Asia Credit Research

Industrial REITs: Sector Update

Friday, 04 November 2016

Ploughing ahead

- Overall Singapore industrial space sector continues to weaken, though Industrial REIT profiles under our coverage remain stable against the previous two quarters. About 3.0mn sqm of industrial space coming in until end-2017, but supply-demand imbalances should rectify from 2018 onwards.

- Expect more revitalization projects within the industrial property space as older, low-specification properties become out-of-step with Singapore's on-going economic restructuring. In addition to multi-storey industrial buildings built in the 1960s-80s, certain older business parks properties will also need to be upgraded to maintain competitiveness.

- No new foreign acquisitions announced during the quarter among our Industrial REIT coverage; international expansion still remains a key diversification strategy

- **Recommendation:** Industrial REITs continue to play a defensive role in a bond portfolio. Our top picks are VIVA Industrial Trust (VIVA's)'s VITSP 4.15 '18s. We have recently upgraded the REIT's issuer profile to Neutral from Negative.

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Issuer	Issue	Maturity / First Call Date	Outstanding Amount (SGDm)	Ask Price	Ask YTW	I-Spread	Bond Rating
AAREIT	AAREIT 3.8 '19	21/05/2019	50	101.38	3.23	182	BBB-/NR/NR (Issuer)
AAREIT	AAREIT 4.35 '19	05/12/2019	30	101.90	3.69	220	BBB-/NR/NR (Issuer)
AREIT	AREIT 2.5 '19	16/05/2019	95	101.6	1.85	44	NR/A3/NR
AREIT	AREIT 2.95 '20	03/08/2020	100	103.05	2.10	52	NR/A3/NR
AREIT	AREIT 4 '22	03/02/2022	200	107.75	2.42	65	NR/A3/NR
AREIT	AREIT 3.2 '22	03/06/2022	150	103.85	2.46	65	NR/A3/NR
AREIT	AREIT 4.75 '49c20	14/10/2020	300	105.25	3.31	171	NR/Baa2/NR
CREIT	CREISP 3.5 '18	05/11/2018	155	101.55	2.69	137	NR/Baa3/NR
CREIT	CREISP 4.1 '20	29/04/2020	30	102.90	3.21	167	NR/Baa3/NR
CREIT	CREISP 3.95 '20	21/05/2020	130	102.35	3.24	169	NR/Baa3/NR
CREIT	CREISP 3.95 '23	09/05/2023	50	100.45	3.87	196	NR/Baa3/NR
MINT	MINTSP 3.75 '19	08/03/2019	125	103.75	2.09	71	NR/NR/BBB+
MINT	MINTSP 3.65 '22	07/09/2022	45	103.75	2.94	111	NR/NR/BBB+
MINT	MINTSP 3.79 '26	02/03/2026	60	104.12	3.27	113	NR/NR/BBB+
Sabana	SSREIT 4.00 '18	19/03/2018	90	98.01	5.61	440	NR/NR/NR
Sabana	SSREIT 4.25 '19	03/04/2019	100	96.44	5.86	447	NR/NR/NR
SBREIT	SBREIT 3.45 '18	21/05/2018	100	100.50	3.11	187	NR/Baa3/NR (Issuer)
SBREIT	SBREIT 3.6 '21	08/04/2021	100	100.10	3.57	191	NR/Baa3/NR
VIVA	VITSP 4.15 '18	19/09/2018	100	100.00	4.15	284	BB+/NR/NR
MLT	MLTSP 5.375 '49c17	19/09/2017	350	103.00	1.86	74	NR/Baa3/NR
MLT	MLTSP 4.18 '49c21	25/11/2021	250	103.25	3.47	172	NR/Baa1/NR (Issuer)

