OCBC Bank

Issuer Profile:

Neutral (3)

Neutral (4)

Ticker:

ARTSP

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Ascott Residence Trust ("ARTSP")

Recommendation

- **On 21 October 2019, equity holders of both ART and ASCHTS overwhelmingly approved the proposed combination of ART and Ascendas Hospitality Trust ("ASCHTS"), which is ~28%-indirectly owned by CapitaLand Ltd (Issuer profile: Neutral (3)), ART's Sponsor. The total assets of the enlarged ART would be SGD7.6bn and by asset size, we expect ART to be the ninth largest REIT listed on the Singapore Stock Exchange.**
- **We expect an improvement to ART's financial flexibility given its enlarged scale while hospitality assets in our view are highly marketable (particularly those located in gateway cities). We expect an improved EBITDA/Interest coverage from the combination following ASCHTS stronger standalone interest coverage though aggregate leverage is likely to be at the higher end versus REITs under our coverage at ~37%.**
- **While the increased exposure to Australia is a credit negative in the short term, we think the impact is manageable as this also reduces ART's exposure to China, New York City and Europe, areas which we expect to be weaker in the next 12 months.**
- **Since the announcement of the proposed combination of ART and ASCHTS, we had been watching ART for an upgrade and are now lifting our issuer profile on ART to Neutral (3), from Neutral (4), on the back of expectations that ART's credit profile would slightly improve post completion of combination with ASCHTS and remain stable over a 12 month period. Net-net, we think the enlarged asset base, improved interest coverage and better financial flexibility offsets the marginally weaker geographic spread and higher leverage, which drives the upgrade.**
- **We think the ART curve is largely trading tight, notwithstanding its improved credit profile and prefer Frasers Hospitality Trust's FHREIT 4.45%-PERP which is paying 3.64% YTC with a short first call date in May 2021. We hold Frasers Hospitality Trust' issuer profile at Neutral (3). For bondholders who want to stay invested in the ART curve, we think the ARTSP 3.88%-PERP trading at a YTC of 3.63% provides an acceptable senior-sub spread of ~80bps to its comparable senior.**

Relative Value:

Bond	Maturity / Call date	Aggregate leverage	Ask YTM/YTC	Spread
ARTSP 4.205% '22s	23/11/2022	33.0%	2.44%	98bps
ARTSP 3.523% '23s	09/11/2023	33.0%	2.66%	116bps
ARTSP 4.0% '24s	22/03/2024	33.0%	2.78%	128bps
ARTSP 4.68%-PERP	30/06/2020	33.0%	2.97%	148bps
ARTSP 3.88%-PERP	04/09/2024	33.0%	3.63%	211bps
FHREIT 2.63% '22s	06/07/2022	35.1%	2.57%	111bps
FHREIT 3.08% '24s	08/11/2024	35.1%	2.80%	127bps
FHREIT 4.45%-PERP	12/05/2021	35.1%	3.64%	218bps
MLTSP 4.18%-PERP	25/11/2021	37.0%	3.54%	208bps
MLTSP 3.65%-PERP	28/03/2023	37.0%	3.64%	216bps

Indicative prices as at 31 October 2019 Source: Bloomberg
Aggregate leverage based on latest available quarter

Background

- Ascott Residence Trust ("ART") invests primarily in serviced residences and rental housing properties. It is the largest hospitality trust listed on SGX with a market cap of SGD3.0bn. As at 30 September 2019 and including the lyf at one-North co-living space that is being developed, ART's portfolio consists of 74 properties with more than 11,700 units across 37 cities in 14 countries.
- By asset value, 57.8% of ART's assets are located in the Asia-Pacific region (Singapore

contributes 17.6% to ART), 25.7% in Europe (of which France and the UK contributes 9.6% and 9.0% respectively). 16.5% of assets are located in New York City.

- ART is currently ~45%-owned by CapitaLand Ltd ("CAPL", Issuer profile: Neutral (3)), while it is sponsored by The Ascott Limited, a wholly-owned subsidiary of CAPL. The remaining shareholding is dispersed across institutional and retail investors.

