Asia Credit Research

OCBC Bank

Soilbuild Business Space REIT: Credit Update

Thursday, 02 March 2017

Penalised more than necessary

- **SBREIT's SGD bonds have reacted negatively since its Baa3 investment grade rating was placed on Negative outlook by Moody's in August 2016 (Ask YTM on the '18s widened by 90bps and Ask YTM on the '21s widened by 107bps to date).**
- **We see a 1-in-3 chance of an outright downgrade (in line with the implied Negative outlook). This is more optimistic than market's current expectation that a downgrade is inevitable based on pricing movement.**
- **Based on our downside case scenario analysis which assumes no rental revenue from 72 Loyang Way and other properties in the marine offshore and oil & gas sector, we find EBITDA/Interest at 3.5x (above its financial covenant of 1.5x) and aggregate leverage at 40% (below MAS regulatory cap of 45%).**
- **Since 4Q2016, SBREIT has reduced its reliance on the marine offshore and oil and gas trade sectors to 13% of rental income (20% in FY2016).**
- **We are keeping SBREIT's issuer profile at Neutral and Overweight both the bonds.**

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- **Background:** We think key investor concerns behind the price drop stems from overall concerns from the weakened domestic industrial property sector, uncertainty surrounding 72 Loyang Way (formerly "Technics Building") which still remains vacant, and a potential ratings downgrade to High Yield which may have prompted investors to offload holdings as a pre-emption.

  SBREIT, listed on the Singapore Stock Exchange with a market cap of SGD674mn as at 14th February 2017, is sponsored by Soilbuild Group Holdings Ltd ("Soilbuild"). Soilbuild owns 25.7% of SBREIT and 100% of the REIT Manager. Soilbuild is in turned wholly-owned by Mr. Lim Chap Huat who co-founded Soilbuild in 1976 with two partners. Soilbuild started as a construction company and then in 1981 entered property development focusing on residential, industrial and business park developments. The bond documentation provides for a Change of Control redemption at the option of bondholders. This is triggered should (1) the Sponsor and Soilbuild's ownership in the REIT fall below 20% or (2) Soilbuild ceases to own at least 51% of the REIT Manager or any other issued share capital of the REIT Manager giving Soilbuild the right to vote in general meetings of the REIT Manager.

Figure 1: SBREIT SGD Bonds

Issue	Maturity / First Call Date	Outstanding Amount (SGDm)	Ask Price	Ask YTW (%)	I-Spread	Bond Rating
SBREIT 3.6% '21	4 August 2021	100	96.5	4.54	245	NR/Baa3/NR
SBREIT 3.45% '18	21 May 2018	100	99.7	3.73	229	NR/NR/NR

Note: (1) Indicative prices as at 14 February 2017
(2) Moody has an issuer rating on SBREIT of Baa3 with a Negative outlook

- **Credit Rating History:** On 22 March 2016, Moody's assigned a first-time Baa3 rating to SBREIT with a Stable outlook. In July 2016, following the tenant default at 72 Loyang Way and on the back of SBREIT's proposed acquisition of Bukit Batok Connection from the Sponsor, Moody's issued a paper capturing their scenario analysis in relation to the potential loss of revenue and funding structure of the Bukit Batok Connection. On 18 August 2016, Moody's placed SBREIT's Baa3 rating on a Negative outlook, reflecting the rating agency's expectations that SBREIT's credit profile will weaken in FY2017 following (1) lack of clarity on its leasing strategy for 72 Loyang Way; (2) partially debt-funded acquisition of Bukit Batok Connection; and (3) pressure on occupancy rates in a challenging operating environment.

