

Sabana Shari'ah Compliant Industrial REIT / ESR-REIT: Credit Update

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Merger of equals on the horizon?

- **SSREIT and EREIT had respectively confirmed that they are in discussions. No definitive agreements in place yet and there is no certainty of a deal. REIT-to-REIT transactions in the Singapore market are uncommon, despite being the sixth largest REIT market globally by listed market cap.**
- **A combined EREIT and SSREIT entity will be somewhat more levered (we assume SSREITM needs to be bought out) with weaker coverage ratios in the near term, though we expect this move to be beneficial in the medium term for both EREIT and SSREIT.**
- **Recommendation:** We are keeping EREIT's issuer profile on Neutral, with the bonds on Neutral. In light of its weaker interest coverage ratio versus peers, we are maintaining SSREIT's issuer profile on Negative though lifting both the SSREIT'18s and SSREIT'19s to Overweight from Neutral.

- **Background:** Further to news reports, SSREIT had on 7 August 2017 confirmed that it is in discussions with ESR Funds Management (S) ("EREITM") to explore options in connection with SSREIT's on-going Strategic Review. EREITM is the REIT Manager of ESR REIT ("EREIT"), a separately listed Industrial REIT on the Singapore Stock Exchange, sponsored by e-Shang Redwood ("ESR"). No definitive legally binding agreements have been entered into as of report date. On 8 August 2017, EREIT clarified that EREITM had been approached by SSREIT's REIT Manager ("SSREITM") to explore options in connection with SSREIT's Strategic Review though there is no certainty that any agreement will materialise.

- SSREIT, incorporated in Singapore, is listed on the SGX with a market cap of SGD490mn (as at 11 August 2017). SSREIT has total assets of SGD995mn and all investment properties are Singapore-based. The current Sponsor, Vibrant Group, and its related parties hold a ~12%-stake in SSREIT itself and Vibrant Group indirectly owns 51% in SSREITM. EREIT is also incorporated in Singapore and listed on the SGX with a market cap of SGD737mn (as at 11 August 2017). EREIT has SGD1.37bn in total assets and all investment properties are Singapore-based. EREIT's current Sponsor, ESR, is a privately held developer and manager of logistics facilities focusing on China, Japan, South Korea and Singapore. The company is owned by Warburg Pincus, the founders and other institutional investors. ESR owns a 12%-stake in EREIT and 80% of EREITM.

- Mr. Tong Jinquan and ESR are common unitholders across both the REITs. Mr. Tong holds 6.2% in SSREIT and 18.5% in EREIT. In March 2017, it emerged that ESR bought a 5%-stake in SSREIT. Recently in July 2017, a Warburg Pincus-led consortium (reportedly including ESR) was shortlisted as a bidder for Global Logistics Properties, though had lost the bid to a management-led consortium.

- **Updating our views factoring in new information:** Admittedly, we had turned bearish over the prospect of a combination between EREIT and SSREIT on expectations that EREIT would be expanding regionally instead of focusing on Singapore. Given that EREIT and SSREIT have indeed been in talks, we have factored in the updated information in our recommendation. Figure 1 sets out possible scenarios and our thoughts on each.

- **Aggregate leverage of SSREIT had declined though interest coverage remains weaker versus peers:** In January 2017, dissenting unitholders of SSREIT had emerged in an attempt to seek the removal of the current REIT Manager. Among

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their concerns was a fall in share price since the REIT's IPO in November 2010. SSREIT's heavily discounted rights issue to fund three announced acquisitions in December 2016 sparked heightened concern, given the downturn in Singapore's industrial space sector. While the requisition to remove the current REIT Manager had failed, unitholders managed to share their grievances. Since then, all of SSREIT's proposed acquisitions (which would have cost the REIT SGD82mn) had been cancelled and the proceeds from the rights issue had effectively been used to reduce aggregate leverage to 37% as at 30 June 2017 versus 43.2% in end-2016. In 2Q2017, SSREIT's interest coverage was 2.9x, below the sector median of 4.1x, though still considerably above its covenanted 1.5x level.

- **Management and board movements:** In May 2017, the CEO had announced his resignation (though will stay until end-2017 or earlier date as may be agreed). A new CEO would be sought in conjunction with SSREIT's Strategic Review. On 31 July 2017, the Chairman and Independent Director who had been helming the Strategic Review Committee had also resigned for health reasons.

