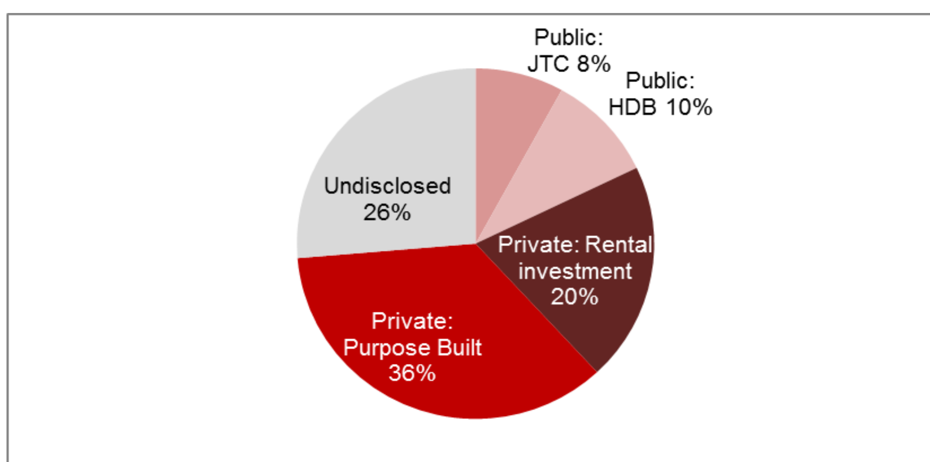
uncompleted strata-titled developments still available for sale (6 out of 10 units are zoned as B1, we estimate). Such unit sizes have a limited end-user pool.

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



Source: JTC Quarterly Market Report for 4Q2016
Note: Accumulated incoming industrial space from 1 January 2017 and beyond (total of 4.4mn sqm)

Figure 4: Upcoming Supply by Development Type – Singapore



Source: Estimated by OCBC Credit Research using data from JTC Quarterly Market Report for 4Q2016.

C) Industrial Space at a Crossroad

Blurring of lines between manufacturing and services: We see the lines blurring between manufacturing and services as a natural evolution of Singapore's manufacturing moving up the value chain. Manufacturing design, product and quality assessment, B2B marketing, after-sales servicing, consulting services are some of the services that fall within the manufacturing value-chain. There is a need for the government to re-look at permissible uses and the viability of keeping the hard line in the sand between industrial and commercial (office) use. The Business Times have done a commendable job over the past weeks in resurfacing the issues surrounding industrial space use. Based on currently applicable definitions, industrial-zoned buildings are broadly defined into three sub-segments:

Table 1: Permissible Uses by Property Type

Industrial Sub-segment	Brief Description	Examples
Business 1 ("B1")	• Clean and light industrial use: Premises where the processes carried out or the machinery installed can be done so in any residential area without polluting the area with noise, vibration, odor, fumes, smoke, soot, ash, dust or grit • Nuisance buffer is 50mn or less	**Approved use (examples):** • Manufacturer of textile goods without dyeing, bleaching other finishing operations, boxes of paperboard • Packing and bottling of herbs, medicinal oil and dried foodstuff • Manufacture of aluminum window frames

		• Printing, publishing and allied industries **Planning permission required and subject to restrictions:** • Warehouse showroom, workers dormitory, e-Business and media activities, industrial canteen and childcare centres
Business ("B2")	• Clean and light industrial use: Premises where the processes carried out or the machinery installed can be done so in any residential area without polluting the area with noise, vibration, odor, fumes, smoke, soot, ash, dust or grit • General industrial use: Premises that are industrial buildings but not light industrial or special industrial buildings • Nuisance buffer is more than 50m but still within health and safety buffers	**Approved use (examples):** • Vehicle/motorcycle repair and servicing • Installation of tyres & batteries, car accessories • Food manufacturing, catering • Manufacture of furniture, musical instruments, wooden and cane wares, power supply systems • Repair and maintenance of engine and pumps • Industrial laundry • Blending of detergents and cleaning preparations, perfumes, hair care **Planning permission required and subject to restrictions:** • Warehouse showroom, workers dormitory, e-Business and media activities, industrial canteen and childcare centres
Business Park	• Buildings are used for non-pollutive industries that engage in high technology, research and development, high value-added and knowledge intensive activities	**Planning permission required and subject to restrictions:** • e-Business and media activities • Canteen and childcare centres • Commercial uses such as shops, restaurants and offices if this is within 15% of allowable white space (limits may vary for some sites)

Source: Urban Redevelopment Authority, National Environmental Agency
Note: e-Business refers to telecommunications, data farm/data centre, internet service provider, software development and call centre

"Crossovers" in industrial property product offering: We have seen property developers coming out with fancier industrial products to attract an expanded buyer pool ie: investors versus end-users. These include industrial properties with office-like finishings and industrial properties with residential features (swimming pools, BBQ pits, near schools). Some of these new products (eg: small-strata units) can be explained by opportunistic behaviour on the part of property developers to capture investment flow away from the residential property market post the introduction of property cooling measures. Though more broadly, we think the market is also responding to meet on-the-ground realities of a changing industrial landscape. In particular, within the light industrial B1 space, newer properties have borrowed from features seen in business park properties. Business parks as a property asset class assimilate office-like features and corporate campuses, though typically with much shorter land tenures.