Figure 2: Our take on Moody's view

Key downgrade pressure points: Moody's View		Our take
Status of 72 Loyang Way	SBREIT does not find replacement tenants at 72 Loyang Way	72 Loyang Way contributed 9.6% (SGD7.9mn p.a)[1] to rental prior to its default. SBREIT has received SGD11.8mn from the security deposit which covered rent for 18 months (to date, ~3 months left unutilized). SBREIT's acquisition of Bukit Batok Connection forms a replacement rental stream with initial rent of SGD8.0mn per annum. We assume zero rent from 72 Loyang Way in our downside case. Managemen has guided that it is in the midst of negotiations with prospective tenants though new leases are subject to JTC approval.
Bukit Batok Connection acquisition from Sponsor	SBREIT funds the acquisition with more debt than equity	In October 2016, SBREIT completed the acquisition. The property was optimally funded 60% by equity and 40% by debt. The equity was done via a preferential offering and Sponsor and his immediate family members took up their proportionate stake.
Aggregate leverage	Aggregate leverage exceeds 40%	As at 31 December 2016, SBREIT's aggregate leverage was 36.7%. A 33% revaluation loss was taken for 72 Loyang Way and this has been reflected in the aggregate leverage ratio. In our downside case (assumptions below), we find SBREIT's aggregate leverage to be 40%. SBREIT is likely to keep aggregate leverage within its internal threshold of 40%.
Interest Coverage	Falls below 3.0x	In our downside case which does not take into account full year contribution from Bukit Batok Connection, SBREIT's EBITDA/Interest coverage is at 3.5x. Assuming full year contribution from Bukit Batok Connection and the acquisition debt taken, we find EBITDA/Interest at 3.7x. This is well above SBREIT's covenanted level of 1.5x.
Secured debt as a percentage of total assets	Secured debt/deposited assets exceed 15-20% on a sustained basis	As at 31 December 2016, SBREIT's secured debt/deposited assets was 14.5%, in line with levels at time of initial rating.
Pressure on occupancy rates in a challenging environment	Including 72 Loyang Way, 23.3% of portfolio gross rental income is generated from end-tenants operating in the marine offshore and oil & gas segments.	Overall slower environment for tenants have led to weaker occupancy profile (89.6% as at 31 December 2016 versus 96.8% as at 31 December 2015). We view the overall operating environment for the industrial space in Singapore to have weakened though supply-demand may rectify from 2018 onwards. There is still volatility in occupancy and downside risk to lease rates across the sector in FY2017.

- **Downside scenario:** We have run a downside case on SBREIT to assess the REIT's credit metrics. We see the likelihood of a rating downgrade to be kept at 1-in-3 (as implied by Moody's Negative outlook) over the next 6 months. This is more optimistic than market's current expectation of a 1-in-1 chance of a downgrade. The key risk to our call is that Moody's places a higher weight on sector outlook, although for such a move to happen, this would implicate all Singapore-centric industrial REITs and not specific to SBREIT.

[1] *As a portion of annualized gross rental income for FY2015. Technics Oil & Gas' listed equity was suspended since 1 June 2016*

Our downside scenario assumptions:

A) Total loss of revenue from marine offshore and oil & gas sectors: SGD20mn revenue impact (representing 20% of total revenue in FY2016)
B) Zero rental income from 72 Loyang Way, building valuation stays at SGD65mn
C) 40% valuation hit from 3 buildings currently on Master Leases by tenants in marine offshore and oil & gas sectors (31 December 2016 aggregate valuation of these buildings: SGD92.5mn)
D) 25% valuation hit from Tuas Connection (31 December 2016 valuation: SGD122mn)
E) Aggregate leverage levels stay at ~SGD480mn and there are no asset disposals nor new acquisitions

Credit metrics in our downside scenario:

A) EBITDA/Interest coverage: 3.5x
B) Aggregate leverage: 40%

- **Downside at Multi-tenanted Tuas Connection Contained at 25%:** Tuas Connection is made up of landed detached and semi-detached factory units for heavy engineering where certain tenants operate in the marine offshore and oil & gas sectors. The other tenants are involved in machinery and equipment, construction and pharma. Within the context of the Tuas area, the building has good accessibility. Tuas Connection is located 5 minutes' drive from both Gul Way MRT and Tuas Link MRT stations (part of the new Tuas West Extension on the East West Line and is targeted to complete in 2Q2017). The site is also within the vicinity of Tuas Biomedical Park which caters for pharma, biotech and medtech manufacturing (growth sectors for Singapore). Based on a recent site visit, we observed that the building is flexible enough to accommodate tenants from diverse trade sectors. We think a valuation hit (if any) is likely lower than that of the other 3 buildings.

