OCBC Bank

Asia Credit Research

Earnings Review: Ascott Residence Trust ("ART")

Issuer Profile: Neutral (4)

Ticker: **ARTSP**

Background

Ascott Residence Trust ("ART") invests primarily in serviced residences and rental housing properties. It is the largest hospitality trust listed on the SGX with a market cap of SGD2.3bn. As at 30 June 2018, ART's portfolio consists of 73 properties located in 37 cities across 14 countries.

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Recommendation

- 2Q2018 revenue growth was driven by acquisitions, with same-store sales still exhibiting a small decline of 0.5% (versus -2.5% in 1Q2018).
- EBITDA/Interest coverage remains stable at 4.5x while aggregate leverage has fallen to 35.7% (1Q2018: 36.1%) on account of revaluation gains of ART's serviced residences properties and a decline in q/q gross debt levels.
- Operating performance of properties on management contracts (those which are not backed by master leases nor minimum income) continue to perform weaker, though we take some comfort that Master Leases make up ~32% to gross profit, providing some level of income stability.
- We are maintaining our neutral call on the ARTSP 4.68%-PERP which has a first call in June 2020 and lifting the ARTSP 5.0%-PERP which has a first call in October 2019 to neutral (from underweight). Adjusted for the shorter tenure, we prefer both the ARTSP perpetuals over the MLTSP 4.18%-PERP. While MLT operates in the industrial space sector, we hold both MLTSP and ARTSP at an issuer profile of Neutral (4).

Relative Value:

Bond	Maturity/Call date	Aggregate leverage	Ask YTW	Spread
ARTSP 5.0%-PERP	27/10/2019	35.7%	3.27%	149bps
ARTSP 4.68%-PERP	30/06/2020	35.7%	3.38%	149bps
MLTSP 4.18%-PERP	25/11/2021	36.4%	3.47%	142bps
MLTSP 3.65%-PERP	28/03/2023	36.4%	3.71%	155bps

Indicative prices as at 17 August 2018 Source: Bloomberg
Aggregate leverage based on latest available quarter

Key Considerations

- **Decline in same-store sales, though narrower versus 1Q2018:** ART's 2Q2018 revenue increased SGD6.9mn (5.6% y/y) to SGD130.5mn, mainly due to additional revenue from new properties acquired in 2017 (acquisition of two serviced residences in Germany, DoubleTree by Hilton New York and Ascott Orchard Singapore), partly offset by the decrease in revenue from divestments (SGD2.9mn negative impact from sale of the 18 rental housing properties in Tokyo and the divestment of Citadines Biyun Shanghai and Citadines Gaoxin Xi'an in January 2018) and a SGD0.6mn decline in contribution from existing properties. The SGD0.6mn decline represents a 0.5% y/y decline in same-store sales (which excludes the impact of acquisitions and divestments). We take some comfort though that this decline was narrower than the 2.5% y/y decline in same-store sales in 1Q2018.

- **Foreign exchange losses though revaluation gains mitigated impact on bottomline:** Despite the stronger top line, foreign exchange losses of SGD6.5mn was reported in 2Q2018 (1Q2018: gains of SGD17.9mn), resulting in a 36% y/y decline in net income before changes in fair value of financial derivatives, serviced residence properties and assets held for sale to SGD37.1mn. Per company, FX losses was due to depreciation in EUR against SGD. Where possible, ART uses natural hedging, though we had observed less balance sheet hedging for EUR at the beginning of 2Q2018 versus beginning of 2Q2017, which could explain the losses. In 2Q2018, ART had hedged 46% of its balance sheet overall assets. ART recognised a SGD26.7mn revaluation gains from serviced residences in 2Q2018 (properties are valued semi-annually at ART) which drove total return for the period after tax to SGD50.1mn, despite the FX losses. While revaluation gains are a non-cash item, it expands total asset value and improves aggregate leverage. In local currency terms, the properties in the Philippines, Vietnam, France, Germany and the UK saw higher revaluation gains versus the independent valuation as at 31 December 2017.