Hard-line on light industrial may lead to structural vacancies: Based on current rules, 60% of area within industrial buildings need to cater to core manufacturing industrial activities (eg: manufacturing, warehousing storage) while the remaining 40% can be used for ancillary usage (eg: offices, showrooms, neutral area and common facilities). Unauthorised users can be charged for failing to comply with the rules. In order to maintain cost competitiveness, businesses who are traditional users of industrial properties continue to weigh the choice between the type of activities to keep within Singapore versus activities to move out of the country. Singapore is also making it a point to attract higher value-added manufacturing activities into the country (such as pharma, medtech, electronics, petrochemical and aviation). Such new growth typically requires built-to-specification industrial properties rather than generic properties. Both JTC Corporation ("JTC") and the Housing Development Board ("HDB")[3] are in the process of building new industrial spaces to facilitate industry clustering as a key growth strategy for the country. In our view, what this means is that a hard line on 60/40 could lead to a significant amount of space being kept structurally vacant.

[3] *JTC: Lead government agency responsible for the development of industrial infrastructure to support and catalyse the growth of industries and enterprises in Singapore; HDB: Industrial land grandfathered from the Singapore Improvement Trust set up in 1927. In October 2016, it was announced that all industrial units and industrial land leases under HDB will be transferred to JTC in Q12018. This is aimed at facilitating more comprehensive master-planning of industrial districts*

Based on news reports, the Urban Redevelopment Authority ("URA") is working with JTC and the Economic Development Board ("EDB") to review land-use policies and planning guidelines to facilitate flexibility in land use. Directionally, we agree that this is a right move, though it remains to be seen the exact changes that will be introduced. Our base case is that permissible uses on industrial B2 and to an extent, business parks will be left "status quo".

C) Credit Ratios Stable Against 4Q2016

Leverage: Compared to the immediately preceding quarter, median leverage as measured by total debt-to-total asset was 90bps higher at 37.4% as at 31 December 2016 (30 September 2016: 36.5%)[4]. Two Industrial REITs have issued perpetual securities. Adjusting 50% of the outstanding value on perpetual securities as debt, AREIT's adjusted debt-to-total asset as at 31 December 2016 was 33.3% and we estimate that this has risen somewhat to ~35% following the acquisition of 12,14,16 Science Park in February 2017. Mapletree Logistics Trust's adjusted leverage was 44.0% as at 31 December 2016, having climbed from 42.9% as at 30 September 2016. On an adjusted basis, MLT remains the most levered Industrial REIT in our portfolio and we expect the company to remain shareholder friendly. At the time of launching SSREIT's rights issue in December 2017, the REIT's management guided that aggregate leverage will fall to ~40% post completion of the rights issue.

Coverage: Sector-wide coverage ratios (as measured by EBITDA/Gross interest) for twelve months of 2016 increased slightly to 4.1x (12M2015: 4.0x). We maintain the view that with the exception of distressed situations, REITs are unlikely to defer perpetual distributions. As such we also adjust perpetual distributions in our coverage ratio in assessing credit risk. **AREIT:** Adjusting for 50% of perpetual distribution, we find that adjusted coverage (EBITDA/Gross interest plus 50% of perpetual distribution) for AREIT to be 4.5x and assuming 100% of perpetual distribution within coverage ratios, AREIT's adjusted coverage (EBITDA/Gross interest plus 100% of perpetual distribution) was lower at 4.3x in 12M2016. AREIT perpetuals were issued in October 2015 and as at 31 December 2016, perpetuals as a proportion of total capital was manageable at only 3% of total capital. **MLT:** Adjusting for 50% of perpetual distribution, we find that adjusted coverage (EBITDA/Gross interest plus 50% of perpetual distribution) have weakened to 4.4x in 12M2016 (down from 5.1x in 12M2015). Taking into account the full perpetual distribution, we find adjusted coverage ratios to have weakened to 3.7x (down from 4.3x in 12M2015). This reflects higher interest at MLT as well as a new SGD250mn perpetual which was issued in May 2016. As at 31 December 2016, perpetuals make up 11% of total capital. For the avoidance of doubt, in the case where perpetual distribution is deferred, this does not constitute an Event of Default ("EoD").

