Asia Credit Research

OCBC Bank

Soilbuild Business Space REIT: Credit Update

Monday, 23 October 2017

Recalibrating

- **On 18 September 2017, SBREIT announced that it has called upon the insurance guarantee from the Master Lessee at NK Ingredients property. The property represented 6.2% of gross revenue in 3Q2017. As NK Ingredients was not within the marine, offshore and oil & gas space, we had not factored tenant arrears at this property into our earlier downside case scenario.**
- **We have reviewed the impact of the recent arrears and have updated our base case and downside case for SBREIT.**
- **We see low-to-moderate counterparty credit risk at five of the 12 properties owned by SBREIT (representing 81.0% of gross revenue in 3Q2017). These are multi-tenanted properties of which two office-like business parks are valued at SGD461mn.**
- **Unencumbered properties amount to SGD883mn and provide a 3.0x coverage to unsecured debt.**
- **Despite the heightened counterparty credit risk at certain properties, SBREIT is still within our parameters of a Neutral issuer profile under our downside scenario.**
- **Recommendation:** We see SBREIT's credit profile as on par with ESR REIT ("EREIT"). SBREIT is unrated while EREIT is rated at Baa3/Negative outlook by Moody's. We hold the SBREIT'18s and SBREIT'21s at Neutral and are recommending a switch from the EREIT curve to SBREIT. A switch from the EREIT'18s into the SBREIT'18s would allow a 70bps pick-up (for a 5.5 month shorter maturity on the SBREIT). For an 11 month extension in maturity, the SBREIT'21s is providing a 70bps pick up versus the EREIT' 20s.

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- **Background:** SBREIT has released its 3Q2017 results, and we have analysed the financial results and considered the updated developments in our credit update. We had been cautious over SBREIT's tenant continuity among tenants in the marine, offshore oil and gas space and have built a downside case around arrears of such tenants. On 18 September 2017, SBREIT announced that its Master Lessee at NK Ingredients building had been in arrears. This Master Lessee operates in the chemicals sector (supplier of raw materials) and was outside our downside expectations. SBREIT is now unrated by the credit rating agencies, having dropped its ratings in July 2017.

  SBREIT, listed on the Singapore Stock Exchange with a market cap of SGD714mn as at 23rd October 2017, is sponsored by Soilbuild Group Holdings Ltd ("Soilbuild"). As of report date, the REIT owns two business park properties and ten industrial properties, with a total asset value of SGD1.2bn. Mr Lim Chap Huat (founder of the Sponsor) is still the largest single unitholder of SBREIT with an 8.4%-stake, followed by Mr Jinquan Tong at ~6.8%. Post a transfer of units by Mr Lim to his three adult children in July 2017, they each respectively hold a ~6.7% stake in SBREIT. The transfer of units triggered a Change of Control ("CoC") event which saw some bonds being tendered back to the issuer (current amount outstanding SGD181.5mn against SGD200mn prior to the CoC). We view this as part of the family's succession planning and hence minimal impact to SBREIT's day-to-day operations. Collectively, the Lim family still holds ~28.5% in SBREIT.

  The Sponsor, Soilbuild, started as a construction company and then in 1981 entered property development focusing on residential, industrial and business park developments.

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	8 April 2021	88.0	100.0	3.60	190	NR/NR/NR
SBREIT 3.45% '18	21 May 2018	93.5	100.25	3.02	188	NR/NR/NR

