Asia Credit Research

Singapore REITs: Sector Update

Tuesday, 16 July 2019

Oiling the wheels of growth

- While we support the relaxation of an aggregate leverage limit as a pro-market move, in our view, debt markets can no longer take a broad brush approach to assume that REITs are a low credit risk sector. Instead, we think debt markets are likely to respond accordingly to the actions committed by each REIT (i.e.: case by case basis).
- The traditional assumption that REITs have lower growth can no longer be relied upon as we think REITs are likely to use the opportunity to expand (inorganically or through redevelopments / developments).
- Overall, we expect aggregate leverage to creep up, though settling at a new norm (which factors in the markets' comfort level with the credit risk against the returns investors are getting out of this sector) over time.
- REIT managers that continue to practise financial discipline and uphold the market's expectation of REITs as lower risk vehicles that generate stable income to pay its capital source providers are likely to continue to be favoured.
- Should the new aggregate leverage cap be above 50%, some possible safeguards include (1) a higher EBITDA/Interest coverage that is above the suggested 2.5x. We think a more stringent coverage ratio would better serve its purpose and reduce the likelihood of a "false sense of security", especially in the current low interest rate environment which has suppressed the denominator and (2) a cap on the secured debt a REIT could take relative to its total deposited asset value to allow for higher financial flexibility and a better recovery in the off chance of a default given that bondholders are invariably unsecured debt holders.

Treasury Advisory
Corporate FX & Structured Products
Tel: 6349-1888 / 1881
Interest Rate Derivatives
Tel: 6349-1899
Investments & Structured Products
Tel: 6349-1886

Institutional Sales
Tel: 6349-1810

Credit Research
Seow Zhi Qi
+65 6530 7348
zhiqiseow@ocbc.com

Ezien Hoo, CFA
+65 6722 2215
EzienHoo@ocbc.com

Background

Monetary Authority of Singapore (MAS) published a consultation paper on 2 July 2019 on the following proposed amendments to the Code on Collective Investment Schemes to provide Singapore's REITs with more flexibility to manage their capital structure and to streamline the fundraising process for REITs:

(1) Review the aggregate leverage limit of 45%

Leverage limit(s) seeks to ensure that a REIT is well-capitalized. The suggested approach is to allow REIT's aggregate leverage to exceed 45% but not more than 50% if the REIT is able to meet a minimum interest coverage requirement of 2.5x and allow perhaps an even higher leverage, say 55%, if the REIT has demonstrated good financial discipline such as having a higher minimum interest coverage.

Aggregate Leverage is defined as Total Borrowings and Deferred Payments over Deposited Assets. Interest coverage is defined as EBITDA (excluding effects of any fair value changes) over Interest expenses. Both Aggregate Leverage and Interest coverage include proportionate share of borrowings and assets at Joint Ventures.

The aggregate leverage limit is not considered to be breached if the REIT's minimum interest coverage requirement subsequently falls below the minimum interest coverage requirement threshold due to circumstances beyond the control of the REIT manager. However, the REIT should not incur additional borrowings or enter into further deferred payment arrangements.

(2) Removal of notification requirement when REITs make an offer of units to accredited and other investors

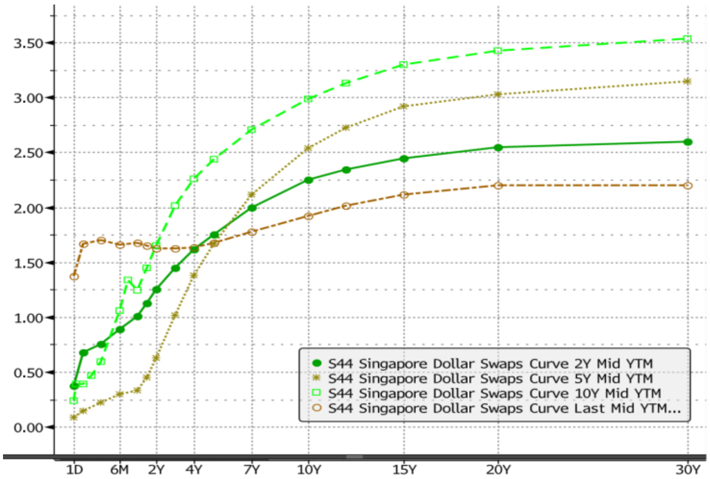
This serves to boost the efficiency of the fundraising process for REITs, and bring it more in line with the fundraising process for companies and business trusts.