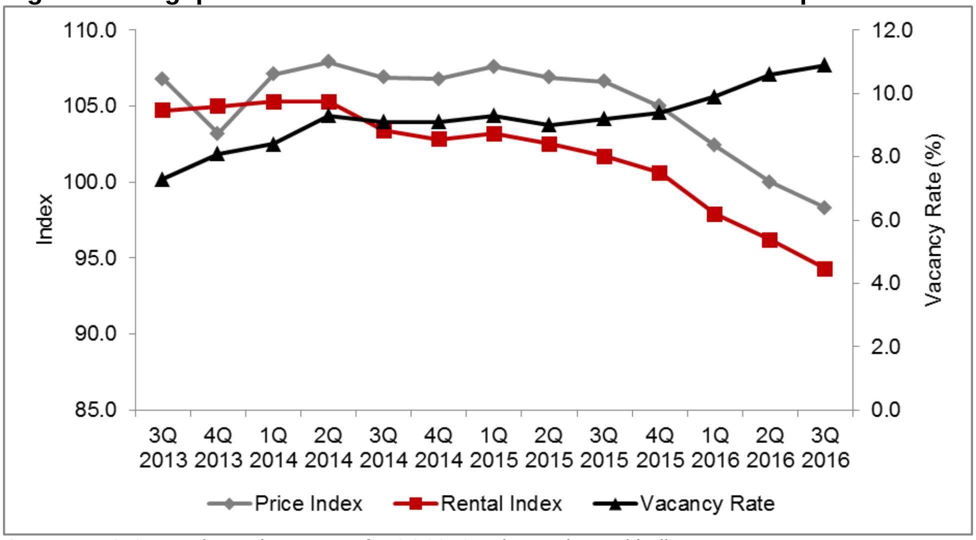
Note: (1) Indicative prices as at 4th November 2016
(2) Bond Rating is used except where specified
(3) VIVA corporate credit rating is held at BB by S&P

A) 3Q2016 Singapore Industrial Update

On an overall basis, all key indicators as per JTC's 3Q2016 data were weaker from the immediately preceding quarter. The price index is now at 98.3 and represents six consecutive quarters where prices have softened. The rental index has also declined by 2% against 2Q2016, with the warehousing sub-segment being the hardest hit at 4.4% decline. Rental index on the business park sub-segment was relatively flat, at only 0.2% decline. However, Colliers International, a property consultancy, opined that the lift in 3Q2016 business park rental index was mainly due to higher-rents from a newly completed building.

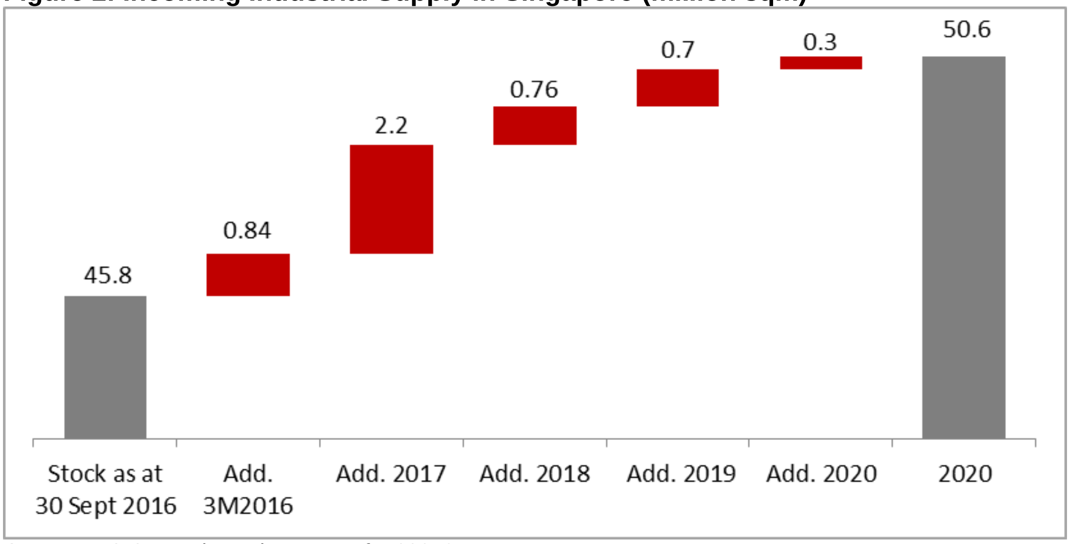
Overall, we expect rental rates to further compress as landlords prioritize retention of tenants. Knight Frank, a property consultancy has opined that average rental rates may fall 6-8% y/y during 4Q2016. Vacancy rate was recorded at 10.9% in 3Q2016, representing two consecutive quarters where overall vacancies have risen above 10%. Overall transaction volumes (based on numbers of caveats lodged) continue to be low, with around 200 caveats lodged in 3Q2016. There was around 700 caveats lodged YTD, falling from ~1,000 during the same period last year. We do not expect the price index to inch upwards next quarter. Against a backdrop of the softer manufacturing environment, we have seen certain end-users putting up their properties for sale (eg: sales-and-leasebacks and outright consolidation of operations), with some of these assets purchased by Industrial REITs. Most recently, a Finnish manufacturer focused on marine and energy clients is putting 5 industrial properties in Singapore for sale.

