Asia Credit Research

Earnings Review: ESR-REIT ("EREIT")

Issuer Profile: Neutral (4)

Ticker: **EREIT**

Background

Listed in 2006, ESR-REIT ("EREIT") is an industrial REIT in Singapore, with total assets of SGD1.7bn as at 31 March 2018. The REIT's largest unitholder is Jinquan Tong with ~18.3% stake. E-Shang Redwood Group, a company backed by Warburg Pincus, is now the second largest unitholder with a 12.3%-stake in EREIT and 80%-stake in the EREIT's REIT Manager.

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Recommendation

- Despite our weaker outlook on EREIT's operating performance over the next 12 months, we see low refinancing risk at the REIT and like the proposed merger between EREIT and VIVA Industrial Trust (as of report definitive agreements have not been signed). We maintain EREIT's issuer profile at Neutral (4).
- We see more value in the short dated EREIT 3.5% '18s versus Suntec REIT's SUNSP 2.83% '18s which is trading 60bps tighter. While Suntec REIT operates in a sector with stronger industry dynamics (within a 12 month period) versus EREIT, we have both issuer profiles at Neutral (4). Additionally, both are rated at similar rating levels by external rating agencies.
- Comparing the EREIT 4.6%-PERP with Cache Logistics Trust's CACHE 5.5%-PERP, we prefer the EREIT 4.6%-PERP which gives a 20bps spread pick-up, with a three month shorter time to first call. We do not cover Cache Logistics Trust.

Relative Value:

Bond	Maturity/Call date	Aggregate leverage	Ask Yield	Spread
EREIT 3.5% '18	05/11/2018	30.0%	2.56%	92
EREIT 4.6%-PERP	03/11/2022	30.0%	5.49%	316
SUNSP 2.83% '18	12/11/2018	36.4%	1.92%	28
CACHE 5.5%-PERP	01/02/2023	36.3%	5.26%	291

Indicative prices as at 23 April 2018 Source: Bloomberg
Aggregate leverage based on latest available quarter

Key Considerations

- **Growth in 1Q2018 driven by acquisitions under new management:** 1Q2018 gross revenue increased 21% y/y to SGD33.6mn, mainly driven by the full quarter contributions from two acquired properties, namely 8 Tuas South Lane and 7000 Ang Mo Kio Avenue 5 (both acquisitions completed in December 2017). This was partly offset by declines from (1) conversion of 21B Senoko Loop and 3 Pioneer Sector 3 into multi-tenanted buildings, (2) non-renewal of leases at 12 Ang Mo Kio, 31 Kian Teck and 30 Toh Guan and (3) four property divestments (gross proceeds of SGD81.2mn) since 1Q2017 (87 Defu, 23 Woodlands Terrace, 55 Ubi Avenue 3 and 9 Bukit Batok). Borrowing costs have increased 21% y/y to SGD6.1mn as higher debt was drawn down in 4Q2017 to help fund new acquisitions. Interest coverage as measured by EBITDA/Interest was 3.5x (flat against 1Q2017: 3.5x).

- **Aggregate leverage significantly lower post-equity fundraise:** As at 31 March 2018, aggregate leverage was significantly lower at 30.0% (4Q2017: 39.6%). SGD170mn of debt was repaid during the quarter, bulk from the SGD141.9mn in equity raised at EREIT's preferential offering and SGD23.9mn of proceeds from divestment of 9 Bukit Batok (completed on 5 March 2018). Perpetuals at EREIT make up 10% of its total capital. Assuming 50% of perpetuals as debt, we find adjusted aggregate leverage at 35%, significantly reduced from 44% in end-2017 (44% provides little buffer to EREIT's external rating trigger point for a potential downgrade).

- **Low refinancing risk:** As at 31 March 2018, all debt at EREIT remains unsecured and all SGD1.6bn of investment properties (assuming 100% of 7000 Ang Mo Kio) was unencumbered, providing ample financial flexibility to raise secured debt, if need be. Short term debt amounted to SGD155.0mn (the EREIT 3.5% '18 bond coming due in November 2018). With available committed revolving credit facilities of SGD213.0mn, we see low refinancing risk at EREIT.

- **Portfolio occupancy down:** Portfolio occupancy was 90.7% as at 31 March 2018, falling from 93.0% in end-2017. Ceteris paribus (without factoring in the proposed merger of Viva Industrial Trust ("VIVA")), we expect EBITDA to fall in FY2018 following a tenant downsizing and pre-termination of a separate tenant in the offshore marine sector. These two tenants collectively make up 7.1% of portfolio rental income. Notwithstanding that the downsizing tenant may still take up some space, conservatively, we assume that the full 7.1% is at heightened risk of dropping out of the portfolio in the next 12 months. Another 6.8% of rental income is attributable to Hyflux (8 Tuas South Lane is under a partial sale-and-leaseback with Hyflux), a company which in our view is currently facing liquidity strains. In our worst-case scenario where all these tenants are non-contributing, we estimate EBITDA/Interest at 3.0x.

- **Leases coming due in next 12 months:** A negative rental reversion of 15.8% was recorded for FY2017. As at end-2017, 22.4% of rental income would have come due by end-2018, though by end-March 2018, this figure (while still significant) had dropped to 18.1%, implying certain leases had been renewed. Of the 18.1%, 2/3 relates to multi-tenanted buildings and the rest are single-tenanted expiries. EREIT disclosed that in 1Q2018, rental reversion was -0.2%. In our view, this may not be reflective of the next few quarters. With lease expiries pressures building, EREIT is more likely to take further concession on rents (to keep occupancy up) and offer more competitive lease rates.

- **Merger talks between EREIT and VIVA on-going:** As of report date, the two are in exclusive discussions, though no definitive agreements have been signed. The current period of exclusivity ends on 30 April 2018, unless the date is extended again. Currently, the proposed structure envisages an all-share deal where new shares in EREIT will be issued to unitholders of the target. Our base case assumes that a merger deal will happen between EREIT and VIVA, as an all-share deal, with the only cash outlay being cost of buying VIVA REIT Manager and transaction costs. We hold VIVA at an issuer profile of Neutral (5) and if a merger transpires between the two, an indicative issuer profile of Neutral(4) for the merged entity.

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Explanation of Issuer Profile Rating / Issuer Profile Score

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.

Negative ("Neg") – The issuer's credit profile is either weaker or highly geared on an absolute basis, or expected to deteriorate to a weak or highly geared position over the next six months.

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

Explanation of Bond Recommendation

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.

Neutral ("N") – The performance of the issuer's specific bond is expected to perform in line with 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.

Underweight ("UW") – The performance of the issuer's specific bond is expected to underperform 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.

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.

Withdrawal ("WD") – We may withdraw our issuer rating and bond level recommendation on specific issuers from time to time when corporate actions are announced but the outcome of these actions are highly uncertain. We will resume our coverage once there is sufficient clarity in our view on the impact of the proposed action.

Analyst Declaration

The analyst(s) who wrote this report and/or her or his respective connected persons did not hold securities in the above-mentioned issuer or company as at the time of the publication of this report.

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