What does the transaction mean to REIT bondholders

While the proposed amendments have yet to be set in stone, we see the following as the key impact should REITs be allowed a higher aggregate leverage, notwithstanding safeguards that are put in place:

- **Growing asset base through the use of leverage:** In the current low interest rate environment, valuation of properties has in general gone up over the past few years. Arguably, the room for an upward revaluation of assets or capitalization rate compression would be smaller in the next 12 months. While the REITs may be in a position to make acquisitions and propel earnings given the larger debt headroom, we think it could come with higher credit risk as some properties might not have been accretive for unit holders based on the 45% leverage limit, but accretive to unitholders with a 50% or 55% leverage limit where more debt could be used to fund the acquisition as opposed to using more equity. Even though this will boost the growth ability of REITs, REITs have been seen as a lower risk and low growth asset class which is able to generate stable income to pay its capital source providers (bank debt, bonds, perpetuals and equity holders). As such, it is questionable whether growth in and of itself is a good thing for bondholders.

Figure 1: Historical Singapore dollar swaps curve of Mid YTM versus Tenor



Source: Bloomberg (Last Mid YTM refers to that for 16 July 2019)

With reference to Figure 1, we find that relative to the historical SGD swap curves (i.e. 2 years, 5 years and 10 years ago from today 16 July 2019), the curve beyond a tenor of 6 months has progressively flatten. This reflects the low interest rate environment we are in where the 5Y SGD swap rate is just 1.6579% and the 10Y SGD swap rate is below 2% at just 1.92%, much lower than that of 10 years ago.

- **Potentially weaker credit metrics:** A higher aggregate limit can weaken the credit metrics of REITs whose aggregate leverage was historically generally kept within 40% (despite the being allowed up to 45%). Assuming REITs are able to stretch their aggregate leverage to 50%, broadly, this would translate to a net gearing (net debt over equity) of 1.0x. We assume that debt equals to liabilities with REITs not keeping minimal cash balance. While this may sound overly mechanical, we observe that REITs do not tend to keep large cash balances as (1) more than 90% of taxable income is distributed out to unitholders for tax purposes and (2) holding cash earning little interest income makes little sense for REITs due to the negative carry as their cost of funds is much higher than the returns from cash. Also, while some trade payables exist, we expect this to be small due to the "investment property holding" nature of REITs (vis-à-vis operating businesses). Additionally, capex and acquisition related liabilities tend to be temporary. As such assuming debt makes up all of the REIT's liabilities is a reasonable approximation in our view. Assuming an aggregate leverage of 55%, this translates to a net gearing of 1.2x. This would be much higher than our estimated average net gearing of 0.53x as at 31 March 2019 for the REITs under our coverage. If 50% of perpetuals was taken as debt, we find the current adjusted average net gearing higher at 0.56x.

Figure 2: Net gearing of REITs and property developers as at 31 March 2019

Type	Company	Net gearing	Aggregate Leverage
Property Developer	Frasers Property Ltd	0.87x	46.9%
	Mapletree Investments Pte Ltd	0.76x	42.6%
	CapitaLand Ltd	0.58x	37.4%
	City Developments Ltd	0.36x	31.1%
REIT	ESR-REIT	0.77x	42.0%
	Suntec REIT	0.60x	38.6%
	Mapletree Logistics Trust	0.62x	37.7%
	Cache Logistics Trust	0.64x	37.4%
	Mapletree North Asia Commercial Trust	0.59x	36.6%
	Ascendas REIT	0.58x	36.3%
	Keppel REIT	0.39x	35.7%
	Starhill Global REIT	0.54x	35.7%
	Ascott Residence Trust	0.53x	35.7%
	CapitaLand Retail China Trust	0.57x	35.5%
	CapitaLand Commercial Trust	0.37x	35.2%
	First REIT	0.54x	34.5%
	CapitaLand Mall Trust	0.43x	34.4%
	Frasers Hospitality Trust	0.50x	34.1%
	Lippo Malls Indonesia Retail Trust	0.54x	33.9%
	Mapletree Industrial Trust	0.45x	33.8%
	Mapletree Commercial Trust	0.50x	33.1%
	Frasers Commercial Trust	0.43x	29.1%
	Frasers Centrepoint Trust	0.41x	28.8%

