Asia Credit Research

Soilbuild Business Space REIT: Credit Update

Monday, 01 August 2016

Cross that bridge when you come to it

- **Defensible results in 1H2016 in spite of Technics Building:** Soilbuild Business Space REIT ("SBREIT") reported a 3.9% increase to SGD39.7mn (1HFY2015: SGD38.2mn) while Net Property Income ("NPI") increased 6.2%. This was on the back of revenue from Technics Building (acquired in May 2015) amounting to SGD3.2mn and improvement at Solaris of SGD0.3m (which was more than sufficient to offset weaknesses at other properties). Whilst SBREIT is still able to recognize revenue from Technics Building and have successfully drawn down on its security deposit (ie: holding cash), the REIT has an on-going legal proceeding against the tenant and guarantor at Technics Building to claim rent in arrears and other sums. Taking out the effect of Technics, we find gross revenue to have reduced to SGD36.5mn. In 1H2016, SBREIT reported cash flow from operations (pre-interest expense) of SGD40.1mn, a marked increase from 1H2015's SGD33mn due to the receipt of SGD11.8mn in rental deposits in relation to Technics Building. Aggregate leverage at SBREIT remains stable at 35.9% (31 March 2016: 36%). Interest coverage ratio remains healthy at 4.2x (excluding the impact of Technics Building).

- **Bukit Batok acquisition:** In mid-June 2016, SBREIT announced its intention to acquire Bukit Batok Connection from the Sponsor for ~SGD100m under a sales-and-leaseback arrangement (long term lease of 7 years). The Sponsor, Soilbuild Group Holdings Ltd holds ~25% of the REIT units. This transaction is subjected to unitholders approval. An extraordinary general meeting ("EGM") is targeted for mid-August 2016 and should the transaction be approved, SBREIT will firm up the funding structure thereafter.

- **Concentration to Sponsor:** The Sponsor is an increasingly important counterparty to SBREIT. Assuming Technics Building is non-contributing, we estimate that rental contribution from the Sponsor will rise to ~34% post the Bukit Batok acquisition. The portion of exposure which needs to be supported by the Sponsor is not more than SGD10m (~12%) of portfolio gross revenue and thereby manageable, in our view.

Property	Estimated annual rental (SGDmn)	Commentary
Solaris	18.1	**Low risk:** Business park property where Sponsor is Master Lessee, underlying is 100% leased by sub-tenants. 54% of underlying tenants will expire post-August 2018
West Park BizCentral	1.7	**Low risk:** 5 year old industrial property where SBREIT is a tenant for 71,979 sq ft out of NLA of 1.24mn. Underlying occupancy of the property is 82.7%
Bukit Batok Connection	8.0	**Medium risk:** New industrial property completed in May 2016. The acquisition (if completed), will be leased by Sponsor under a Master Lease. Moody's estimate that underlying tenants occupy less than half of the property.

- **Potential credit rating action:** On 25 July 2016, Moody's (currently holding SBREIT at Baa3) issued a paper capturing their scenario analysis of SBREIT in relation to the potential loss of revenue at Technics Building and jointly, the funding structure of Bukit Batok. Moody's mid-range and downside case scenarios may bring about a negative rating action.

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	Base Case	Mid-range Case	Downside Case
Decline in rental revenue at 72 Loyang Way	50%	50%	100%
Decline in valuation at 72 Loyang Way	25%	25%	50%
Funding mix for Bukit Batok			
Unsecured debt	*50%*	*0%*	*75%*
Secured debt	*0%*	*50%*	*0%*
Equity	*50%*	*50%*	*25%*

Note: Extracted from Moody's paper as at 25 July 2016: Assumptions under each of the three scenarios. Moody's does not view these scenarios as the expected outcomes but is using the scenarios to show how SBREIT's financial profile might be affected