- **72 Loyang Way Status:** Aggregate leverage as at 31 December 2016 already bakes in a SGD32mn in revaluation loss (33% down from valuation at time of purchase). As of report date, we estimate that there is ~3 more months left in the security deposit that was drawndown post the original tenant defaulting. This building was acquired under a sales-and-leaseback and fully-funded by equity in mid-2015. Per management, JTC would need to approve tenants at the building and that any lease can only commence post such approvals. We have assumed zero rental income in our downside case.

- **Bukit Batok Connection as a "replacement asset" for interest coverage and helps diversify away from marine offshore oil & gas:** In June 2016, SBREIT announced that it was intending to acquire Bukit Batok Connection from the Sponsor for SGD100.5mn (including acquisition cost). This building was acquired in end-September 2016. It is located within the vicinity of Bukit Batok MRT and a 7-minute drive from West Mall. The acquisition was 60%-equity and 40% debt funded which in our view was optimal. The Sponsor took up his proportionate stake in the equity fundraising and received SGD96.3mn in upfront payment on the sale. The Sponsor is also the Master Leasee on the property (7-year lease term), paying SGD8mn in the initial year, stepping up 2% p.a. We think Bukit Batok Connection provides an alternate rental stream to SBREIT and fills the EBITDA gap left by 72 Loyang Way. Based on observations, the building is currently ~40% occupied. Effectively, the Sponsor is paying the remaining rent as the building is not yet stabilised. In 4Q2016 (first full quarter results with Bukit Batok Connection), the marine offshore and oil & gas sector contributed 13% in revenue versus 20% for the full year.

- **Alignment of Interest with Sponsor:** While the Sponsor itself is unlisted, its construction arm Soilbuild Construction Group Limited (market cap of SGD147mn as at 14 February 2017) reported net profit of SGD8.4mn and cash flow from operations ("CFO") of SGD26.3mn in 9M2016. SGD13.4mn and SGD13.3mn was paid in dividends to shareholders in both 9M2016 and 9M2015 respectively, of which ~73% accrues to the Sponsor. We think the net outlay that has to be borne by Sponsor on Bukit Batok Connection as manageable. At time of IPO, there were 4

Sponsor assets under the Rights of First Refusal (“ROFR”), Bukit Batok Connection being one. SBREIT is an important vehicle for the Soilbuild group in its capital management strategies and we continue to see strong alignment of interest between Sponsor and SBREIT (Sponsor owns 25.7% of SBREIT).

- **Business Space Makes Up 37% of Portfolio Value:** Solaris and Eightrium, two buildings zoned as business parks are valued at SGD461mnin in aggregate and makes up 37% of SBREIT’s portfolio as at 31 December 2016 (total portfolio: SGD1.2bn). The buildings contributed ~SGD27.4mn of rent in FY2016, representing 34% of total revenue. Assuming an EBITDA margin of 78%, these two buildings itself would have provided EBITDA/Interest coverage of 1.5x in FY2016. Both buildings cater to knowledge industries and provide business spaces outside the Central Business District.

A) **Solaris at One-North:** Solaris is a well-recognized building 5 minutes’ walk away from One-North MRT, an area identified by the Singapore government as a key knowledge industry hub. While the Master Lease for Solaris will expire in August 2018, we see low tenancy risk. The building is nearly fully occupied. As at 31 December 2016, by gross rental income, 56% of underlying leases is due to expire only after August 2018. In October 2015, Apple took up half of Innovis (18 floor-building opposite Solaris) which has helped add cachet for the vicinity. Other neighbouring buildings include INSEAD’s Asia campus, Fusionpolis and JTC Launchpad.