Source: Company, OCBC Credit Research

With reference to Figure 2, we find that REITs typically have a lower net gearing than property developers. We think with the change to the aggregate leverage, net gearing of REITs could inch higher and come close to that of property developers.

- **Unlike commercial real estate debt, REIT bonds are unsecured:** It is also worth noting that bonds issued by REITs are typically unsecured, and rank *pari passu* with all other present and future unsecured creditors of the REIT. This means that should the REIT become unable to pay the principal of, or any interest on its bond, bondholders do not have an explicit recourse on the REIT's properties unlike situations where the properties are pledged as collateral.

- **Interest coverage ratio of 2.5x offers little safeguard:** We think setting a minimum interest coverage (including contributions from associates and JVs) that is ~45% below the current market average of 4.65x is useful merely theoretically. It almost certainly would not be triggered as the average reported interest coverage across all REITs listed on SGX is comfortably above 2.5x. In fact, interest coverage of at least 2.5x is already the market norm. This would also mean that no REIT is really barred from the 55% aggregate leverage if a minimum interest coverage ratio of 2.5x were to be implemented. Therefore, we think MAS can consider a higher interest coverage ratio.

Figure 3: EBITDA/Interest for REITs

Company	Calculated EBITDA/Interest[1]	Reported EBITDA/Interest[2]
ESR-REIT	4.63x	3.70x
Suntec REIT	1.81x	2.90x
Mapletree Logistics Trust	4.75x	4.90x
Cache Logistics Trust	4.74x	4.30x
Mapletree North Asia Commercial Trust	4.08x	4.20x
Ascendas REIT	4.64x	5.20x
Keppel REIT	1.18x	4.10x
Starhill Global REIT	3.65x	3.80x
Ascott Residence Trust	4.67x	4.50x
CapitaLand Retail China Trust	6.10x	5.00x
CapitaLand Commercial Trust	3.61x	5.80x
First REIT	7.30x	N.A.

CapitaLand Mall Trust	4.51x	4.90x
Frasers Hospitality Trust	4.74x	4.80x
Lippo Malls Indonesia Retail Trust	8.46x	N.A.
Mapletree Industrial Trust	6.39x	6.50x
Mapletree Commercial Trust	4.51x	4.50x
Frasers Commercial Trust	3.18x	4.68x
Frasers Centrepoint Trust	5.75x	6.00x
Average	4.74x	4.65x

Source: Company, OCBC Credit Research
[1]Based on consolidated figures (30 June 2018 - 31 March 2019). Exclude associates and JVs
[2]Reported figures as at 31 March 2019. Include associates and JVs

- **Poor internal liquidity due to the unique structure of REITs:** REITs are required to distribute at least 90% of taxable income each year to obtain tax exempt status by Inland Revenue Authority of Singapore. This is one main reason why REITs have minimal cash on its balance sheet. Based on our calculations, cash to short term debt is 0.77x on average across the sector which demonstrates weak internal liquidity, albeit one that the Singapore capital markets have come to expect as market norm. Despite weak internal liquidity, majority of REITs have had very strong access to bank debt and capital markets since their inception in Singapore (barring the period of financial crisis in 2008-2009). We note that the proposed change to aggregate leverage is on the assumption that the tax exempt status remains pegged to distributing at least 90% of taxable income. This meant that REITs is likely to continue be incentivized to keep liquidity low despite being allowed to take up more leverage.