Note: (1) Indicative prices as at 23 October 2017

A) Recent Performance

- **More arrears in 9M2017:** SBREIT saw its revenue increased by 7.8% to SGD64.1mn. This was mainly driven by contribution from Bukit Batok Connection "BBC" (acquired in September 2016 from Sponsor) as well as improvements at Solaris, Tuas Connection and Tellus Marine. These were offset somewhat by reduction in revenue from 72 Loyang Way. In 9M2017, 32% of net property income ("NPI") was attributable to Solaris and Eightrium (both "office-like" business park properties). Mainly due to the loan draw down to partly finance the acquisition of BBC, finance expenses were 11.1% higher at SGD11.9mn. EBITDA was up 8.0% to SGD51.0mn, resulting in EBITDA/Interest of 4.3x (9M2016: 4.4x). Headline numbers though still include contribution from NK Ingredients (6.2% contribution to gross revenue in 3Q2017). NK Ingredients had been in arrears for SGD3.4mn per SBREIT's announcement on 18 September 2017 and our base case assumes that the Master Lessee will pre-terminate this lease. Trade and other receivables ballooned to SGD8.5mn as at 30 September 2017 (from SGD4.3mn in end-December 2016). 72% of these relate to NK Ingredients and KTL Offshore Pte. Ltd ("KTL"). KTL had been in arrears for seven months. An arrangement has been reached between SBREIT and KTL where KTL is continuing as a Master Lessee of the KTL Offshore building (4.6% contribution to gross revenue in 3Q2017). Adjusting EBITDA downwards for the lack of contribution from NK Ingredients and KTL, we find EBITDA/Interest at 3.8x. As at 30 September 2017, aggregate leverage was stable at 37.9%. We expect asset erosion on certain buildings come end-2017 (when the properties are revalued, though within the regulatory cap of 45%). Occupancy rates at SBREIT improved to 94.1% as at 30 September 2017 (up from 92.6% as at 30 June 2017). In the remaining three months of the year, 5.0% of leases (by rental income) will come due, the space mainly relates to WestPark BizCentral).

B) Counterparty credit risk

Improvements in the manufacturing sector (a main driver for the industrial leasing market) have happened, but it is not broad based. We have observed tenant weaknesses in some pockets of the Industrial REIT sector. While Master Lease arrangements (eg: in a Sales-and-Leaseback transaction) provide REITs with a stable source of income over a longer period of time, the REIT is subject to lumpiness in cash flow should a Master Lessee pre-terminate. Such properties tend to be purpose-built and hence may stay vacant for longer in a pre-termination scenario. SBREIT demands a larger security deposit (six to 12 months) from Master Lessees versus three to five months from tenants in multi-tenanted buildings. We see this as partial mitigation to cash flow volatility.

Update on 72 Loyang Way: In July 2016, the Master Lessee at 72 Loyang Way defaulted on its lease. The property, located on the waterfront with a jetty was purpose-built for the Master Lessee (whose main business was in engineering-related services for the offshore oil and gas sector) and was purchased by SBREIT under a sales-and-leaseback the year before. Prior to its default, this property contributed 9.8% to 1QFY2016 gross revenue and 8.1% to investment property portfolio as at 31 March 2016. The building sits on a number of JTC leasehold land titles. In Singapore, land is allocated to end-users for specific purposes by the JTC Corporation ("JTC") for a finite period of time. JTC is a statutory body under the Ministry of International Trade and Industry that focuses on planning, promotion and development of Singapore's industrial landscape. Buildings located on land titles leased from JTC are subject to strict sub-letting rules. This is a common way for end-users to buy land zoned for industrial purposes (ie: conventional industrial and business parks), though not the only way. In the case of 72 Loyang Way, 70% of the space needs to be taken up by one anchor tenant. JTC had temporarily lifted subletting requirements on a portion of the space at 72 Loyang Way until end-2020. SBREIT is allowed to sublet up to 30% of the GFA to non-anchor tenants. In 3Q2017, 27% of the space at 72 Loyang Way has been occupied. We note that the company is still negotiating with JTC to increase the proportion of space that can be sublet.

NK Ingredients (2 Pioneer Sector 1) fell through the cracks: In September 2017, we were made aware that a second Master Lessee had been in arrears on their rent. The Master Lessee at NK Ingredients building (located on 2 Pioneer Sector 1) had been in arrears for SGD3.4mn. This property contributed 6.2% to gross revenue in 3Q2017 and comprises 5.0% of SBREIT's investment property portfolio as at 30 September 2017. Similar to 72 Loyang Way, this building is also subject to JTC's sub-letting rules, though in the case of NK Ingredients less onerous. Multiple tenants with each occupying at least 1,500 sqm of space and satisfy certain productivity criteria would qualify as anchor tenants. SBREIT holds an insurance guarantee amounting to SGD5.1mn, of which SGD3.4mn has since been called and received. While NK Ingredients has not officially pre-terminated its lease, our base case assumes a pre-termination. The remaining SGD1.7mn (when called and received) should help cover approximately four months of rent. NK Ingredients operates in the chemical sector (focusing on inputs for the health & beauty industry). We did not factor in this tenant to be in arrear in forming our downside case in February 2017. Should the Master Lessee indeed pre-terminate the lease; SBREIT would be free to put the property back into the rental market.