B) **Eightrium at Changi Business Park:** Eightrium is 7 minutes’ walk away from Expo MRT. The business park was launched in 1997 and focuses on data, software and IT businesses. While properties in the area are still susceptible to the trend in offshoring of services, Eightrium has managed to keep occupancy at 100% since 2014 (as of February 2017, we estimate occupancy at 91%). We think Changi Business Park is a net beneficiary from the relocation of companies to business spaces outside the Central Business District given its proximity to Changi Airport. In addition to banks, organizations in the vicinity of Changi Business Park include Cisco, IBM, Huawei and Singapore University of Technology and Design.

- **Recommendation:** The market has priced in SBREIT as a High Yield issuer even though the likelihood of its credit rating being downgraded is a-third (as implied via Moody’s Negative outlook). We see SBREIT as an opportunity for investors unconstrained by ratings action to buy in. We are maintaining our Neutral issuer profile on SBREIT and see fair value on the ‘18s and ‘21s at an Ask YTM of 3.5% and 3.9% respectively.

  We have considered the following:

A) Cambridge Industrial Trust’s CREISP’18s are trading at an Ask YTM of 100bps tighter than SBREIT’18s. CREISP’20s are trading at an Ask YTM of 120bps tighter than SBREIT’21s. Some yield differential is justifiable given CREISP is rated at Baa3/Stable and its cashflow is less lumpy driven by higher number of assets across its portfolio (49 assets as at 31 December 2016, total portfolio value of SGD1.3bn).

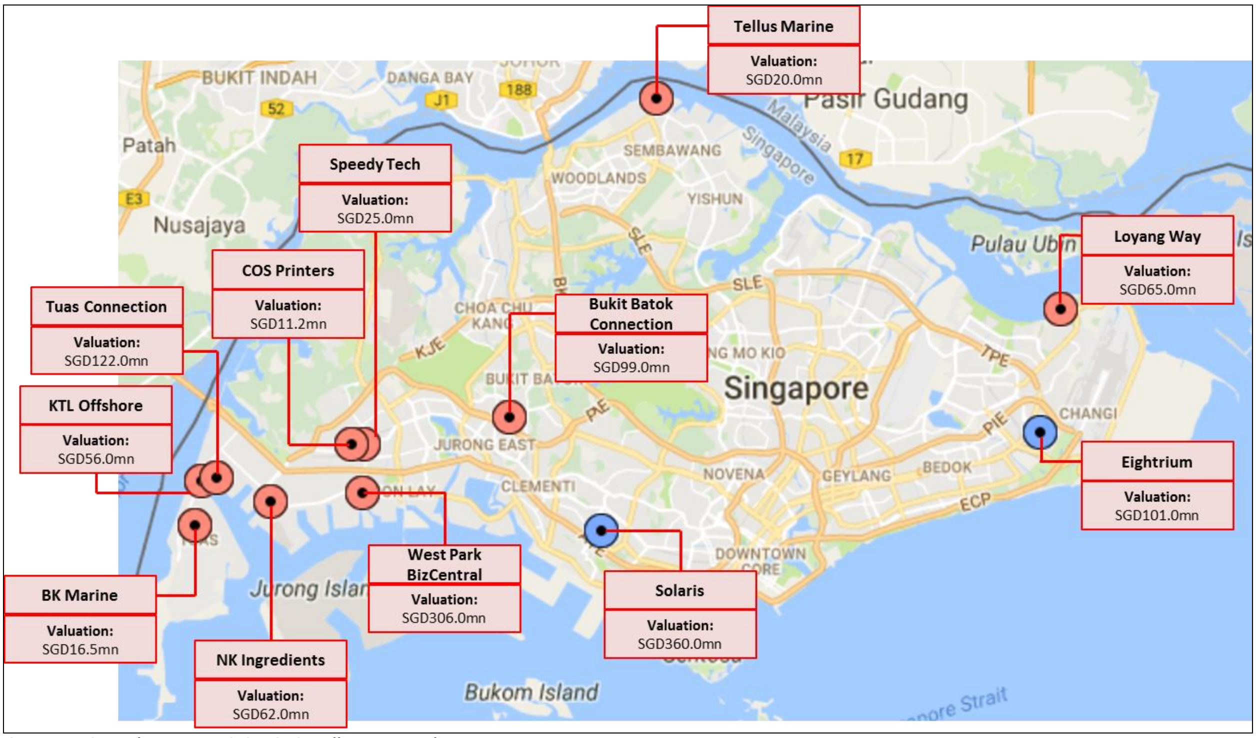
B) Nevertheless, we think CREISP’s short-to-medium term stability reflects its more generic asset base and we see CREIT requiring capital for portfolio rejuvenation in the medium-longer term.