Figure 4: Cash to Short term debt as at 31 March 2019

Type	Company	Cash to Short term Debt
Property Developer	CapitaLand Ltd	1.70x
	Frasers Property Ltd	1.15x
	Mapletree Investments Pte Ltd	0.81x
	City Developments Ltd	1.60x
Industrial REIT	Ascendas REIT	0.09x
	Mapletree Logistics Trust	3.30x
	Mapletree Industrial Trust	0.53x
	ESR-REIT	0.07x
	Cache Logistics Trust	0.59x
Office REIT	CapitaLand Commercial Trust	0.66x
	Mapletree Commercial Trust	0.98x
	Suntec REIT	0.16x
	Frasers Commercial Trust	0.23x
	Keppel REIT	1.76x
Retail REIT	CapitaLand Mall Trust	0.76x
	CapitaLand Retail China Trust	2.07x
	Mapletree North Asia Commercial Trust	0.62x
	Frasers Centrepoint Trust	0.04x
	Starhill Global REIT	0.55x
	Lippo Malls Indonesia Retail Trust	0.62x
Hospitality REIT	Ascott Residence Trust	1.27x
	Frasers Hospitality Trust	0.19x
Healthcare REIT	First REIT	0.17x

Source: Company, OCBC Credit Research

- **……though external credit rating could offer protection:** Should the change comes through, we think high quality REITs may place more emphasis on maintaining their (largely investment grade) credit ratings. Notwithstanding MAS' aggregate leverage guideline, external rating agencies have their own methodology which includes aggregate leverage as a measure to derive the credit rating for the REITs. Therefore, REITs may instead focus on keeping their credit metrics well within external rating agencies benchmark for an investment grade rating (which for aggregate leverage is very likely to be below 50%).

Figure 5: REITs rated externally

Sponsor	REIT	Externally Rated
CapitaLand Ltd	Ascott Residence Trust	✓
	Ascendas REIT	✓
	CapitaLand Commercial Trust	✓
	CapitaLand Mall Trust	✓
	CapitaLand Retail China Trust	✘
Mapletree Investments Pte Ltd	Mapletree Commercial Trust	✓
	Mapletree Logistics Trust	✓
	Mapletree Industrial Trust	✓
	Mapletree North Asia Commercial Trust	✓
Frasers Property Ltd	Frasers Centrepoint Trust	✓
	Frasers Commercial Trust	✓
	Frasers Hospitality Trust	✓
Lippo Karawaci	Lippo Malls Indonesia Retail Trust	✓
	First REIT	✘
ARA Asset Management	Suntec REIT	✓
	Cache Logistics Trust	✘
Keppel Corporation	Keppel REIT	✘
ESR	ESR-REIT	✓
YTL Corporation Berhad	Starhill Global REIT	✓

Source: Bloomberg (as at 16 July 2019)

- **Some REITs bonds have covenants**: Prima facie, the financial covenants on total debt or borrowings to total assets or deposited property value seem mostly looser than the limits set by MAS with some REITs pegging their limit to MAS'. This would mean that should MAS increase its aggregate leverage limit; the financial covenant would likewise loosen.