Key Considerations

- **ART to soon become a large cap REIT:** On 3 July 2019, ART announced a proposed combination with Ascendas Hospitality Trust ("ASCHTS", Issuer profile: Unrated), via a trust scheme of arrangement. The formal announcement came on the heels of the completion of CAPL's acquisition of Ascendas Pte Ltd and Singbridge Pte Ltd in end-June 2019. As Ascendas Pte Ltd indirectly holds a ~28%-stake in ASCHTS and is the single largest equity holder of ASCHTS, it was within expectations that a proposed combination was initiated, this was compounded by the following factors (1) ASCHT's hotels are performing assets (2) ART have been diversifying away from just serviced residences (3) Precedent mergers among Singapore REITs now exist and (4) Larger scale REITs are seen as having a competitive edge and are now favoured by REIT managers and investors alike. On 23 October 2019, ART and ASCHTS announced that the court hearing on scheme sanction application would be held on 19 November 2019. Earlier on 21 October 2019, equity holders of both ART and ASCHTS overwhelmingly approved the proposed combination. Indicatively, the enlarged ART would begin trading on the SGX on 2 January 2020. The total assets of the enlarged ART would be SGD7.6bn and we estimate that by asset size, the ninth largest REIT listed on the Singapore Stock Exchange (assuming Mapletree Commercial Trust (Issuer profile: Neutral (3)) completes the Mapletree Business City II acquisition).

- **Revenue down on a standalone basis led by Singapore divestment, weakness in China and USA:** ART's revenue in 3Q2019 was down by 1.5% y/y to SGD132.4mn, mainly driven by the fall in revenue from Singapore due to the sale of 146-units Ascott Raffles Place in May 2019 (a SGD2.3mn negative impact in 3Q2019 versus 3Q2019). On a same-store basis, adjusting out the contribution of Ascott Raffles Place from 3Q2018, revenue from Singapore would have improved 6.6% y/y (per our estimation) from higher variable rent at Ascott Orchard Singapore. Revenue from ART's New York City properties was down 5.6% y/y in USD-terms due to increased market competition from new supply, with Revenue per Available Unit ("RevPAU") down 6% y/y at USD212. Given the relatively large RevPAU fall of 6% y/y, we think weaker demand may be at play as well. We expect New York City numbers to continue being weak versus 2018 going into 4Q2019 and 2020. ART's portfolio in China was also weaker, with underlying performance down by 4.3% y/y, compounded by the depreciation of the RMB against the SGD due to softer corporate demand particularly in Tier 2 cities (four out of seven of ART properties in China are located in Tier 2 cities). The declines in revenue though was partly offset by higher top line contribution from Australia, albeit driven by acquisition of Citadines Connect Sydney Airport, completed in May 2019, while Australia same-store revenue and gross profit was lower. Vietnam performed well with RevPAU up 9% y/y from stronger corporate demand. ART's five properties there are located across Hanoi and Ho Chi Minh City.

- **Expect interest coverage ratio to be stronger on an enlarged basis:** Reported gross profit though saw a 1.4% y/y increase to SGD65.0mn, though this is likely led by the FRS 116 – Leases impact. Removing the FRS 116 – Leases impact, gross profit for 3Q2019 would have been SGD59.9mn. EBITDA (based on our calculation which does not include other income, other expenses and foreign exchange losses/gains) was SGD60.8mn, while interest expense was higher at SGD12.8mn due to the FRS 116 – Leases impact, with resultant EBITDA/Interest coverage of 4.7x. In September 2019, ART managed to raise a replacement perpetual that was intended to redeem its existing SGD150mn ARTSP 5.0%-PERP at a lower distribution rate of 3.88% (saving it 112bps p.a). The older perpetual was redeemed on 29 October 2019. Assuming that on the outstanding two perpetuals, ART pays out SGD17.5mn

in distribution per year (SGD4.4mn per quarter) and taking 50% of this as interest, we find adjusted EBITDA/(Interest plus 50% perpetual distribution) coverage at 4.0x, still manageable. ASCHT's latest quarter is deemed as 2QFY2019 as ASCHTS had changed its financial year end from 31 March to 31 December, with the current financial year being a nine month period from 1 April 2019 to 31 December 2019. Using the same EBITDA/Interest calculation, ASCHTS 2QFY2019 EBITDA/Interest coverage remains highly manageable at 6.2x, with proforma EBITDA/Interest of the enlarged ART at 5.0x for the most recent quarter.

