Asia Credit Research

Earnings Review: OUE Ltd ("OUE")

Issuer Profile: Neutral (4)

Ticker: **OUESP**

Background

Incorporated in 1964, OUE Ltd ("OUE") is a real estate developer and landlord with a real estate portfolio located at prime locations in Singapore (such as Orchard Road) and across the region. The group has diverse exposure across the office, hospitality, retail and residential property segments. OUE has also recently entered the healthcare segment. OUE is the sponsor and holds a significant stake in both OUE-Hospitality Trust ("OUE-HT") and OUE Commercial REIT ("OUE-CT"). OUE is 68.6%-owned by the Lippo Group.

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Recommendation

- OUE has been absent from the recent property wave with the lack of new projects launched though it continues to generate a stable income stream from its Investment Properties business.
- OUE's continues to have a considerable asset base, supported by its stakes in OUE-CT, OUE-HT, Gemdale Properties and Investments (a China-focused real estate developer) and directly owned OUE Downtown and US Bank Tower. This helps offset the introduction of potential counterparty credit risk to the company.
- OUE Lippo Healthcare continues to drag bottom line though the recent introduction of Itochu as a strategic shareholder is a credit positive while OUE's new convertible and exchangeable bond issuances indicate continued strong access to capital markets.
- We are largely neutral the OUESP curve though we prefer OUESP's shorter dated OUESP '20s over GuocoLand Ltd's GUOLSP '19s, GUOLSP '20s and GUOLSP '21s. The OUESP '20s trades at an ask YTW of 3.41% (145 bps) and a switch from the GUOLSP '20s will allow a spread pick up of 30 bps. For a one year longer tenure, the OUESP '20s provide a 70 bps spread pick up against the GUOLSP '19s.
- We hold OUESP at an issuer profile of Neutral (4) though we may relook this should counterparty credit risk increases. We hold GUOLSP at an issuer profile of Neutral (5).

Relative Value:

Bond	Maturity date/ Reset Date	Net gearing	Ask Yield to Worst	Spread
OUESP 3.8% '20	15/04/2020	0.67x	3.41%	145bps
OUESP 3.75% '22	17/04/2022	0.67x	3.63%	148bps
OUESP 3.55% '23	10/05/2023	0.67x	3.68%	146bps
GUOLSP 3.95% '19	01/04/2019	0.87x	2.48%	72bps
GUOLSP 4.1% '20	13/05/2020	0.87x	3.10%	114bps
GUOLSP 3.62% '21	30/03/2021	0.87x	3.41%	135bps
GUOLSP 4.0% '22	31/01/2022	0.87x	3.63%	149bps
GUOLSP 3.85% '23	15/02/2023	0.87x	3.79%	158bps

Indicative prices as at 10 September 2018 Source: Bloomberg, OCBC, Company
Note: (1) We think there is a reasonable chance for OUESP 4.25% '19c18 to be called in October 2018 as issuer is likely able to replace this with lower cost debt funding

Key Considerations

- **Beyond property development:** Revenue at OUE declined 19.6% y/y in 2Q2018 to SGD150.7mn, mainly due to the absence of Development Property revenue in 2Q2018 (1Q2018: SGD55.2mn of Development Property revenue was recognised). OUE owns land at 28 Nassim Road though there are no new property development projects in the pipeline. OUE Twin Peaks had been fully sold, including those sold under its deferred payment schemes. Revenue from properties sold via the scheme would only be recognised (estimated at ~SGD450mn) when these properties are legally handed over to buyers, with accompanying cash collection at that point. We expect 80% remains to be collected since 20% was paid as downpayment. In 2Q2018, OUE started recognizing Dividend Income (SGD12.6mn) in its top line from 14.8%-owned Gemdale Properties & Investment ("Gemdale") while previously the share of profit from JV in Gemdale was recognized - On May 2018, OUE had terminated the joint venture with Epoch Thrive Limited (the other JV partner) and started recognizing its stake in Gemdale as a financial asset instead.

- **Asset coverage manageable though new counterparty credit risk introduced:** Development Property income historically generated ~10% in net profit margin versus the large pass-through from Investment Property revenue and Dividend Income into earnings line. Despite the fall in top line, EBITDA margins were higher in 2Q2018 at 32% (21% in 1Q2018). EBITDA (based on our calculation which does not include other income and other expenses) was higher at SGD48.7mn (2Q2017: SGD38.5mn). Interest expense though had increased 13.2% due to higher levels of average borrowing and a higher net foreign exchange loss, with resultant EBITDA/Interest coverage of 1.3x against 1.2x in 2Q2017. As at 30 June 2018, unadjusted net gearing was 0.67x, slightly higher versus 0.65x as at 31 March 2018. Taking only assets we think can be monetiseable in a quicker fashion (cash, equity investments, development and investment properties), we find debt-to-asset coverage at OUE manageable at 0.47x. We do not include SGD241.3mn in assets held for sale in our calculation. This asset held for sale relates to PT Alpha Sentra Prima group of entities ("PT Alpha"), a subsidiary of OUE, though we are unable to ascertain the detailed nature of PT Alpha's assets from publicly available information. PT Alpha is being sold to two Indonesian-based purchasers, of which one of them has various on-going business relationships with the broader Lippo Karawaci group. It was shared that OUE had earlier extended ~SGD228.9mn in shareholder's loan to PT Alpha. Post transaction, these loans will be novated to one of the purchasers. In our view, OUE will in effect be a lender and hold a promissory note issued by purchaser with purchaser obliged to repay the sums.