Figure 6: Financial covenants of REIT's bonds

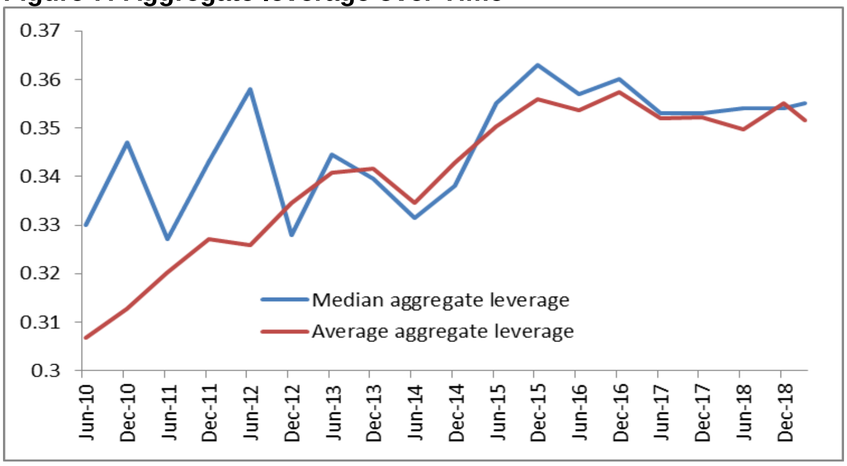
Company	Total Debt/ Total assets	EBITDA/ Interest	Secured debt / Total assets
ESR-REIT	Pegged to MAS rule	> 1.5x	-
Suntec REIT	-	-	-
Mapletree Logistics Trust	-	-	-
Cache Logistics Trust	Pegged to MAS rule	-	-
Mapletree North Asia Commercial Trust	-	-	-
Ascendas REIT	< 0.60x	-	< 0.5
Keppel REIT	< 0.60x	> 1.5x	-
Starhill Global REIT	< 0.60x	> 1.5x	-
Ascott Residence Trust	-	-	-
CapitaLand Retail China Trust	-	-	-
CapitaLand Commercial Trust	-	-	-
First REIT	< 0.50x	> 3.0x	-
CapitaLand Mall Trust	-	-	-
Frasers Hospitality Trust	-	-	-
Lippo Malls Indonesia Retail Trust	-	-	-
Mapletree Industrial Trust	-	-	-
Mapletree Commercial Trust	-	-	-
Frasers Commercial Trust	-	-	-
Frasers Centrepoint Trust	-	-	-

Source: Company information memorandum, OCBC Credit Research

- **REIT Manager's financial discipline is crucial**: We think ultimately should the proposed higher aggregate leverage cap be passed, the market can no longer take a broad brush approach to assume that REITs are a low risk sector. Instead, we think it would be advisable to analyze the REITs on a case by case basis and in particular, consider the REIT's (1) asset quality and cash flow stability, (2) overall strategic direction (including initiatives the REIT manager is looking to pursue (e.g.: development / redevelopments)), and (3) the capital structure which may change the credit profile of REITs and either offset or amplify the impact of higher aggregate leverage. Assuming higher debt headroom for REITs, REIT managers are likely to play an even more active role in determining the growth trajectory of the REITs (including whether to take up leverage in pursuit of growth).

  Historically REITs were allowed an aggregate leverage of 35% (unless externally rated whereby aggregate leverage could go up to 60%). In October 2014, among other proposed changes, the MAS came out with proposed terms to replace the aggregate leverage with a single-tier limit of 45%. Post a consultation period, in July 2015, a decision was made with REITs moving to the single tier limit of 45%. Looking back, we find that both the median and average aggregate leverage had crept higher, most strikingly between June 2014 and December 2016. That said, the ratio remained within a reasonable range and plateaued somewhat subsequently. It is though worth nothing that the use of perpetuals for funding rose during this time, with REIT perpetuals adhering to the prescribed structure which saw these subordinated and equity-like. At OCBC Credit Research, we expect something similar this time, should the new rule be passed, with REITs seeing their aggregate leverage creeping up and settling at a new norm which factors in the markets' comfort level with REIT's credit risk against the returns they are getting out of this sector.

Figure 7: Aggregate leverage over Time



Source: Company, OCBC Credit Research

<u>Who benefits from the amendments</u>

- **Perpetual holders of healthy REITs:** Should a higher aggregate limit be allowed, we think the call risk of the perpetuals of healthy REITs would dissipate as the REITs would have enlarged debt headroom and can raise relatively cheaper senior debt to refinance its perpetuals at first call for non-trivial cost savings. Consequentially, over the medium term, we can expect fewer REIT perpetuals to come to market and instead continue to see senior debt issuances. While senior-swap spreads are not constant over time, at an absolute minimum REIT perpetuals trade at ~50bps higher versus its comparable seniors (though only for high investment grade, at times of high liquidity). More typically REIT perpetual trades at a senior-swap spread of ~100-120bps.

