Perpetuals:
Underweight

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Perpetual Pentalogy: True Test

Non-call at first call date no longer just theory in the SGD-bond market

- **On 29 May 2020, Ascott Residence Trust ("ART", Issuer profile Neutral (4)) announced that it will not be calling its ARTSP 4.68%-PERP which is facing its first call date on 30 June 2020, effectively exercising its right to not call.**
- **Similar to other REIT perpetuals, this perpetual has no step-up margin and the perpetual distribution rate will fall to ~3.02% based on swap rates as at 29 May 2020.**
- **While ART's credit profile had been hampered in our view, the company is far from being in a credit distress situation.**
- **Although technically not the first issuer in the SGD space to do so, ART has set a precedent in the SGD space for an issuer not in distress to miss the call. In our view, ART has signaled to the market that it has opted in favour of economics over continued market access to the perpetual market, thereby sending a ripple effect through the SGD-perpetual market.**
- **Already we are seeing shading of perpetual prices for perpetuals with poorer structures which favour issuers more than investors in this current environment.**
- **We had been underweight the perpetual asset class since 10 March 2020 and are maintaining this call. We are however neutral on specific issues given their more resilient structure amidst this low rate environment**

A quick recap of the perpetual series

1st piece: An introduction to SGD Corporate Perpetual Bonds

- We discussed that **structures are important**, which include resets and step-ups.
- Reset dates and step-up dates should coincide to increase the economic incentive to call.
- Economic incentive to call is higher for step-ups with 300bps or more.
- REITs perpetuals do not include step-ups.

2nd piece: Still worthwhile?

- We discussed that the **chance of missing a call is not zero** especially during a market correction.
- Cost savings is the most common reason to call.
- Older issuances with wider spreads are likely to be called.
- Optimism in perpetuals is driven by compression in spreads and swap rates.

3rd piece: Paying issuers when it is at their option to call?

- We discussed that investors **should not price perpetuals to call unless they are very likely to**.
- Many perpetuals issued since 2017 have call and reset dates that do not coincide.
- Widening of spreads may put newer perpetuals with compressed spreads at risk of non-call.
- Rotate away from perpetuals that look uneconomical to be called on first call.

4th piece: With rates down and spreads up, is this positive or negative for perpetuals?

- We discussed that **issuers will likely not exercise the call** in today's low rate environment.
- Assuming no credit spread compression, issuers likelier to treat perpetuals as more equity-like.
- Uneconomical to call and refinance with another perpetual.
- Issuers may exercise prudence by not calling to keep larger equity cushion in a downturn.

ART – the first non-call of a SGD-perpetual?

ART announced on 29 May 2020 that they will not be redeeming their SGD250mn ARTSP 4.68%-PERP on 30 June 2020, the first call date on the perpetual. While ART's credit profile had been hampered in our view, the company is far from being in a credit distress situation, setting a precedent in the SGD space as an issuer not in distress to miss the call. We think ART's decision was largely driven by cost savings and viewing the perpetuals as more "equity-like" in this environment.

ART however is technically not the first issuer in the SGD space not in distress to miss a call. The first was Olam International Ltd ("Olam", Issuer profile: Neutral (5)) which likely inadvertently missed its first call on the OLAMSP 7.0%-PERP. Olam announced a buyback of the perpetuals at par allowing investors to exit and concurrently announced that it would call the perpetual at the next call date (six months after the first call). Olam's non-call occurrence in March 2017 did not cause the same ripple effect in the SGD-perpetual market and the company successful raised a replacement perpetual at 5.5% p.a. distribution rate in July 2017.

Reasons for ART's non-call

Per ART, it had taken into account the longer term interest of itself and the current macroeconomic environment in their decision not to call. Among factors considered by ART included: (1) Softer demand for accommodation from the COVID-19 outbreak which is expected to adversely impact ART's financial performance (2) Drawing down debt will increase leverage and (3) Current market conditions are not favourable for the issuance of perpetual securities. Our commentary as follows:

(1) **Softer demand for accommodation:** Since the global outbreak of COVID-19, occupancy and average daily rates have reduced significantly across hospitality markets. This is driven by lockdowns, restricted movement of people internationally but also within a country (eg: between states) and dampening in demand for travel. On 9 April 2020, ART first announced to the market the impact of COVID-19 on its business where the REIT shared that lower occupancies and room rates have been observed across all its markets. Properties predominantly catering to the transient segments were the most impacted and 15 out of 88 of its properties have temporarily closed (combination in response to government requirements, health recommendations or business decisions). As at 30 April 2020, 18 out of 88 were temporarily closed.