Figure 1: Singapore Industrial Sector Indices: All Industrial Properties



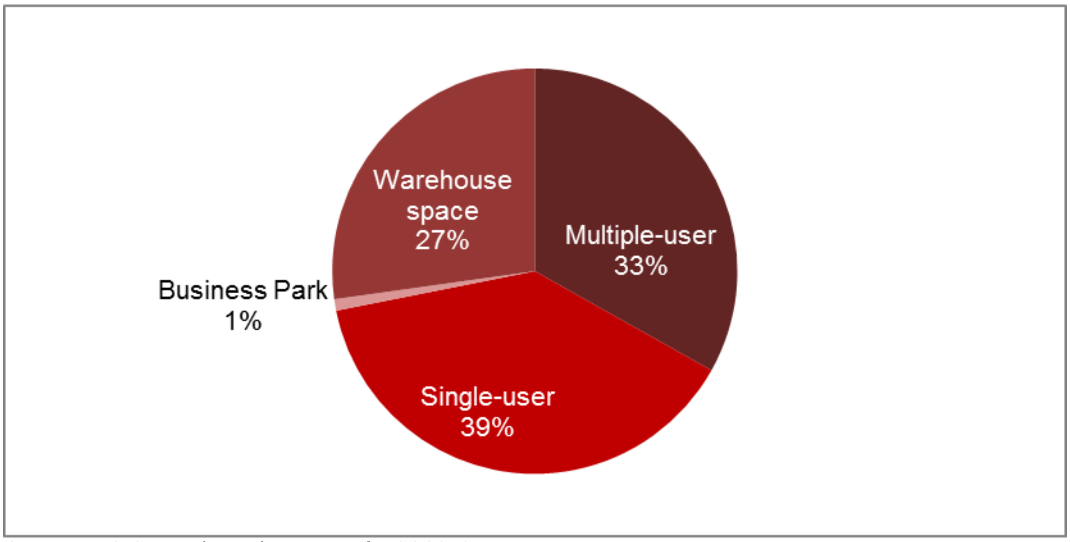
Source: JTC Quarterly Market Report for 3Q2016; price and rental indices

Figure 2: Incoming Industrial Supply in Singapore (million sqm)



Source: JTC Quarterly Market Report for 32016
Note: Assumes no disposal from property stock

Figure 3: Upcoming Supply by Gross Floor Area by Industrial Sub-segment – Singapore



Source: JTC Quarterly Market Report for 3Q2016
Note: Accumulated incoming industrial space from 1 October 2016 and beyond (total of 4.8mn sqm)

B) Business Parks: Not All Equal

Business parks are less susceptible to an impeding glut given the more favourable supply-demand balances. However, headline price and rental numbers mask distinct differentiation between properties zoned as business parks. We think the bright spots among business parks are properties which are (i) attractive as an alternative to offices; (ii) higher specification with amenities (eg: F&B) and transportation nodes; and (iii) located in clusters for high-growth industries. Low occupancy levels at certain properties such as older properties at the International Business Park and properties catering to back offices of financial companies at Changi Business Park are unlikely to improve until these buildings get revitalised. Following our visit to an integrated business park which merges lifestyle elements with business space, we have become more convinced that a "flight to quality" will gain traction within the business park sub-segment.