C) First REIT’s FIRTSP’18s is trading at Ask YTM of 3.1%. Lippo Malls Indonesia Retail Trust’s LMRTSP4.1 ‘20s trading at Ask YTM of 4.3%. First REIT is unrated while Lippo Malls Indonesia Retail Trust has an issuer rating of Baa3/Stable.

D) We see fair value of SBREIT ‘18s at around 50 bps tighter and ‘21s at 50-60 bps tighter versus comparable CREIT bonds.

Correction: An earlier version of this report as at 14 February 2017 included SBREIT’s market cap in USD instead of SGD.

Appendix A



Source: Google maps, OCBC Credit Research

Soilbuild Business Space REIT

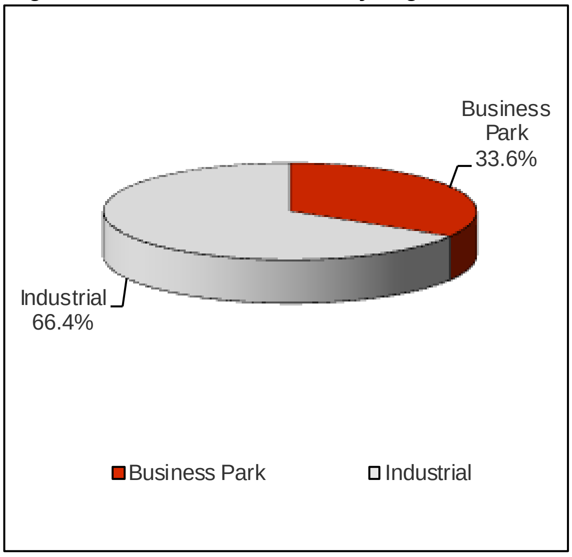
Table 1: Summary Financials

Year Ended 31st Dec	FY2014	FY2015	FY2016
Income Statement (SGD'mn)			
Revenue	68.1	79.3	81.1
EBITDA	51.7	61.1	64.4
EBIT	51.7	61.1	64.4
Gross interest expense	9.7	13.5	14.6
Profit Before Tax	42.4	51.7	-0.6
Net profit	42.4	51.7	-0.6
Balance Sheet (SGD'mn)			
Cash and bank deposits	21.0	16.8	25.7
Total assets	1,054.0	1,214.5	1,275.5
Gross debt	368.9	398.5	472.3
Net debt	348.0	381.8	446.6
Shareholders' equity	650.8	746.0	751.7
Total capitalization	1,019.7	1,144.5	1,224.1
Net capitalization	998.8	1,127.7	1,198.3
Cash Flow (SGD'mn)			
Funds from operations (FFO)	42.4	51.7	-0.6
* CFO	53.6	57.1	71.3
Capex	0.2	25.5	31.9
Acquisitions	94.6	98.1	103.9
Disposals	0.0	0.0	0.0
Dividends	49.6	55.7	58.9
Free Cash Flow (FCF)	53.5	31.6	39.3
* FCF Adjusted	-90.7	-122.2	-123.5
Key Ratios			
EBITDA margin (%)	75.9	77.1	79.4
Net margin (%)	62.3	65.1	-0.7
Gross debt to EBITDA (x)	7.1	6.5	7.3
Net debt to EBITDA (x)	6.7	6.2	6.9
Gross Debt to Equity (x)	0.57	0.53	0.63
Net Debt to Equity (x)	0.53	0.51	0.59
Gross debt/total capitalisation (%)	36.2	34.8	38.6
Net debt/net capitalisation (%)	34.8	33.9	37.3
Cash/current borrowings (x)	0.2	NM	NM
EBITDA/Total Interest (x)	5.3	4.5	4.4