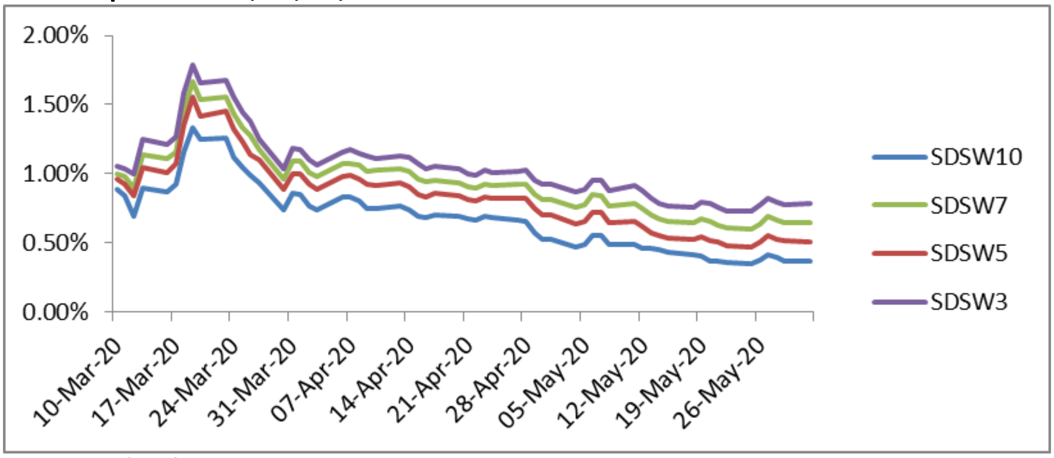
(2) **Debt would increase leverage and reduce debt headroom:** As at 31 March 2020, ART's reported aggregate leverage was 35.4% while its cash balance was SGD300mn on hand and committed credit facilities were ~SGD200mn. At that point ART was also expected to receive SGD163mn in proceeds from the sale of Somerset Liang Court within 2H2020 (though this transaction is now delayed). With ART only facing SGD404mn of debt due in 2020 (representing 16% of its total debt) as at 31 March 2020, part of its income underpinned by master lease agreements including those signed with its Sponsor, CapitaLand Ltd ("CAPL", Issuer profile: Neutral (3)) and sizeable unencumbered assets, we think ART maintains access to debt markets and would have been able to raise debt as replacement capital if it wanted to do so. ART's effective borrowing cost is low at only 1.8% p.a. and taking a more current reflection of its current cost of debt, ART's bond curve implies that a 5 year senior bond may cost ~3.5%. However, a replacement of the perpetual into debt may have led aggregate leverage higher to 39%, still within the MAS cap (now at 50%), although ART had flagged possible asset value corrosion in its 29 May 2020 announcement.

(3) **Current market conditions are not favourable for the issuance of perpetual securities**: As part of its capital management, ART's managers prefer a diversification of its funding sources and in our view, this would mean a preference to keep the perpetual as a perpetual. Based on swap rates as at 29 May 2020, the perpetual distribution rate on the ARTSP 4.68%-PERP would reset down to 3.02% p.a. (from the current 4.68% p.a.) although the actual perpetual distribution rate would only be determined on 30 June 2020 being the first call date coinciding with the reset date in this case (it is worth noting not all perpetuals have coinciding call, reset and step-up dates). At 3.02% p.a., this is even cheaper than its senior bonds. ART's credit spreads on the ARTSP 4.0% '24s had blown out of the water from less than 125bps to more than 320bps in early April 2020 and while tightened in May 2020, they are still around ~305bps. Without further credit spread tightening, this implies that a hypothetical ART perpetual may need to price a replacement perpetual at 4.5% - 5.0% p.a. (a

whopping cost saving of 150-200bps from letting the existing perpetual reset lower). In our view, maintaining the perpetual as "cheap funding" amidst a significantly more challenging business condition is likely the right thing to do for ART's unitholders. Using today's market value of equity, equity still makes up 51% of its capital base even after a year-to-date fall in market price of 28%, whereas perpetual holders only make up 7% of the capital base.

SGD swap rates continued to rally since our publication of the 4th perpetuals piece on 10 March 2020 when we turned Underweight on perpetuals. As such, non-call risks have further increased as distribution rates, which are periodically referenced off SGD swap rates, are likely to be reset even lower.