- **Sponsor of REITs look to benefit**: Although "better able to compete against private capital and foreign REITs when making acquisitions from third parties" was cited as a key reason for a higher leverage limit, we think this change would also allow Sponsors of REITs to inject properties more easily into the REITs from a financial standpoint (including their sizeable properties). Given cost of debt is lower than the cost of equity, and REITs are now able to raise a higher quantum of debt, we think more properties would become accretive to unit holders on a levered basis and getting blessed by unitholders (i.e.: Sponsor assets would require unitholders' approval). Sponsors typically own the REIT managers (at least in part) while REIT manager fees tend to be linked to asset base. As such while having a Sponsor pipeline is beneficial to REITs in terms of growth, this benefit to bondholders is less apparent given bondholders do not share in the upside.

Figure 8: Debt headroom of REITs based on 31 March 2019 figures

Type	Company	Debt headroom (SGD 'bn) at aggregate leverage of 45%	Debt headroom (SGD 'bn) at aggregate leverage of 55%
Industrial REIT	Ascendas REIT	0.98	2.11
	Mapletree Logistics Trust	0.58	1.37
	Mapletree Industrial Trust	0.46	0.88
	ESR-REIT	0.09	0.39
	Cache Logistics Trust	0.12	0.27
Office REIT	CapitaLand Commercial Trust	0.73	1.47
	Mapletree Commercial Trust	0.84	1.55
	Suntec REIT	0.59	1.51
	Frasers Commercial Trust	0.34	0.56
	Keppel REIT	0.57	1.18
Retail REIT	CapitaLand Mall Trust	1.13	2.19
	CapitaLand Retail China Trust	0.29	0.59
	Mapletree North Asia Commercial Trust	0.66	1.44
	Frasers Centrepoint Trust	0.46	0.74
	Starhill Global REIT	0.29	0.61
	Lippo Malls Indonesia Retail Trust	0.22	0.42
Hospitality REIT	Ascott Residence Trust	0.49	1.02
	Frasers Hospitality Trust	0.27	0.52
Healthcare REIT	First REIT	0.15	0.29

Source: Company, OCBC Credit Research

- **Boost the competitiveness of SGX:** Singapore and Hong Kong impose a leverage limit of 45% while Malaysia imposes a 50%. Thailand allows REITs to leverage up to 60% if they have an investment grade credit rating, while the US does not impose any leverage limit as per MAS' consultation paper. Given Singapore's leverage limit is on the stricter end of the spectrum, we think loosening the leverage limit would make SGX more attractive to REITs looked to become publicly listed. This may possibly help SGX retain its attractiveness as a listing venue or even build upon its success as the go-to exchange for REITs.

<u>Conclusion and Recommendation</u>

Overall, a higher aggregate leverage is a pro-business move. With greater capital structure flexibility, Singapore REITs may potentially be able to scale greater heights. A change towards relaxing the aggregate leverage cap is likely to garner strong support from REIT managers, Sponsors and equity holders alike. From our perspective as credit research analysts, should the new limit be implemented, we would expect REIT managers to practise financial discipline to maintain the trust of its investors and investors' trust in the sector. Separately, we think debt markets are likely to respond accordingly to the actions committed by each REIT rather than taking a blanket assumption that REIT as a sector has a low credit risk.

In our view, some safeguards that could work include (1) a tighter EBITDA/Interest coverage than the suggested of 2.5x and (2) a cap on the secured debt a REIT could take relative to its total asset value. While we support the current proposal of having a minimum interest coverage ratio, we think a more stringent one would better serve its purpose as a safeguard. This is particularly so as we are now in a low interest rate environment, and hence the denominator i.e. interest amount is suppressed. We think the latter safeguard could help reduce the probability of bondholders (typically unsecured debt holders) running into a default situation where they do not get much back.

Notwithstanding the poor internal liquidity that REITs have, bank lenders and capital market investors (including retail investors reliant on REITs for income) have come to see REITs as a low risk asset class, largely because REITs have maintained manageable amounts of debt. We think a comparison of listed REITs to the real estate private equity class is moot as the latter targets highly sophisticated investors who are arguably in a stronger position to respond in the off chance of a default.

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

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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.

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