Source: Company, OCBC estimates

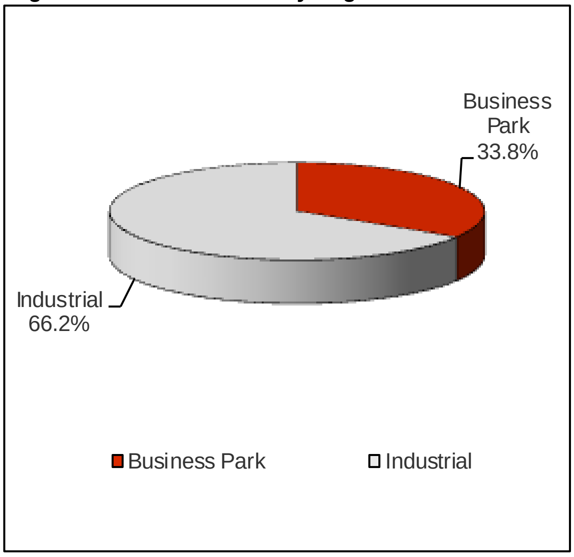
**FCF Adjusted = FCF - Acquisitions - Dividends + Disposals | *CFO before deducting interest expense*

Figure 1: Revenue breakdown by Segment - FY2016



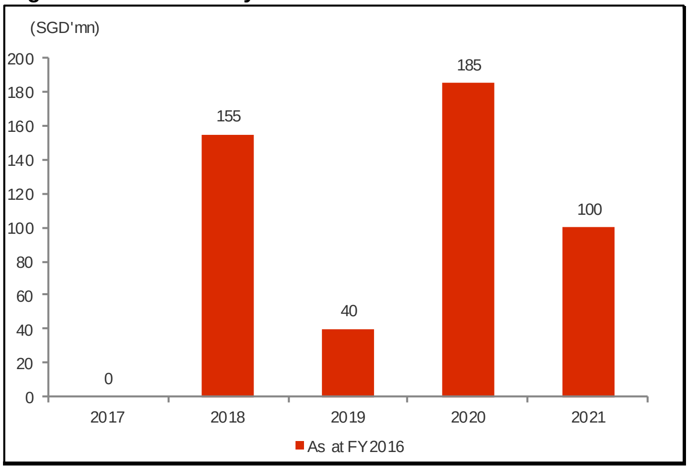
Source: Company

Figure 2: NPI breakdown by Segment - FY2016



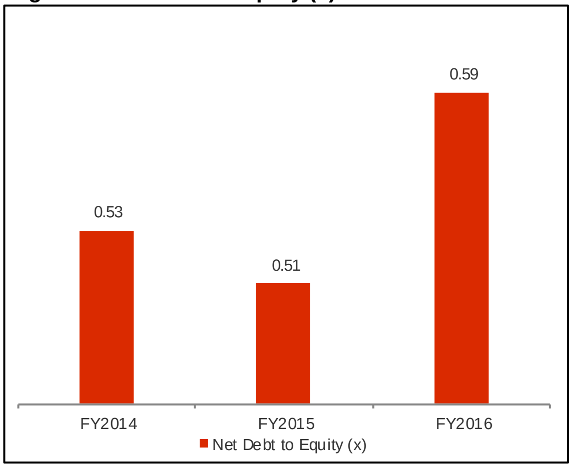
Source: Company

Figure 3: Debt Maturity Profile



Source: Company

Figure 4: Net Debt to Equity (x)



Source: Company, OCBC estimates

The credit research team would like to acknowledge and give due credit to the contributions of Yeo Jin Peng.

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