SGD swap rates – 3Y, 5Y, 7Y, 10Y



Source: Bloomberg as at 1 June 2020

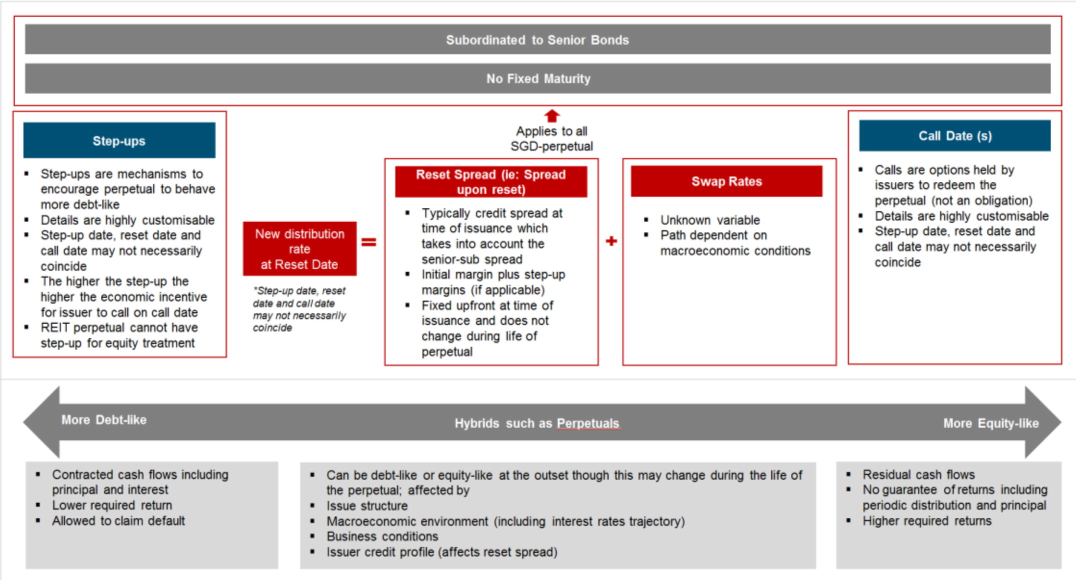
Building blocks of a corporate perpetual

SGD perpetuals are created from the following building blocks:

(1) Perpetuals are subordinated securities and in a liquidation scenario has a lower priority of ranking versus senior debt
(2) No fixed maturity (applies to all perpetuals)
(3) Step up dates with step-up margin to economically encourage issuers to call (bulk of perpetuals have these except REIT perpetuals where it is not allowed for equity treatment)
(4) First call date and subsequent call dates (these are call options (not obligations) held by issuers)
(5) Reset spread which is the spread upon reset date
    a. Typically the credit spread at time of the perpetual's issuance, factoring in the prevailing market senior-sub spreads
    b. Reset spread of perpetuals with longer length of time to reset date should be wider given more credit risk associated with longer maturities
(6) New distribution rate at reset date is the aggregate of the reset spread which is known upfront and the unknown swap rate, which is highly dependent on underlying macroeconomic environment
    a. For perpetuals with no step-ups (such as the ARTSP 4.68%-PERP), the initial spread equals to reset spread
    b. For perpetuals with step-ups margins, the new distribution rate at reset date equals initial spread plus step-up margin plus swap rate

While all SGD perpetuals share the bulk of the above building blocks, details are customizable to meet issuer and investor needs and also dependent on market conditions. We consider REIT perpetuals to be the most vanilla segment of the perpetual market as the bulk of REIT perpetuals have a five year call date, no step-up dates (and no step up margins) and the call date equals to reset date.

Building blocks of a typical perpetual



Source: OCBC Credit Research

Heralding other perpetual issuers to not call? Even if there was any consideration on reputational risks of missing the call (which may affect continued market access), we think this will change with Ascott REIT's decision not to call, setting the precedence for other SGD perpetual issuers to follow suit. Primarily, refinancing with another perpetual is likely more expensive than allowing the existing perpetual to reset. In today's environment, cash is king amidst a downturn. Going forward, we think that the markets may consider each perpetual on a case by case basis instead of pricing regardless to call. After all, call is an option held by the issuer, and not the investor.

Risk of deferral of perpetual distributions

REIT perpetuals typically do not have dividend pushers. This means the REIT is not obligated to pay perpetual distributions upon payment of equity dividends to equity holders. REIT perpetuals however have dividend stoppers which halt equity dividends to equity holders should the REIT choose to miss or defer the perpetual distributions. Therefore, while there is risk of a REIT perpetual missing perpetual distributions, we think this risk is somewhat capped as the REIT has to resume payment of perpetual distributions before the REIT can declare equity dividends. Our base case assumes that while REITs are not legally obligated to pay dividends, its equity holders do expect equity dividends under normal business conditions given its nature as low growth stable income equity as well as the tax transparency in Singapore. Therefore, the REITs are incentivized to make equity dividends payments their equity holders. With the outbreak of the COVID-19 pandemic, REITs in Singapore, particularly retail and hospitality REITs, have been severely impacted and have cut equity dividends significantly though all of them have continued to declare lower equity dividends. Amongst the REITs under our coverage, Lippo Malls Indonesia Retail Trust ("LMRT") faces high risk of deferral of perpetual distributions. While LMRT has not deferred its perpetual distributions, the REIT did not accrue distributions to perpetual holders under its statement of distribution, leaving the option open for a deferral. Another point to note is the non-cumulative nature of REIT's perpetual distributions. This means that the REITs are not required to pay back any missed payments.