Figure 1: Possible Scenarios

Scenario	Assumptions	OCBC Comments
General offer of SSREIT by EREIT in an all-cash deal, all-script deal or a combination thereof	<p>Floor price of SGD0.47 per unit (ie: SGD490mn), being market cap of SSREIT as at 11 August 2017</p> <p>12%-stake in SSREIT is held by Vibrant Group and its related parties</p> <p>Acquisition of SSREITM for SGD40-60mn, assumed at 4-6% of Assets Under Management ("AUM")</p>	<ul style="list-style-type: none"> • Significant investment outlay required (including dilution to EREIT unitholders) • EREITM to become the REIT Manager • Delisting of SSREIT units from the SGX is a Dissolution Event • Upon the occurrence of a Dissolution Event, the sukuks shall be redeemed • As of date of this report there has not been any takeover of a REIT via a general offer in Singapore
Acquisition of SSREIT via a trust scheme in an all-cash deal, all-script deal or a combination thereof	<p>Floor price of SGD0.47 per unit (ie: SGD490mn), being market cap of SSREIT as at 11 August 2017</p> <p>12%-stake in SSREIT is held by Vibrant Group and its related parties</p> <p>Acquisition of SSREITM for SGD40-60mn, assumed at 4-6% of AUM</p>	<ul style="list-style-type: none"> • Significant investment outlay required (including dilution to EREIT unitholders) • EREITM to become the REIT Manager • Amendment to trust deed to allow transaction to take place and court sanction is required • Can be used in friendly-deal • Usually when bidders wish to acquire the entirety of target's shares • Acquirer, parties acting in concert and common substantial shareholders of the acquirer and target abstain from voting (ie: Mr. Tong Jinquan and ESR) • Delisting of SSREIT units from the SGX is a Dissolution Event • Upon the occurrence of a Dissolution Event, the sukuks shall be redeemed • As of date of this report there has not been any completed takeover of a REIT via trust scheme. Croesus Retail Trust (a Business Trust) is undergoing a proposed privatisation by way of a trust scheme
Sale of assets by SSREIT to EREIT	<p>Investment properties at SSREIT valued at SGD964mn as at 30 June 2017.</p> <p>Gross debt of SGD365.8mn as at 30 June 2017</p>	<ul style="list-style-type: none"> • Significant investment outlay required (including dilution to EREIT unitholders) • Disposal of substantial part of SSREIT assets is considered a Dissolution Event • Upon the occurrence of a Dissolution Event, the sukuks shall be redeemed • Payment to SSREIT for the assets is used to repay debtholders
EREITM acquires	12%-stake in SSREIT is held by	<ul style="list-style-type: none"> • Lower investment outlay, can be funded at the EREIT level without

<p>100% of SSREITM and the 12% owned by Vibrant Group and its related parties in SSREIT</p>	<p>Vibrant Group and its related parties. Valued at ~SGD59mn, being 12% of SGD490mn</p> <p>Acquisition of SSREITM for SGD40-60mn, assumed at 4-6% of AUM</p>	<p>diluting EREIT unitholders</p> <ul style="list-style-type: none"> • The two Industrial REITs stay listed • This is the lowest-cost option though due to potential for conflict of interest, higher regulatory risk • MAS approval required for ESREITM to manage two separate REITs in the same sector • As feedback to the 2014 consultation paper proposing enhancements to the REIT regulatory regime, the MAS had stated that it is prepared to consider applications from REIT managers to manage more than one REIT, if the REIT Manager have the expertise and can properly mitigate potential conflicts of interest • In 2009, a REIT Manager was exploring the merger of two Industrial REITs and sought MAS' approval to manage the two REITs concurrently. This was not approved in light of the potential conflicts arising from competing interest of unitholders in the two separate REITs
<p>Amalgamation of SSREIT and EREIT</p>	<p>Acquisition of SSREITM for SGD40-60mn, assumed at 4-6% of AUM</p> <p>Both SSREIT and EREIT unitholders to swap their existing units into units of the newly merged REIT</p>	<ul style="list-style-type: none"> • Lower investment outlay, can be funded at the EREIT level without diluting EREIT unitholders • Unlikely to be considered as having a material adverse effect on EREIT and highly unlikely to be an Event of Default • Amalgamated REIT can be either one of the existing REITs or a new REIT as successor • Delisting of SSREIT units from the SGX is a Dissolution Event • Upon the occurrence of a Dissolution Event, the sukuks shall be redeemed • EREITM becomes REIT Manager of the merged REIT • True mergers of equals are uncommon among Singapore listed companies • As of date of this report, there has not been any merger of equals of REITs in Singapore
<p>Vibrant Group acquires SSREITM instead of EREIT and/or EREITM</p>	<p>Acquisition of the remaining stake in SSREITM not currently held</p>	<ul style="list-style-type: none"> • No re-rating of the SSREIT curve • Vibrant Group, the current Sponsor of SSREIT had also announced that it is in discussions with SSREIT to acquire an additional stake in SSREITM in April 2017 • No binding agreement have been entered into