Figure 5: Credit Ratios of Industrial REITs Under Coverage

REIT	Aggregate Leverage (%)		EBITDA/Gross Interest (x)		Debt Duration (in years)	
As at	30-Sep-16	31-Dec-16	12M2015	12M2016	30-Sep-16	31-Dec-16
AAREIT	34.0	34.6	3.5	3.7	2.4	2.1
AREIT	34.2	31.8	5.3	4.8	3.8	3.9
CREIT	36.9	37.5	3.5	3.5	3.4	3.1
MINT	29.0	29.4	8.4	8.4	3.5	3.2
MLT	37.6	38.7	6.2	5.6	3.7	3.5
Sabana	41.5	43.2	3.0	2.4	2.1	1.9
SBREIT	36.0	37.6	4.5	4.4	3.1	2.8
VIVA	39.8	37.2	2.9	2.9	3.5	3.2
Median	**36.5**	**37.4**	**4.0**	**4.1**	**3.5**	**3.2**

Source: REIT financial statements and company presentations for the quarter ended 31 December 2016
Note: (1) Gross interest for AREIT excludes loss of fair value from Exchangeable Collaterised Securities

D) Credit Rating Agency Actions in 4Q2016

Of the 8 Industrial REITs we cover, 7 are rated by international rating agencies. On 15 November 2016, Moody's assigned a first time Ba1 corporate family rating to VIT. The

[4] *Mean of 36.3% as at 31 December 2016 against 36.1% as at 30 September 2016*

REIT's sole bond, the VITSP 4.15%'18s, is rated Ba2.

MLT's Baa1 credit rating was placed on Negative outlook on 16 December 2016 by Moody's on the back of the REIT's fully-debt funded acquisition of four properties in Australia. Earlier in August 2016, SBREIT's Baa3 credit rating was placed on Negative outlook. Our base case[5] remains that there is a 1-in-3 chance of an outright downgrade (in line with the implied Negative outlook), though the market has fully priced in a downgrade.

E) OCBC Credit Research Actions in 4Q2016

We have lowered MLT's issuer profile to Negative from Neutral in December 2016[6] following expectations that aggregate leverage will remain elevated over a 6 month period. We will however move this back to Neutral should there be further signs of deleveraging from asset sales.

VIT's issuer profile has been raised to Neutral from Negative on 31 October 2016[7] as we expect that over a 6-month period and to the extent that the existing bond is concerned (ie: 19 months to maturity), we think VIT's credit profile will improve to be in line with peers.

We have lowered SSREIT's curve to Underweight on 10 January 2017 (issuer profile maintained at Negative). In our view, compression in financial flexibility at the REIT may continue to pressure SSREIT's bond prices downwards. Two groups of dissenting (and uncoordinated) unitholders have emerged, with one group officially sending in a requisition letter asking for an Extraordinary General Meeting to be held. This group of investors are pushing for the removal of the current REIT manager. There are no Change of Control ("CoC") provisions in the bond documentation for the SSREIT 4.0 '18s and SSREIT 4.25 '19s, though the convertible bonds (the SSREIT'17s) contain a CoC. In our view, REITs need a functioning REIT Manager at all times to continue as a going-concern. SSREIT's bond documentation stipulates that if pre-existing REIT Managers are removed and a replacement manager is not appointed in accordance to the Trust Deed, this would constitute a Dissolution Event/EoD. This is a standard clause in the SGD bond market among REIT issuers. Our base case is that majority of SSREIT unitholders (by percentage holding) would vote in a manner that preserves the highest valuation for their stake versus putting the REIT into disarray (ie: status quo). An upside case for the bonds would be for new shareholders of the REIT Manager to emerge. As an example, this can happen if a buyer comes in to purchase stakes in the REIT Manager in a friendly M&A deal. As of report date, SSREIT has announced that a Strategic Review is being carried out to undertake a review of options available for SSREIT to enhance unitholder value. A Strategic Review Committee comprising 3 directors (of which 2 are independent directors) has been appointed.

F) Closing Thoughts

While the overall occupancies and lease rates in the industrial space sector are expected to continue facing pressure over the next 3 months, we believe strategic and financial interest in the space exists. We think it is an opportune time for M&A activities in the sector and see consolidation as credit positive for the smaller industrial REITs. Signalling foreign interest, in January 2016, e-Shang Redwood (backed by Warburg Pincus) expanded into Southeast Asia via its ~11% stake acquisition in CREIT and 80% of the latter's REIT Manager. Among larger Industrial REITs, we think two key recurrent themes will continue as a means of reducing concentration to their Singapore portfolio. (1) Foreign expansion, particularly into Australia (2) greenfield and redevelopment projects in a move to revitalise portfolio.

[5] *OCBC Asia Credit – Soilbuild REIT - Penalised more than necessary (14 Feb 2017)*
[6] *OCBC Asia Credit Daily (15 December 2016)*
[7] *VIVA Industrial Trust – Credit Update (31 October 2016)*

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