KTL Offshore still a tenant: On 13 October 2017, SBREIT disclosed that the Master Lessee at KTL Offshore building, namely, KTL Offshore Pte Ltd ("KTL") had been in arrears for seven months, amounting to SGD2.7mn. This is within expectations given the challenges facing the marine, offshore oil and gas sectors. Despite the arrears, an arrangement has been reached between KTL and SBREIT where the REIT would refrain from exercising its rights on SGD1.5mn due from KTL. The conditions imposed by SBREIT include (1) KTL to increase existing security deposit from SGD3.8mn to SGD5.3mn; (2) KTL to deliver a second insurance guarantee for SGD1.5mn for the period from August 2021 to August 2023. Effectively, SBREIT is allowing KTL to extend the SGD1.5mn in arrears by 24 months to August 2023 in return for an insurance bond; and (3) KTL is required to pay interest at 6.0% p.a. on the SGD1.5mn. As of report date, SBREIT holds an insurance bond amounting to SGD5.3mn and KTL is continuing as a Master Lessee. The property's lease expires in August 2021. In 3Q2017, the KTL Offshore building contributed 4.6% to gross revenue.

Outlook for counterparty credit risk: We see low-to-moderate counterparty credit risk on five of the 12 properties owned by SBREIT, which collectively make up 81.0% of gross revenue in 3Q2017 and 79% of investment properties value as at 30 September 2017. All five of the properties are multi-tenanted. Two of these are business park properties (valued at SGD461.2mn) and main tenants are larger companies and statutory boards. In our view, these tenants are far likelier to cancel their leases with compensation than to early terminate due to tenant defaults. We had estimated that BBC was 40%-occupied based on a site visit in 1Q2017. Per company, 80% of the underlying space is now occupied by sub-tenants. BBC is Master Leased by the Sponsor and Sponsor takes all the leasing market risk. We take some comfort that BBC (when subjugated to actual market conditions) is able to raise its underlying occupancy. For 72 Loyang Way and 2 Pioneer Sector 1, which collectively made up 7.4% of gross revenue in 3Q2017 and 10.2% of investment properties portfolio, we think the worst has happened and new tenancies are upsides to our current base case. The remaining five properties are Master Leased and collectively make up 11.4% of gross revenue and 10.3% of investment properties value. We consider this income source as at-risk. Three of these properties operate in the still challenging marine, offshore and oil & gas sectors (collectively 7.9% of gross revenue recognized in 3Q2017). The other two are leased to privately held entities and we are lacking the information to ascertain the actual financial standing of such tenants.

Figure 2: Buildings and key tenants

Property	Type	Contribution to Gross Revenue (%)	As a % of investment portfolio value	Brief description
West Park BizCentral	Industrial	25.2%	24.6%	• Pioneer Crescent • Ramp-up factory and hi-tech facility • Occupancy of 95.0%, improving from 91.2% in 2Q2017 • 54 tenants • Main tenants: Dyson, DNOW, Hitachi
Solaris	Business Park	22.8%	28.9%	• One-North • Office-like business park • Master Leased by Sponsor • 23 tenants • Main tenants: SPRING (lease until 2020), John Wiley & Sons, Autodesk, Mediatek
Tuas Connection	Industrial	12.5%	9.8%	• Tuas • Detached and semi-detached factory units • 93.2% occupied, stable versus 2Q2017 • 14 tenants • Main tenants: Flowserve, Owens Cornings, Harding Safety
Eightrium @ Changi Business Park	Business Park	10.8%	8.1%	• Changi Business Park • Office-like business park • 100% occupied • 14 tenants • Main tenants: Nestle, DBS, Asus
Bukit Batok Connection	Industrial	9.7%	8.0%	• Bukit Batok • Ramp-up light industrial • Under a Master Lease with Sponsor • Main tenants: Various small, medium enterprises
72 Loyang Way	Industrial	1.2%	5.2%	• Loyang • Ancillary office, production facilities, worker dormitory and jetty • 27% occupied, increasing from 22.8% in 2Q2017 • Main tenants: Undisclosed
NK Ingredients (2 Pioneer Sector 1)	Industrial	6.2%	5.0%	• Tuas • Office, lab, warehouse and production facilities • Under a Master Lease • Main tenants: NK Ingredients
KTL Offshore	Industrial	4.6%	4.5%	• Tuas • Detached purpose-built factories with ancillary office • Under a Master Lease • Main tenants: KTL Offshore Pte Ltd
Speedy-Tech	Industrial	2.3%	2.0%	• Jurong Industrial Estate • Light industrial building • Under a Master Lease • Main tenants: Speedy-Tech Electronics Ltd
Tellus Marine	Industrial	1.9%	1.6%	• Woodlands • Industrial building • Under a Master Lease