- **Base case scenario:** We view the amalgamation of SSREIT and EREIT as our base case. This assumes that EREIT, EREITM and its shareholders wishes to minimize the investment outlay required for the transaction. There are no change of control ("CoC") on the SSREIT' 18s and SSREIT' 19s, SSREIT bondholders will not be able to put the sukuks back to the issuer. Five of the possible scenarios may trigger a Dissolution Event and as such we think it is more likely that a transaction would be put through a sukuk holders vote.
- **Key risks to our call:**
 - A) A deal with EREIT and/or EREITM does not transpire: Back to drawing board
 - B) ESR and/or Warburg Pincus decide to take SSREIT on its balance sheet: This would change the transaction mechanics. Our credit view on EREIT though, would be unchanged given that MAS imposes a 45% leverage cap on all REITs and that EREIT has set an internal targeted leverage of between 30-40%.
 - C) Dissolution Event arises: Unitholders (by value of stakes held) would want to preserve highest value for their stake, thus lowering the chance of SSREIT being

thrown into disarray. Far likelier for asset sales to be coordinated as part of a broader transaction. We see non-repayment risk as manageable, with asset coverage sufficient for unsecured debt holders. SSREIT's aggregate leverage was 37% and secured debt only made up 13% of total assets as at 30 June 2017.

Our base case assumptions:

- A) A transaction involving EREITM and EREIT rather than at the ESR/Warburg Pincus level
- B) EREIT, EREITM and its shareholders wishes to minimize investment outlay
- C) Continuation of externally managed REIT structure
- D) EREIT gears up to buy SSREITM for SGD50mn but keeps within the aggregate leverage cap of 45% on a standalone basis
- E) Existing borrowings at SSREIT and EREIT are retained as part of a larger merged entity
- F) 20% corrosion in asset value of SSREIT by the time transaction completes, taking into account possibility of non-renewal of Master Leases with current Sponsor

Credit metrics for the merged entity in our base case scenario:

- A) EBITDA/Interest coverage: 2.8x
- B) Aggregate leverage: 43%

Figure 2: SSREIT SGD Bonds

Issue	Maturity / First Call Date	Outstanding Amount (SGDm)	Ask Price	Ask YTW (%)	I-Spread	Bond Rating
SSREIT 4.0% '18	19 March 2018	90	99.3	5.28	430	NR/NR/NR
SSREIT 4.25% '19	03 April 2019	100	96.2	6.74	553	NR/NR/NR

Note: (1) Indicative prices as at 11 August 2017

Figure 3: EREIT SGD Bonds

Issue	Maturity / First Call Date	Outstanding Amount (SGDm)	Ask Price	Ask YTW (%)	I-Spread	Bond Rating
EREIT 3.5% '18	5 Nov 2018	155	101.25	2.47	137	NR/NR/NR
EREIT 4.1% '20	29 Apr 2020	30	103.25	2.84	147	NR/NR/NR
EREIT 3.95% '20	21 May 2020	130	102.85	2.87	148	NR/NR/NR
EREIT 3.95% '23	9 May 2023	50	103.42	3.29	149	NR/NR/NR

Note: (1) Indicative prices as at 11 August 2017

- **Recommendation:** We are maintaining a Neutral issuer profile on EREIT and Neutral the EREIT curve. We are maintaining our Negative issuer profile on SSREIT on account of its weaker interest coverage versus peers. However, we are lifting the SSREIT '18s and SSREIT '19s to Overweight from Neutral. For investors who are willing to ride through the event risk, SSREIT 4.0%'18s allow a pick-up of 200bps over the VITSP 4.15% '18s.

We have considered the following:

- A) EREIT is unlikely to be geared up beyond 45% for any potential transaction. While there could be a near term increase in leverage and weaker coverage, a combination of EREIT and SSREIT would create a larger platform (total assets of SGD2.2bn) which should benefit from lower cost of operations and enhanced ability to compete with the larger REITs over the medium-longer term.
- B) VITSP 4.15% '18s (NR/Ba2/NR) is trading at a YTM of 3.38% (spread of 230 bps). This bond provides a ceiling to the valuation of SSREIT.

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