- **Interest coverage improved slightly:** EBITDA (based on our calculation which does not include other income and other expenses) was SGD52.5mn (up 7.0% y/y) while interest expense increased by 3.9% y/y due to higher debt took on for acquisitions. EBITDA/Interest coverage improved slightly to 4.5x (2Q2017: 4.4x). Perpetuals made up 8% of total capital and adjusting 50% of perpetual distribution as interest expense, we estimate that adjusted EBITDA/Interest expense was 3.7x.

- **Manageable aggregate leverage:** As at 30 June 2018, ART's reported aggregate leverage was 35.7% and adding 50% of perpetuals as debt, adjusted aggregate leverage would be ~39% based on our estimation, slightly lower versus 40% as at 31 March 2018. As at 30 June 2018, short term debt was SGD270.6mn, this only represents 14% of total gross debt at ART. Of the sum, SGD166mn comes due within the six months from 1 July 2018, including the JPY5bn (~SGD61mn) bond due in September and the SGD100mn ARTSP 4.3% '18 due in November. Cash balance was SGD196.8mn, more than suffice to pay down these two bonds coming due though we think it is more likely for ART to try to refinance the bonds due. We estimate that SGD2.6bn of serviced residence properties remains unencumbered, which can help ART raise secured funding if need be. As at 30 June 2018, secured debt was 17% of total assets.

- **Weaker operating performance for properties under management contracts:** In SGD terms, at a gross profit level, properties under Management Contracts worsened 2.3% y/y to SGD34.3mn (2Q2017: SGD35.1mn). All geographies saw flat-to-weaker underlying performance. The US reported higher gross profit of 31.9% y/y to SGD9.1mn, though this was due to the acquisition in New York. Singapore saw flat revenue though reported gross profit grew 4.2% y/y to SGD2.5mn on account of lower expenses. China and Japan were affected by divestments in 2017 while the rest of the properties in Australia, Indonesia, the Philippines and Vietnam were negatively affected by weaker underlying performance and currency depreciation against the SGD. In 2Q2018, properties under management contract made up 54% of total gross profit (59% in 2Q2017).

- **Master Leases contribute 32% to gross profit:** Reported gross profit from Master Leases increased 28.2% y/y to SGD20.0mn, driven by the acquisitions of Ascott Orchard Singapore and two serviced residences in Germany. The three acquired properties in 2017 are master leased to ART's Sponsor, The Ascott Limited (wholly-owned subsidiary of CapitaLand Ltd (Issuer profile: Neutral (3)). Master Leases provide income stability to ART. Under such arrangements, ART is effectively facing the Master Lessees as counterparty (bulk are with subsidiaries of CapitaLand), helping to insulate ART from seasonality common in the hospitality business and especially useful at a time where the extended stay segment is under pressure. 14% of gross profits are from management contracts with a minimum guaranteed income.

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Positive ("Pos") – The issuer's credit profile is either strong on an absolute basis, or expected to improve to a strong position over the next six months.

Neutral ("N") – The issuer's credit profile is fair on an absolute basis, or expected to improve / deteriorate to a fair level over the next six months.

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To better differentiate relative credit quality of the issuers under our coverage, we have further sub-divided our Issuer Profile Ratings into a 7 point Issuer Profile Score scale.

IPR	Positive		Neutral			Negative	
IPS	1	2	3	4	5	6	7

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Overweight ("OW") – The performance of the issuer's specific bond is expected to outperform the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

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Other

Suspension – We may suspend our issuer rating and bond level recommendation on specific issuers from time to time when OCBC is engaged in other business activities with the issuer. Examples of such activities include acting as a joint lead manager or book runner in a new issue or as an agent in a consent solicitation exercise. We will resume our coverage once these activities are completed.

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Analyst Declaration

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