Based on SBREIT's historical funding structure for acquisitions and the REIT's internal aggregate leverage threshold of 40%, we are of the view that SBREIT will be disciplined in the use of straight debt. A far likelier possibility would be funding Bukit Batok via perpetual securities and/or a mix of debt and equity. We think a 60:40 debt-to-equity structure should be sufficient for the deal to be accretive to unitholders and equity markets remain open for most REITs, hence there is no necessity for SBREIT to over-lever. We see the Bukit Batok property akin to a "replacement asset", and assuming the use of debt/equity remains optimal, interest coverage is likely to still exceed 3.5x. With regards to Moody's concerns on the use of secured debt, we expect secured debt as a percentage of total assets ("secured leverage") to be contained at 20-25% (currently 15%) and hence manageable. AAREIT (currently rated by S&P at BBB-) would see its secured leverage at 95% (post refinancing AAREIT 4.9% '16s) while Ascott Residence Trust (currently rated by Moody's at Baa3) has secured leverage at 21%.

- **Proactive management of leases:** We see Moody's concerns over loss of revenue at Technics Building from 3Q2017 as valid. However, SBREIT's management team continues to be proactive in responding to challenges facing the industrial space lease sector and net-net we see the downside case of 100% loss in rental revenue as remote. The Technics Building can be leased out to multiple-tenants, despite the building traditionally being used by a sole tenant. Nevertheless, management has cautioned heightened volatility in portfolio occupancy going forward in light of the softer environment. Portfolio occupancy was 92% as at 30 June 2016 falling from 94.8% as at 31 March 2016 (30 June 2015: 99.8%) attributable to the fall in occupancy at West Park BizCentral.

- **Exposure to the marine offshore and oil & gas sector:** The marine offshore and oil and gas sector contributed 11% and 12% respectively (collectively 23.3%) to monthly gross rental income. Rental income in these segments are made up by 17 tenants, the largest being Technics Offshore. 3 other important tenants in this sector by contribution to gross rental income are (i) KTL Offshore (4.4%) (ii) Tellus Marine (1.5%) and (iii) Beng Kuang Marine (1.3%). All three tenants are under long term Master Leases (until at least 2020) and privately held. We take comfort that rental deposits for Master Leases ranges between 12 to 18 months, which shields SBREIT's cash flow and gives it time to secure a new tenant in the event of deepening stresses in the sector these tenants operate in.

- **Recommendation:** Based on current available information, we view the likelihood of a negative outlook to be more probable vis-à-vis an outright downgrade. Nevertheless, we maintain our Neutral issuer profile on the back of the REIT's defensive credit profile. In the off-chance that SBREIT gets downgraded to non-investment grade, we see price weakness on the curve as an opportunity for investors who are unconstrained by ratings action to buy in.