				• Main tenants: Tellus Marine
Beng Kuang Marine	Industrial	1.4%	1.3%	• Tuas • Warehouse with workers dormitory • Under a Master Lease • Main tenants: Picco Enterprise Pte Ltd
COS Printers	Industrial	1.2%	0.9%	• Jurong Industrial Estate • Factory and warehouse • Under a Master Lease • Main tenants: C.O.S Printers Pte Ltd

Note: (1) Gross revenue per 3Q2017. Investment portfolio value refers to valuation as at 31 December 2016 and capex spent in 9M2017

(2) Business parks are a sub-type of Industrial properties. Business Parks are "Office-like" and cater to knowledge industries. These typically provide business spaces outside the Central Business District

Source: SBREIT website, investor presentation

C) Asset coverage and short term obligations

Sufficient asset coverage: The book value of SBREIT's assets has rightly taken a hit following the default of the original Master Lessee at 72 Loyang Way. As at 31 December 2016, asset value for 72 Loyang Way was SGD65mn against SGD97 as at 31 December 2015 (before the default). Should the Master Lessee default at 2 Pioneer Sector 1, we expect SBREIT's asset value to further erode. Assuming a further 55% erosion on 72 Loyang Way and 40% asset erosion on 2 Pioneer Sector 1, SBREIT may lose SGD60.7mn in asset value from its SGD1.2bn valuation as at 30 September 2017 (which has yet to take in the negative impact from 2 Pioneer Sector 1). As at 30 September 2017, only Solaris has been secured for debt facilities. SGD883mn of investment properties are unencumbered. As at 30 September 2017, secured debt made up 14.6% of total assets. The remaining unencumbered investment properties provide a 3.0x coverage to total unsecured debt (inclusive of the two SGD bonds outstanding). It is worth noting during an upturn, we may see an improvement in asset values and improving aggregate leverage levels (assuming debt stays constant).

Short term obligations due: Over the next 12 months, the SBREIT'18s with an outstanding amount of SGD93.5mn and SGD55mn in interest-free loan extended by Sponsor will come due. By August 2018, the Master Lease at Solaris will expire and the security deposit amounting to SGD18.7mn would also need to be refunded to Sponsor. In aggregate, SBREIT faces SGD167.2mn in short term obligations versus its cash balance of SGD10.5mn as at 30 September. It is expected that the SGD55mn would not be rolled forward by Sponsor and instead refinanced via bank loans. On 19 October 2017, SBREIT had entered into a SGD200mn secured bank loan facility to refinance its current secured facility. Assuming that the bank loan was completed on 19 October 2017, weighted average debt maturity of SBREIT would be 2.9 years (against 2.1 years as at 30 September 2017). With bank debt and fixed income markets accessible and SGD883mn of properties still unencumbered, we see refinancing risk at SBREIT as manageable.

D) Base case scenario: In light of the updated information, we have presented here our base case scenario on SBREIT.

Our base case scenario assumptions

A) Rental income from 27%-occupied space at 72 Loyang Way
B) Further asset value erosion on 72 Loyang Way, building valuation drops to SGD29.1mn (representing 30% of the original purchase price)
C) Zero rental income from tenant at 2 Pioneer Sector 1
D) 2 Pioneer Sector 1 building valuation drops by 40% to SGD37.2mn
E) Zero rental income from all tenants in the marine, offshore and oil & gas sectors
F) 40% valuation hit on three buildings Master Leased by tenants in the marine, offshore and oil & gas sectors. Valuation drops to SGD55.5mn (31 December 2016 aggregate valuation of SGD92.5mn)

Credit metrics in our base case scenario:

A) EBITDA/Interest coverage: 3.4x
B) Aggregate leverage: 41%

E) Downside scenario: In February 2017, we ran a downside case on SBREIT to assess the REIT's credit metrics to assess the probability of a credit rating downgrade by Moody's. Moody's has since removed its credit rating per SBREIT's request. We are revising our downside case with more onerous assumptions in light of the updated information.