- **Adjusted aggregate leverage for the enlarged ART to be on high side:** As at 30 September 2019, reported aggregate leverage at ART was 33.0%, at similar levels to 2Q2019, though taking 50% of the outstanding perpetuals as debt, we find adjusted aggregate leverage at 37%. Short term debt was SGD271.4mn, representing only 14% of gross debt and against ART's cash balance of SGD385.4mn. We expect cash balance to decline by ~SGD84mn to ~SGD301mn as 5% of the total proposed combination consideration would be in cash (95% in new ART equity to be issued to ASCHT equity holders) and high transaction costs in relation to the proposed combination. Even at ~SGD301mn, cash-to-short term debt due would be comfortably at 1.1x. Cash would continue to make up ~5% of total enlarged assets, within the levels of cash ART has historically maintained as a buffer. In January 2019, ART took possession of a land site at one-North, Singapore for a greenfield development of a co-living space there under the brand "lyf" (total development cost including land of SGD117mn). By 30 September 2019, including the land site and work done, SGD70.5mn had been recorded on ART's balance sheet as assets, leaving another SGD46.5mn to be debt funded. Taking these impacts into consideration and combining with ASCHTS's current standalone balance sheet, we estimate that the enlarged ART would see an aggregate leverage of ~37%, with adjusted aggregate leverage at ~39% and on the higher end of REITs under our coverage. On a standalone basis, ASCHT's aggregate leverage was 33.8% as at 30 September 2019.

- **Good financial flexibility:** Earlier in 2015, ASCHTS had entered into a forward agreement to buy the serviced apartment components of a mixed-used development in Melbourne from a third party and was on the hook to pay the remaining purchase price of AUD115mn (~SGD108mn). In September 2019 though, this agreement had been terminated and there is no more outstanding investment outlay at ASCHT. Short term debt coming due at ASCHTS was also manageable at SGD75.0mn (being the ASCHTS 3.3% '20s maturing in April 2020). As of writing we understand there are no plans to early prepay either of the two outstanding SGD bonds issued by ASCHTS. On top of its enlarged scale, we expect secured debt-to-total assets of the enlarged ART to be ~13%. While ART's standalone secured debt-to-total asset was 14%, we consider only ASCHTS's TMK bond with an outstanding amount of SGD183.7mn to be secured debt, representing only 9% of its total asset. Hospitality assets in our view are highly marketable (particularly in gateway cities) while unencumbered assets provides further flexibility to raise secured debt if need be.

- **Increasing concentration to Australia is a credit negative though manageable impact:** Post completion, CAPL's stake in the enlarged ART would be diluted to ~40% as new equity will be issued to existing equity holders of ASCHTS. We see this as a credit neutral impact given that CAPL would still be the single largest unitholder in the enlarged ART while ART maintains strong operational linkages with CAPL's hospitality arm. In terms of geographical spread, the key impact from the combination of ASCHTS would be the increase in properties located in Australia and Japan given that on a collective basis, these contribute 74% to ASCHTS's standalone gross profit. By gross profit, Australia only comprises 6.9% of ART's geographical exposure in 3Q2019, although based on our estimation, this could go up to ~15% for the enlarged ART while exposure to Japan could rise from 11.2% to ~16%. On the flipside, the enlarged ART would have lower exposure to the USA, China, Europe and Southeast Asia (dominated by Singapore). While gaining higher exposure to Australia at this juncture seems to be a sketchy move in light of the weakened outlook (ASCHTS's Australia gross profit fell 13.6% y/y in 2QFY2019), this is partly offset by (1) Reduction to China, which had seen

weaker performance outside of Tier 1 cities (2) Reduction to New York City, which had faced oversupply issue in 2019 that is not expected to turnaround in the next 12 months and (3) Europe where ART's French properties are at risk of facing lower lease renewals on Master Leases.

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

Please note that Bond Recommendations are dependent on a bond's price, underlying risk free rates and an implied credit spread that reflects the strength of the issuer's credit profile. Bond Recommendations may not be relied upon if one or more of these factors change.

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.

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