- **Investment Properties as a key credit driver:** Investment properties at OUE is mainly derived from OUE-CT ((Issuer profile: Unrated) which OUE has a 55.7%-ownership stake. OUE-CT's financials is consolidated into OUE and OUE-CT contributes two-thirds of Investment Properties revenue. Other Investment Properties held outside OUE-CT include OUE Downtown (OUE Downtown 1 and 2, Downtown Gallery, Oakwood Serviced Apartments), the US Bank Tower in Los Angeles, 23 residential units at OUE Twin Peak and healthcare assets at OUE Lippo Healthcare Ltd ("OUE-LH", Issuer profile: Unrated). Overall Investment Properties revenue increased 4.2% y/y to SGD69.8mn, driven by the increase in full quarter rental contribution from Downtown Gallery (retail mall in Shenton Way opened in May 2017). On a q/q basis which removes the timing impact of Downtown Gallery's opening, overall investment properties revenue was up slightly by 0.4% q/q. For OUE-CT specifically, revenue declined 2.6% y/y to SGD43.1mn on the back of lower retail revenue from One Raffles Place Shopping Mall (H&M an anchor tenant had left). Finance costs increased by 9% y/y to SGD12.3mn from higher level of average debt, which drove total return after tax lower by 10% y/y to SGD15.3mn. As at 30 June 2018, total debt at OUE-CT totalled SGD1.4bn on investment properties of SGD3.5bn. This leaves an asset buffer of SGD2.1bn, of which, after removing minority investor claims, SGD1.7bn is attributable to OUE. Additionally, OUE Downtown was valued at SGD1.59bn while US Bank Tower was valued at USD605mn (~SGD823mn) in end-December 2018. Investment Properties asset base looks to provide sufficient buffer against OUE's standalone debt (taking away debt at OUE-CT and OUE-LH) which we estimate at SGD1.9bn.

- **Hospitality segment is the second revenue driver:** OUE manages hospitality assets in Singapore and Malaysia. In 2Q2018, the Hospitality segment contributed SGD54.0mn in revenue (up 11.1% y/y) led by full quarter contribution from Oakwood Premier OUE Singapore serviced apartments which opened in June 2017. It is also the master lessee and hotel manager of Mandarin Orchard Singapore and Crowne Plaza Changi Airport ("CPCA") owned by OUE-HT (Issuer profile: Unrated). OUE owns 590mn of stapled securities in OUE-HT, representing a 32.4%-ownership, which OUE-HT recorded as an associate. In end-2017, non-cancellable lease obligations (an off-balance sheet liability) borne by OUE on such master leases amounted to SGD710.3mn. Mitigating the risk with this off-balance sheet liability, the two hotel assets are quality properties. Our colleagues at OCBC Investment Research have observed Mandarin Orchard Singapore outperforming its peers against industry operating statistics.

- **OUE Healthcare drags bottom line though balance sheet has strengthened with new capital:** In 2Q2018, revenue from the Healthcare segment declined 15.3% y/y to SGD9.5mn mainly due to lower revenue from OUE-LH's 163-bed

Wuxi New District Phoenix Hospital in China and the China pharmaceutical distribution business. Additionally, while rental revenue from Japan nursing homes had stayed stable, in SGD terms this had deteriorated. Overall, the OUE-LH business continues to be loss-making, with EBITDA of only SGD0.2mn and losses after tax of SGD2.9mn in 2Q2018 (1Q2018: losses after tax of SGD2.7mn). In January 2018, Itochu, a major sogo shosha took a strategic stake amounting to SGD78.8mn in OUE-LH by subscribing into new shares issued. This provides the business with cash infusion that will go towards working capital and growth purposes (eg: planned Chengdu hospital and KLCC integrated development project with specialist medical suites). Post transaction, OUE holds 64.4%-stake in OUE-LH while Itochu is now the second largest shareholder holding 25.3%. As at 30 June 2018, net gearing at OUE-LH was high at 2.1x though had declined from 8.2x in end-2017.

- **Tapping alternative sources of funding:** In April 2018, OUE issued a SGD154.75mn convertible bond that are convertible into new shares of the listed OUE holding company. Another SGD150.0mn in exchangeable bond ("EB") that is exchangeable into existing stapled securities of OUE-HT (rather than new stapled securities) was also issued at the same time. The use of an EB means that if OUE is unable to deliver the stapled securities when requested by EB holders, this constitutes an event of default. Net-net, OUE has sold a call option on 158.5mn OUE-HT stapled securities based on the current adjusted exchange price. As of report date both the CB and EB are unlikely to be converted / exchanged into shares.

- **Refinancing risk has declined:** As at 30 June 2018, consolidated short term debt at OUE was SGD1.3bn. SGD0.5bn (or 38% of the short-term debt) relates to OUE-CT and in August 2018, OUE-CT had fully refinanced these. SGD0.2bn will come due in 4Q2018; we think this relates to OUE-LH with bulk being secured debt. The remaining SGD0.6bn will come due in 1Q2019. In aggregate the remaining short-term debt amounts to SGD0.8bn and makes up 22% of total debt. In our view, OUE should be able to refinance its remaining short-term debt given the sufficient asset coverage.

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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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