A) All assumptions in the base case scenario; and
B) Zero rental income from COS Printers and Speedy-Tech (being non-Sponsor Master Leased properties outside the marine, offshore and oil & gas sectors); and
C) 40% valuation hit on these two properties. Valuation drops to SGD21.7mn (31 December 2016 aggregate valuation of SGD36.2mn)

Credit metrics in our downside scenario:

A) EBITDA/Interest coverage: 3.2x
B) Aggregate leverage: 43%

- **Recommendation:** Despite the heightened counterparty credit risk at certain properties, SBREIT is still within our parameters of a **Neutral** issuer profile under our downside scenario. We see SBREIT's credit profile as on par with ESR REIT ("EREIT"). SBREIT is unrated while EREIT is rated at Baa3/Negative outlook by Moody's. We hold the SBREIT'18s and SBREIT'21s at Neutral and are recommending a switch from the EREIT curve to SBREIT. A switch from the EREIT'18s into the SBREIT'18s would allow a 70bps pick-up (for a 5.5 month shorter maturity on the SBREIT). For an 11 month extension in maturity, the SBREIT'21s is providing a 70bps pick up versus the EREIT' 20s.

We have considered the following:

A) EREIT had announced the proposed acquisition of Hyflux building for SGD111mn (inclusive of transaction cost) on 19 October 2017. Potential increase in EREIT aggregate leverage to ~42%. This assumes that Hyflux building is fully debt-funded as currently intended by EREIT.
B) EREIT discloses its top ten tenants by contribution to gross revenue. We see 10-12% of gross revenue as at-risk. This includes tenants from industries facing generalised weakness and those who had announced plans for consolidation into a single-location, which may eventually see them moving out of EREIT properties.
C) The EREIT'18s are trading at an Ask YTM of 2.3%, spread of 107bps
D) The EREIT 3.95% 20s are trading at an Ask YTM of 2.87%, spread of 131bps
E) The VITSP'18s are trading at an Ask YTM of 3.2%, spread of 198bps

Soilbuild Business Space REIT

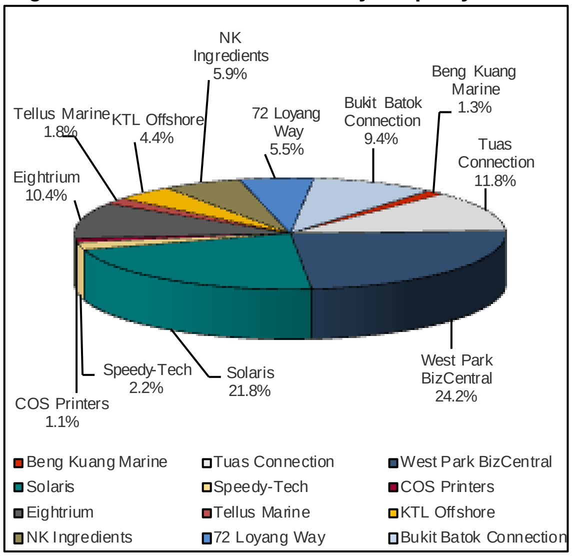
Table 1: Summary Financials

Year Ended 31st Dec	FY2015	FY2016	9M2017
Income Statement (SGD'mn)			
Revenue	79.3	81.1	64.1
EBITDA	61.1	64.4	51.0
EBIT	61.1	64.4	51.0
Gross interest expense	13.5	14.6	11.9
Profit Before Tax	51.7	-0.6	39.7
Net profit	51.7	-0.6	39.7
Balance Sheet (SGD'mn)			
Cash and bank deposits	16.8	25.7	10.5
Total assets	1,214.5	1,275.5	1,266.1
Gross debt	398.5	472.3	474.4
Net debt	381.8	446.6	463.9
Shareholders' equity	746.0	751.7	749.5
Total capitalization	1,144.5	1,224.1	1,223.9
Net capitalization	1,127.7	1,198.3	1,213.4
Cash Flow (SGD'mn)			
Funds from operations (FFO)	51.7	-0.6	39.7
* CFO	57.1	71.3	32.6
Capex	25.5	31.9	0.2
Acquisitions	98.1	103.9	0.0
Disposals	0.0	0.0	0.0
Dividends	55.7	58.9	47.3
Free Cash Flow (FCF)	31.6	39.3	32.4
* FCF Adjusted	-122.2	-123.5	-14.9
Key Ratios			
EBITDA margin (%)	77.1	79.4	79.7
Net margin (%)	65.1	-0.7	61.9
Gross debt to EBITDA (x)	6.5	7.3	7.0
Net debt to EBITDA (x)	6.2	6.9	6.8
Gross Debt to Equity (x)	0.53	0.63	0.63
Net Debt to Equity (x)	0.51	0.59	0.62
Gross debt/total capitalisation (%)	34.8	38.6	38.8
Net debt/net capitalisation (%)	33.9	37.3	38.2
Cash/current borrowings (x)	NM	NM	0.1
EBITDA/Total Interest (x)	4.5	4.4	4.3