Ascendas Real Estate Industrial Trust ("AREIT")'s has 8 business parks/science parks properties in Singapore, with occupancy-levels of less than 80% (below sector-wide averages of 81%), these represented a valuation of ~SGD480mn as at 31 March 2016. AREIT is sufficiently diversified, in our view, to withstand such structural changes to the business park sub-sector, especially since its SGD1.0bn portfolio acquisition of Australian properties in end-2015. We think AREIT's on-going asset enhancement initiatives will expand in this sub-segment.

C) Credit Ratios Stable Against 2Q2016

Leverage: Compared to the immediately preceding quarter, leverage as measured by total debt-to-total asset was flat at 36.5% as at 30 September 2016. Adjusting 50% of the outstanding value on perpetual securities as debt, we find AREIT adjusted debt-to-total asset to have fallen to 35.8% (2Q2016: 38.8%) following equity issuances and repayment of debt using proceeds from property divestment. Mapletree Logistics Trust ("MLT")'s adjusted leverage ratio is now 42.9%, having climbed from 41.3% in 2Q2016. On an adjusted basis, MLT is the most levered Industrial REIT in our portfolio, followed by Sabana Shari'ah Compliant Industrial REIT ("Sabana") at 41.5% and VIVA Industrial Trust at 39.8% as at 30 September 2016.

Coverage: Sector-wide coverage ratios (as measured by EBITDA/Gross interest) for the nine months of 2016 increased slightly to 4.1x (9M2015: 4.0x). We maintain the view that with the exception of distressed situations, REITs are unlikely to defer perpetual distributions. As such we also adjust perpetual distributions in our coverage ratio in assessing credit risk: (i) Adjusting for 50% of perpetual distribution, we find that adjusted coverage (EBITDA/Gross interest plus 50% of perpetual distribution) for AREIT to be 4.4x (9M2015: 4.2x). MLT's coverage was 4.4x in 9M2016, declining from 5.3x in 9M2015; (ii) Assuming 100% of perpetual distribution within coverage ratios, AREIT's adjusted coverage (EBITDA/Gross interest plus 100% of perpetual distribution) is 4.2x in 9M2016, similar to its 9M2015 numbers while MLT's weakened to 3.7x in 9M2016 against 4.4x in 9M2015.

Figure 4: Credit Ratios of Industrial REITs Under Coverage

REIT	Aggregate Leverage (%)		EBITDA/Gross Interest (x)		Debt Duration (in years)	
As at	30-Jun-16	30-Sep-16	9M2016	9M2015	30-Jun-16	30-Sep-16
AAREIT	33.1	34.0	3.7	3.5	1.9	2.4
AREIT	37.0	34.2	4.7	5.5	3.3	3.8
CREIT	37.4	36.9	3.5	3.4	3.1	3.4
MINT	28.2	29.0	8.5	8.4	3.7	3.5
MLT	35.7	37.6	5.5	6.6	3.6	3.7
Sabana	41.2	41.5	2.5	3.1	1.6	2.1
SBREIT	35.9	36.0	4.4	4.5	3.4	3.1
VIVA	40.0	39.8	2.8	2.9	3.7	3.5
Median	36.5	36.5	4.1	4.0	3.4	3.5

Source: REIT financial statements and company presentations for the quarter ended 30 September 2016
Note: (1) Gross interest for AREIT excludes loss of fair value from Exchangeable Collaterised Securities

D) Credit Rating Agency Actions in 3Q2016

Of the 8 Industrial REITs we cover, 7 are rated by international rating agencies. There have been no changes to credit ratings since 1st July 2016 to date.

E) OCBC Credit Research Actions in 3Q2016

We have raised VIVA Industrial Trust's issuer profile to Neutral from Negative on 31 October 2016[1] as we expect that over a 6-month period and to the extent that the existing bond is concerned, we think VIT's credit profile will improve to be in line with peers.

[1] *VIVA Industrial Trust – Credit Update (31 October 2016)*

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