Bank capital instruments – is it time to worry?

We have seen COVID-19 have a selectively progressive but now far reaching impact across industries within the credit space. Financial institutions are no different with concerns on earnings due to the impact of lower interest rates, potentially lower future demand for credit and rising credit costs. At the same time, the wide-spread distress seen within the economy has driven estimates of both rising default rates and an increase in non-performing loan ratios. These two influences make capital preservation key in ensuring a financial institution remains solvent and also continues to fulfill its important role in facilitating the flow of credit through the economy.

So far, banks have been somewhat insulated from immediate capital concerns due to (1) The strong build up in capital since the Global Financial Crisis due to relatively benign or supportive operating environments and regulator enforced rising minimum capital requirements; and (2) The relaxation of various prudential requirements by bank regulators to create balance sheet buffer for banks to continue lending. Still, it has not stopped various regulators from strongly recommending or outright restricting financial institutions from leaking capital as the severity of COVID-19 increased. This highlights the highly regulated nature of the banking industry as well as the systemic importance of financial institutions in keeping the economy going. Shareholders globally have since had to accept the reduction, deferment or cancellation of equity dividends by many banks including National Australia Bank Limited ("NAB", Issuer profile: Positive (2)), UBS Group AG ("UBS", Issuer profile: Neutral (3)) and HSBC Holdings PLC ("HSBC", Issuer profile: Neutral (3)).

It has also not stopped the management of some banks from deciding to take a conservative and economically prudent approach to capital conservation by deciding not to call bank capital instruments at first call. This most recently included Lloyds Banking Group Plc (Not rated by OCBC Credit Research) who became the third European bank this year to extend an Additional Tier 1 bond beyond its first call date, deciding not to exercise its call option in late June for the EUR750mn LLOYDS 6.375% PERPc20s. While the reason given was the need to preserve capital during the coronavirus epidemic, the other reason was the likely wider spread that Lloyds Banking Group Plc would have needed to pay to refinance or replace the security. With the bond trading around 3c below par, it appears investors had already priced in the higher call risk and anticipated the bank's decision. German banks Aareal Bank AG and Deutsche Bank AG have also extended AT1 bonds this year.

So will the theoretically higher call risk also become a reality for bank capital instruments in the SGD space? The question is perhaps not so clear cut in our view. For one, the presence and permanence of perpetuals in a Financial Institutions capital structure is driven by both economic and regulatory considerations. The regulatory requirement to hold minimum levels of capital makes the existence of bank capital instruments more permanent and although it may be more economical not to call based on today's swap rates, we think that banks would be willing to go through short term pain for long term gain by preferring to call a bank capital instrument when due. Financial Institutions in the SGD space in general also benefit from their systemically important roles and solid market positions, as well as access to different capital markets and currencies meaning they can be more opportunistic in managing their cost of capital. As such, the influence of economics may be somewhat diluted for bank capital as opposed to corporate perpetuals. That being said, economics will play an increasingly important role the longer the pandemic impacts economies and issuers. It has already amplified the existing underlying vulnerabilities in the issuers we rate with ultimately fundamentals likely to be a key consideration in any evaluation of call risk. For now as economies open and a recovery hopefully begins, we are not worried yet but we continue to monitor the space.

Where to from here for investors?

As mentioned in our first publication on perpetuals, structures are important. LMRT has expressed potential deferment of distributions (our base case of LMRT assumes it will miss the distributions) while ART is set to miss the call, in part because these perpetual is structured with distributions being non-cumulative and without step-ups. We believe this will be the primary focus for investors going forward looking at potential new issues, demanding larger step-ups and/or other structures which protect investors against a collapse in rates and rising non-call risk. However, for investors still seeking the "impossible trinity" (High Yield, Low Risk, Limited Tenor), perpetuals are not proving to be the answer. A choice has to be made, either to accept lower yields or take on higher credit risk (which is not ideal in a downturn given heightened risk of default). Given the relatively flat yield curve and lower rates, it may not be meaningful to look towards extension in maturity. Net-net given the type of securities available in the market (eg: lack of bullet subordinated bonds), we think investors would still be willing to invest in perpetuals although the perpetuals will need to be structured in such a way that protects investors from low rates (eg: with higher step-up, significantly higher spreads) as investors will now be more cognizant that the underlying perpetual structure matters.