Source: Company, OCBC estimates

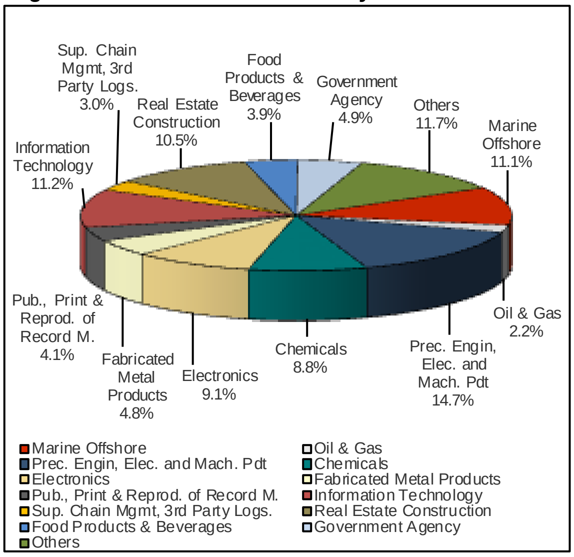
**FCF Adjusted = FCF - Acquisitions - Dividends + Disposals | *CFO after deducting interest expense*

Figure 1: Revenue breakdown by Property - 9M2017



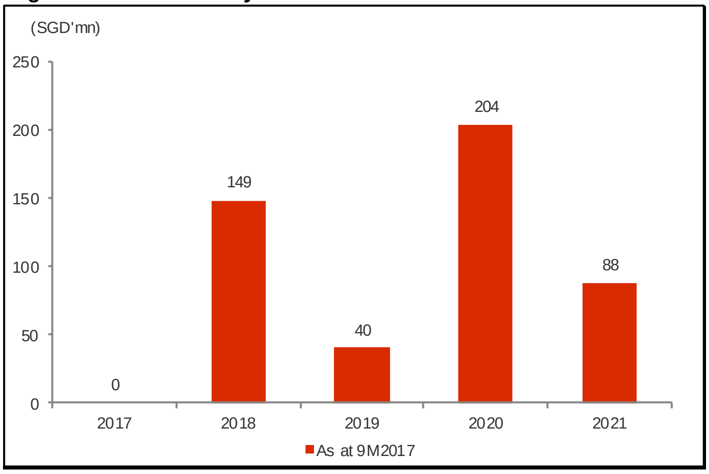
Source: Company, OCBC estimates

Figure 2: Revenue breakdown by Business - 9M2017



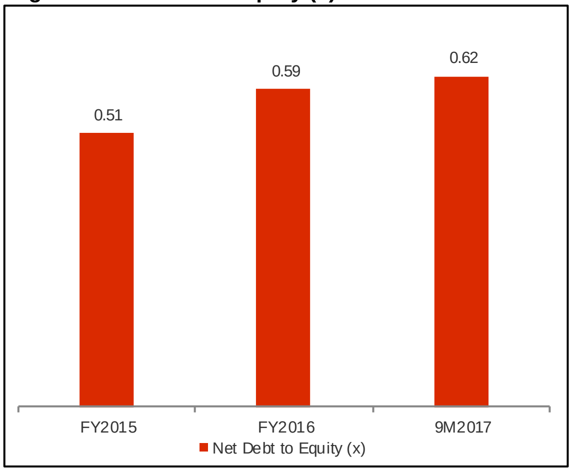
Source: Company, OCBC estimates

Figure 3: Debt Maturity Profile



Source: Company, OCBC estimates

Figure 4: Net Debt to Equity (x)



Source: Company, OCBC estimates

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