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 30 June 2018. The REIT's largest unitholder is Jinquan Tong (Mr. Tong) with ~15.2% stake. E-Shang Redwood Group ("ESR"), a company backed by Warburg Pincus, is the Sponsor and second largest unitholder with a 12.9%-stake in EREIT.

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Recommendation

- EREIT is in the midst of a proposed merger with VIVA Industrial Trust ("VIT", Issuer profile: Neutral (5)). Our base case assumes that the proposed merger will go through, with the enlarged trust's aggregate leverage rising to ~41%.
- Net-net, we think the merger will improve EREIT's credit profile, on account of the increase in scale to SGD3.0bn in total assets (with likely benefits to financial flexibility) and a decrease in tenant concentration risk, though insufficient to upgrade the issuer profile from Neutral (4). Of the 46 REITs and Business Trusts listed in Singapore, 14 have a market cap of above SGD2.0bn. We see a good chance for EREIT, after the proposed merger, to rank within the top 20 largest S-REITs by market cap.
- We are lifting the EREIT 3.5% '18s to Neutral and maintaining Overweight the EREIT 3.95% '20s and EREIT 4.6%-PERP. A switch from the SUNSP 3.0% '21s into the EREIT 3.95% '20s will allow a spread pick-up of 66bps and a 1.2 year shorter maturity, which more than compensates for EREIT's impending higher aggregate leverage. Suntec REIT is a retail and commercial-focused REIT, which we similarly hold its issuer profile at Neutral (4).

Relative Value:

Bond	Maturity/Call date	Aggregate leverage	Ask Yield	Spread
EREIT 3.5% '18	05/11/2018	30.5%	2.76%	113
EREIT 3.95% '20	21/05/2020	30.5%	3.56%	163
EREIT 4.6%-PERP	03/11/2022	30.5%	5.84%	367
VITSP 4.15% '18	19/09/2018	41.0%	2.88%	127
CACHE 5.5%-PERP	01/02/2023	35.3%	5.49%	331
SBREIT 3.6% '21	08/04/2021	37.6%	3.68%	164
SUNSP 3.0% '21	16/07/2021	37.9%	3.04%	97

Indicative prices as at 15 August 2018 Source: Bloomberg
Aggregate leverage based on latest available quarter

Key Considerations

- **Q/q fall in 2Q2018 results:** Gross revenue was up 17.6% y/y to SGD32.5mn following the full quarter revenue recognition of 8 Tuas South Lane and 7000 Ang Mo Kio Avenue 5 ("AMK 7000", 80%-ownership), both bought in December 2017, rental escalations on certain properties which helped offset the decline in revenue from the conversion of three properties from master leases into multi-tenancy, expiries and non-renewal of leases of three properties and the absence of revenue from four properties which were sold. On a q/q basis though, EREIT's gross revenue fell 3.2% while net property income ("NPI") fell 1.5% to SGD23.4mn. We think the q/q fall is indicative of the absence of revenue from 9 Bukit Batok Street 22 (sold in March 2018) and lower rents in 2Q2018. For 1H2018, EREIT saw a sharper fall in rental reversion of -4.2% versus 1Q2018 rental reversion of only -0.2%.

- **Interest coverage improved:** EBITDA (based on our calculation which does not include other income and other expenses) was lower by 0.9% q/q at SGD20.9mn. In March 2018, EREIT had raised SGD141.9mn in gross proceeds from an equity preferential offering and bulk of these was used to reduce debt taken earlier to help fund the acquisition 7000 AMK. Interest expense was 14.2% q/q lower at SGD5.2mn in 2Q2018, we think the decline is driven by lower average debt levels in 2Q2018 versus 1Q2018. Despite the slight fall in EBITDA, EBITDA/Interest had improved to 4.0x in 2Q2018 from 3.5x in 1Q2018.

- **Aggregate leverage unlikely to stay low:** As at 30 June 2018, unadjusted aggregate leverage at EREIT was low at 30.5%. EREIT has SGD150mn in perpetuals outstanding, representing 10% of total capital. Adjusting 50% of perpetuals as debt, we find adjusted aggregate leverage still manageable at

35.0%. Nonetheless, with the proposed merger and announced investment plans, we are expecting EREIT's aggregate leverage to climb.

- **Manageable refinancing risk:** As at 30 June 2018, short term debt was SGD155.0mn, comprising the EREIT 3.5% '18 bond due in November 2018. With undrawn available committed facilities of SGD202mn, we see short term refinancing risk as minimal. Another SGD118mn comes due in 2019 (with SGD100mn made up of unsecured bank debt). EREIT is finalizing refinancing of this SGD100mn to 2023 which when completed, will extend weighted average debt expiring to 3.2 years. We estimate that as at 30 June 2018, the weighted average debt expiry at 1.5 years.

- **Update on proposed merger:**
  In practice, the existing EREIT bonds would be supported by a larger asset base with VIT's rental income consolidated at the EREIT level.

(a) **Transaction structure:** To effect the proposed merger, EREIT will acquire all the stapled securities held by the stapled securityholders by way of a trust Scheme of Arrangement, with EREIT as the surviving listing entity. VIT is expected to become a wholly-owned sub-trust of EREIT post-transaction, forming an enlarged trust on a consolidated basis. Our base case assumes that the proposed merger will go through.

