Asia Credit Research

Earnings Review: Keppel Real Estate Investment Trust ("KREIT")

Issuer Profile: Neutral (4)

Ticker: **KREITS**

Background

Keppel REIT ("KREIT") is a real estate investment trust focused on mainly commercial assets. It has an AUM of SGD8.5bn. 87% of the portfolio is based in Singapore, with the balance in Australia. The Singapore assets are mainly stakes in Grade A office assets in the CBD, such as Ocean Financial Centre ("OFC", 99.9% stake), Marina Bay Financial Centre Towers 1, 2 & 3 ("MBFC", 33% stake in each) and One Raffles Quay ("ORQ, 33% stake). KREIT is 46.4% owned by Keppel Corp ("KEP"), its sponsor.

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Recommendation

- Although occupancy rate dipped to 98.0% affecting KREIT's revenue, we think the positive office rental outlook could improve KREIT's portfolio statistics going forward. Although KREIT's aggregate leverage is marginally higher at 39.1%, we maintain our Neutral (4) Issuer Profile.
- We prefer FHREIT 4.45%-PERP to KREITS 4.98%-PERP as it offers a 19bps pickup for a 6-month longer tenor apart from a stronger credit profile at Neutral (3) Issuer Profile, a notch higher than KREIT. Likewise, we think FHREIT '22s provides better value than KREITS '22s.
- However, for KREITS 3.275% '24s, we think bondholders can consider a switch to AREIT 2.47% '23s which has a stronger credit profile at Neutral (3) and offers a higher yield for a shorter tenor.

Relative Value:

Bond	Maturity/Call date	Aggregate leverage	Ask Yield	Spread
KREITS 3.15% '22	**11/02/2022**	**39.1%**	**3.17%**	**85bps**
KREITS 3.275% '24	**08/04/2024**	**39.1%**	**3.44%**	**96bps**
KREITS 4.98%-PERP	**02/11/2020**	**39.1%**	**3.94%**	**177bps**
AREIT 2.47% '23	10/08/2023	35.7%	3.24%	81bps
FHREIT 2.63% '22	06/07/2022	34.0%	3.25%	90bps
FHREIT 3.08% '24	08/11/2024	34.0%	3.41%	90bps
FHREIT 4.45%-PERP	12/05/2021	34.0%	4.19%	196bps

Indicative prices as at 16 October 2018 Source: Bloomberg
Aggregate leverage based on latest available quarter

Key Considerations

- **Weaker revenue at OFC and Australia assets:** KREIT reported 3Q2018 results with property income down 9.4% y/y to SGD36.7mn. Performance was affected by lower occupancy at OFC (3Q2018: 95.5%), 275 George Street (3Q2018: 99.3%) and 8 Exhibition Street (3Q2018: 97.2%), though partly offset by Bugis Junction Towers which is currently fully occupied. Net property income ("NPI") declined in tandem by 10.9% y/y to SGD28.2mn. Although committed occupancy at OFC fell from full occupancy to 95.5% y/y this quarter after ~SGD12mn early surrender of leases by Australia and New Zealand Banking Group Ltd ("ANZ") in the previous quarter, YTD revenue from OFC was higher by 13.4% y/y. Therefore, we do not think that KREIT's portfolio is severely impacted by ANZ's termination of leases at this juncture. The two Australia assets - 275 George Street and 8 Exhibition Street only make up 8.5% of the portfolio income and KREIT has plans to enhance both properties to remain attractive to tenants.

- **Lower contributions from ORQ and MBFC:** Total return before tax fell sharply by 38.5% y/y to SGD24.6mn, driven largely by lower rental support from MBFC (-16.3% y/y) and weaker contributions from associates (-14.3% y/y) and JV (-7.6% y/y). Specifically, MBFC's rental support declined 16.3% y/y while dividend and distribution income dipped 26.8% y/y. It is worth noting that HSBC has signed a 10-year lease at Marina Bay Financial Centre Tower 2 with target occupation by April 2020. ORQ, on the other hand, saw occupancy rate fall to 96.1% from 99.6% in 3Q2017 translating into lower dividend income contribution to KREIT (-15.2% y/y). With supply contracting and rents climbing, we think occupancy rate at ORQ is likely to rebound.

- **Positive office outlook may counter the dip in occupancy and retention rate:** In 3Q2018, retention rate stood at 84% (3Q2017: 91.8%) with committed occupancy at 98% (3Q2017: 99.6%) and WALE at 5.7 years (3Q2017: 6 years). KREIT also has 6.7% of portfolio NLA remaining for renewal and review in 2018 unlike 0.5% of portfolio NLA a year ago. However, with a positive outlook on the office market in view of a tapering supply pipeline and climbing rents on the back of continued demand, we think the dip in occupancy at KREIT's Singapore assets is well-timed to capture opportunities within the increasingly favourable market. According to CBRE, the market's average Grade A rents increased from SGD10.10 psf/mth to SGD10.45 psf/mth over the quarter. Correspondingly, KREIT's average signing rent for Singapore office leases was SGD10.88 psf/mth for 9M2018 (2017: SGD9.40 psf/mth).

- **Marginally weaker credit profile**: Reported aggregate leverage is higher at 39.1% (2Q2018: 38.6%). Likewise, all-in interest rate is also higher at 2.80% (2Q2018: 2.77%) resulting in a weaker interest coverage ratio of 4x (2Q2018: 4.3x). The higher aggregate leverage is largely a result of the loan drawn down to fund the progressive payment for development of 311 Spencer Street in Melbourne. Additionally, KREIT bought back 0.16% of issued units (~5.3mn) in 3Q2018. Given that KREIT may buy back up to 1.5% of issued units over 6 months, we think aggregate leverage can inch higher. While KREIT does not have any maturing debt for the remainder of the year and has obtained a facility to refinance SGD64mn loan that is due in 2019, it does have a sizeable loan aggregating SGD698mn due in 2019. In our opinion, KREIT should be able to refinance these loans when it comes due given that 84% of its assets remain unencumbered.

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Explanation of Issuer Profile Rating ("IPR") / Issuer Profile Score ("IPS")

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 ("IPR") into a 7 point Issuer Profile Score ("IPS") 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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