Soilbuild Business Space REIT

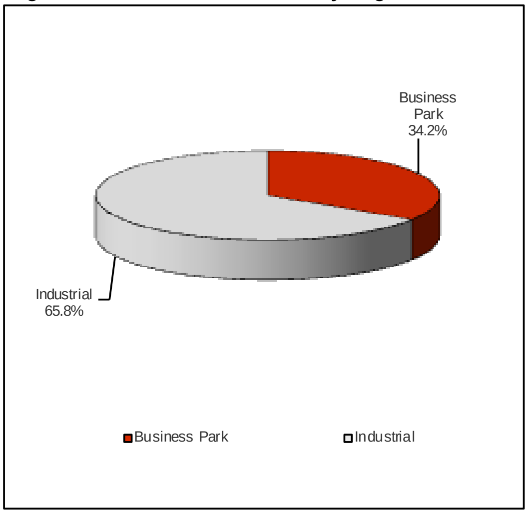
Table 1: Summary Financials

Year Ended 31st Dec	FY2014	FY2015	1H2016
Income Statement (SGD'mn)			
Revenue	68.1	79.3	39.7
EBITDA	50.8	60.0	31.0
EBIT	50.8	60.0	31.0
Gross interest expense	9.7	13.5	6.9
Profit Before Tax	42.4	51.7	24.8
Net profit	42.4	51.7	24.8
Balance Sheet (SGD'mn)			
Cash and bank deposits	21.0	16.8	23.3
Total assets	1,054.0	1,214.5	1,227.2
Gross debt	368.9	398.5	431.2
Net debt	348.0	381.8	407.9
Shareholders' equity	650.8	746.0	742.4
Total capitalization	1,019.7	1,144.5	1,173.5
Net capitalization	998.8	1,127.7	1,150.2
Cash Flow (SGD'mn)			
Funds from operations (FFO)	42.4	51.7	24.8
CFO	53.6	61.6	34.5
Capex	94.8	123.6	31.9
Acquisitions	0.0	0.0	0.0
Disposals	0.0	0.0	0.0
Dividends	49.6	55.7	29.7
Free Cash Flow (FCF)	-41.2	-62.0	2.6
FCF Adjusted	-90.7	-235.2	-27.1
Key Ratios			
EBITDA margin (%)	74.6	75.6	78.1
Net margin (%)	62.3	65.1	62.4
Gross debt to EBITDA (x)	7.3	6.6	7.0
Net debt to EBITDA (x)	6.8	6.4	6.6
Gross Debt to Equity (x)	0.57	0.53	0.58
Net Debt to Equity (x)	0.53	0.51	0.55
Gross debt/total capitalisation (%)	36.2	34.8	36.7
Net debt/net capitalisation (%)	34.8	33.9	35.5
Cash/current borrowings (x)	0.2	NM	NM
EBITDA/Total Interest (x)	5.3	4.4	4.5

Source: Company, OCBC estimates

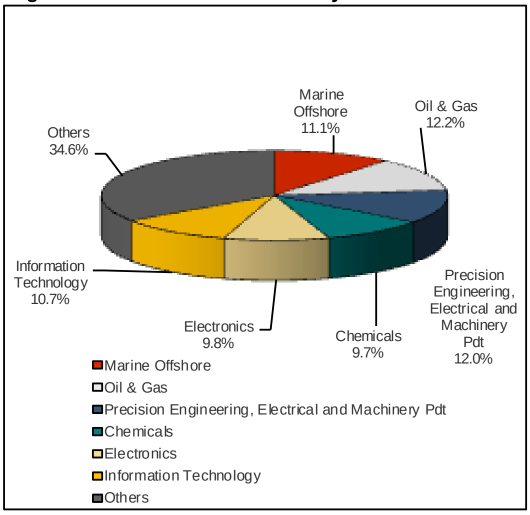
* *FCF Adjusted = FCF - Acquisitions - Dividends + Disposals*

Figure 1: Revenue breakdown by Segment - 1H2016



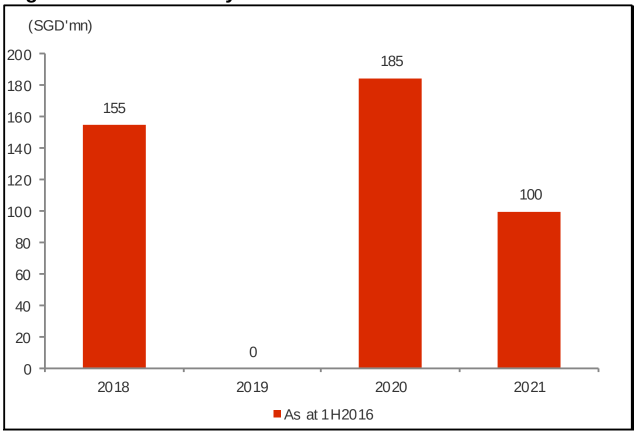
Source: Company

Figure 2: Revenue breakdown by Business - 1H2016



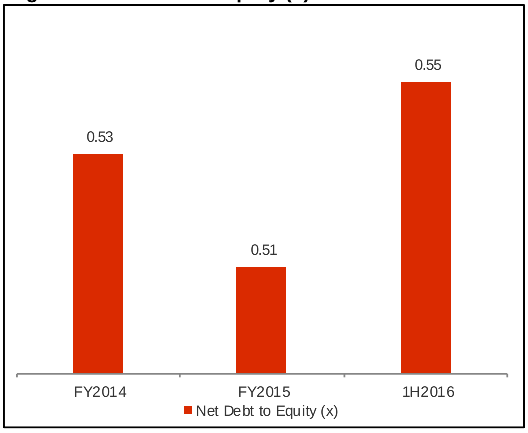
Source: Company

Figure 3: Debt Maturity Profile



Source: Company

Figure 4: Net Debt to Equity (x)



Source: Company, OCBC estimates

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