(b) **Timeline:** An Extraordinary General Meeting ("EGM") will be held on 31 August 2018 for VIT's stapled securityholders to vote on the proposed merger and a scheme meeting is targeted on the same date after the EGM. If approved, the scheme is expected to be effective on 3rd October 2018, with the issue of new EREIT units and delisting of VIT stapled securities to follow soon after.

(c) **90% to be funded by equity:** As payment for VIT, VIT's stapled securityholders will get SGD0.96 per stapled security, where 10% will consist of cash and 90% in new units to be issued by EREIT at an exchange ratio of 1.778x. Each new unit in EREIT is envisaged to be issued at SGD0.54. As at 30 June 2018, there were 975.8mn of VIT units outstanding, we estimate that EREIT will need to pay a cash consideration of SGD93.7mn to VIT stapled securityholders.

(d) **EREIT does not bear cost of buying VIT's REIT Manager:** EREIT is currently managed by ESR Funds Management (S) Limited ("EREITM"), owned by ESR and Mitsui & Co. Ltd ("Mitsui") on an 80:20 basis. VIT is currently managed by Viva Industrial Trust Management Pte. Ltd., as REIT Manager ("VREITM") and Viva Asset Management Pte. Ltd., as trustee-manager of the Viva Business Trust (the business trust is inactive). The enlarged trust is intended to be managed by EREITM post-transaction. In return for earning the future income stream from also managing VREITM, EREITM would buy out the current owners of VREITM for SGD62.0mn via a mix of cash and promissory notes. The funding to buy VREITM will come from ESR, rather than EREIT (we think this is fair since the income stream goes to EREITM for its own benefit). The current owners of VREITM include Mr. Tong, Ho Lee Group Pte Ltd, ESR and certain members of the VIT management team.

(e) **New ownership of EREITM:** Mr. Tong currently owns ~34.4%-stake in VREITM indirectly, and instead of cashing out from his investment in VREITM, proceeds will be used to subscribe into new shares of EREITM. While the valuation of EREITM (prior to new capital injection from ESR and Mr. Tong) is undisclosed, it has been shared that post-merger, ESR would hold a 67.3%-stake in EREITM, Mr Tong will hold a 25%-stake and Mitsui diluted to 7.7%.

(f) **Assets of the enlarged trust to be fully unencumbered:** As at 30 June 2018, VIT's gross debt was SGD536.5mn. Aside from a SGD100mn unsecured bond at VIT which comes due on 19 September 2018, the other SGD436.5mn are all secured bank debt. The intention is for all the outstanding debt at VIT to be refinanced fully into unsecured bank debt and EREIT has obtained banking facilities from four lenders for this purpose. As at 30 June 2018, none of EREIT's assets are encumbered and post transaction, the enlarged trust's SGD3.0bn in asset base would be similarly unencumbered. As at 30 June 2018, VIT's aggregate leverage was 41.0%, much higher than EREIT's 30.5%. Post-merger, we estimate EREIT's aggregate leverage to be at ~39%. This assumes that the proposed facilitation fee of SGD2.3mn (to be paid to VREITM) is passed at the EGM and we assume that an additional SGD28mn (3% of consideration) will need to be paid by EREIT as transaction costs.

(g) **Expect aggregate leverage to breach 40%:** In April 2018, EREIT announced the proposed acquisition of 15 Greenwich Drive 1, a multi-tenanted ramp up logistics facility with ancillary offices in Singapore for a total acquisition cost of SGD99.9mn (SGD86.2mn in consideration to vendor, SGD9.6mn in estimated upfront land premium payable to JTC and SGD4.1mn in acquisition cost). EREIT has shared that this acquisition is likely to be fully debt funded, with targeted completion in 4Q2018. EREIT is also in the midst of an asset enhancement initiative of 30 Marsiling Industrial Estate Road 8 into a high specification building for SGD12.0mn. The earlier tenant at this property had moved out as expected, given that a competing Industrial REIT was engaged to build a built-to-suit property for this tenant. Factoring in the announced capex and proposed acquisition, we expect EREIT's unadjusted aggregate leverage to rise to ~41% post-merger.

(h) **Reduction in concentration risk of leases:** In 2Q2018, the top ten tenants at EREIT contributed 41.6% of EREIT's rental income. AMS Sensors Singapore Pte Ltd (previously known as Heptagon Micro Optics Pte Ltd) was the largest tenant at EREIT contributing 9.1% to rental income. Hyflux Membrane Manufacturing (S) Pte Ltd, a wholly owned subsidiary of embattled Hyflux Ltd ("HFY") was the second largest tenant, contributing 7%. In December 2017, EREIT had acquired 8 Tuas Lane from HFY under a partial sales and leaseback arrangement. In spite of the on-going restructuring at HFY, as of May 2018, there have been no arrears from this lease. Post-merger, we estimate that the top ten tenants of the enlarged trust will make up 20.3% of rental income at EREIT, with no single tenant contributing more than 3.4% to rental income. HFY would still be the second largest tenant though at a significantly smaller contribution of only 2.7%.

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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.

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.

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Other

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