Where to from here for issuers?

We think ART's decision could cause a rippling in the market leading to a broader re-pricing of the perpetual market. How the market reacts sends important signaling effects for issuers who find themselves in the midst of deciding whether to call their existing perpetuals as the call date looms. A large fall in perpetual prices due to non-call is a reflection of declining market appetite for perpetuals, making it harder for potential issuers to access the market (at least at a cost of funding which they are used to).

In our view, time dimension plays a role in this decision as the further away a call date, the higher likelihood for circumstances to differ from today's expectations eg: interest rate trajectory, credit spreads and macroeconomic environment. In an optimistic scenario where a vaccine and/or treatment without prolonged side effects for COVID-19 can be found within the year, we may see credit spread compression quickened while interest rates may no longer be as low as current expectations. This scenario may encourage a call on existing perpetuals instead. As such we have focused the following tables on those whose first call dates are within the next 24 months, seeing them as higher risk from a time dimension perspective.

REIT perpetual issues with first call date in the next 24 months

Issue	1st call date	Reset date	Reset spread (%)	Distribution rate on reset* (%)	Risk of non-call at 1st call
ARTSP 4.68%-PERP	30-Jun-2020	30-Jun-2020	2.50	3.02	4
AREIT 4.75%-PERP	14-Oct-2020	14-Oct-2020	2.43	2.955	2
KREITS 4.98%-PERP	02-Nov-2020	02-Nov-2020	2.705	3.23	2
FHREIT 4.45%-PERP	12-May-2021	12-May-2021	2.45	2.975	3
FIRTSP 5.68%-PERP	08-July-2021	08-July-2021	3.925	4.45	4
LMRTSP 7% -PERP	27-Sept-2021	27-Sept-2021	5.245	5.77	4
SBREIT 6%-PERP	27-Sept-2021	27-Sept-2021	3.79	4.315	3
MLTSP 4.18%-PERP	25-Nov-2021	25-Nov-2021	2.30	2.825	3

Source: Bloomberg, OCBC Credit Research
** Based on swap rates as at 1 June 2020*
*** All REIT perpetuals have no step-up margin which adheres to MAS guidelines for equity treatment*
****4 (red) being the highest risk of non-call at first call, in descending order with 1(green) as the lowest risk*

Non-REIT corporate perpetual issues with first call date in the next 24 months

Issue	1st call date	Reset date	Reset spread (%)	Distribution rate after call date* (%)	Risk of non-call at 1st call
WINGTA 4.35% PERP	24-Aug-2020	24-Aug-2027	3.087	4.35	3
CELSP 3.9% PERP	19-Oct-2020	19-Oct-2020	7.38	7.755	1

Source: Bloomberg, OCBC Credit Research
** Based on swap rates as at 1 June 2020*
***4 (red) being the highest risk of non-call at first call, in descending order with 1(green) as the lowest risk*

Bank capital issues with first call date in the next 24 months

Issue	1st call date	Reset date	Reset spread (%)	Distribution rate on reset* (%)	Risk of non-call at 1st call
BAERVX 5.9% PERP	18-Nov-20	18-Nov-20	3.32	3.8438	1
BNP 4.3% 25c20^	03-Dec-20	03-Dec-20	1.88	2.4038	1
BPCEGP 4.45% 25c20^	17-Dec-20	17-Dec-20	2.16	2.6838	1
STANLN 4.40% '26c21^	23-Jan-21	23-Jan-21	2.095	2.6188	1
ABNANV 4.75% 26c21^	01-Apr-21	01-Apr-21	2.710	3.2338	1
UOBSP 4.0% PERP	18-May-21	18-May-21	2.035	2.5588	1
SOCGEN 4.3% 26c21^	19-May-21	19-May-21	2.335	2.8588	1
BPCEGP 4.50% 26c21^	03-Jun-21	03-Jun-21	2.450	2.9738	1

Source: Bloomberg, OCBC Credit Research
** Based on swap rates as at 1 June 2020*
^ Tier 2 issues
***4 (red) being the highest risk of non-call at first call, in descending order with 1(green) as the lowest risk*

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 bond represents **better relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile.

Neutral ("N") – The represents **fair relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile.

Underweight ("UW") – The represents **weaker relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile.

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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