Singapore Industry Focus

Singapore REITs

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DBS Group Research . Equity

4 Mar 2022

Passing the litmus test

- Financial metrics stay robust in the face of rising interest rates
- Interest coverage ratios remain comfortably above minimum levels based on our stress test analysis
- Valuations (and NAVs) are attractive; cap rate spread compression is not excessive while market upturn will drive asset reflation
- S-REITs to bottom out as rate lift-off approaches

Financial metrics remain robust. While we had in our previous report (Insights Direct - Singapore REITs : Markets mispricing interest rate risk) ascertained that DPU downside risk is limited to c.3.5% (1% hike in refinancing cost) given the sector's diversified refinancing profile, we are further comforted that S-REITs' interest coverage ratio ("ICR") of 4.9x (ranging between 3.2x to 21.0x) is comfortably above the minimum 2.5x imposed by the Monetary Authority of Singapore ("MAS") and possibly loan covenants. This implies that S-REITs have the flexibility to gear up towards the c.50% level if they choose to, although we sense that most managers are keen to keep gearing closer to the c.38%-39% level, providing headroom for opportunistic acquisitions. We have stressed tested our estimates and a 1.0% hike in interest rates will see ICR ratios dip to 4.3x (ranging between 2.5x to 18.0x), implying that S-REITs are well buffered against interest rates hikes.

Valuations may see upside as cap rate spreads are not excessively tight, ahead of expectations. We note that cap rates for various real estate classes have compressed by up to 100 basis points over the past decade. The tightest compression was seen in the industrial (logistics, business parks) and suburban retail sectors given their proven resilience throughout the COVID-19 crisis supported by increasing capital allocations from investors into these emerging asset classes. While cap rates are low, we note that cap rate spreads (cap rate minus 10-year yields) are still within historical range and not excessively compressed. As such, with rental growth picking up in 2022-2023, asset valuations should remain sticky or trend higher as portfolio net operating income ("NOI") improves.

S-REITs offer value, trading below historical mean. Despite a 2.0% rise month-on-month as market risk-off sentiment sets in, 15 of 44 S-REITs still trade within 5% of their 52-week lows and forward yields are higher than their historical mean. As we approach rate hike lift-off in March'22, we remain buyers on weakness for the sector with a preference for re-opening plays (FCT, CICT,SUN,CLCT, ART) and selected high-growth industrial names (FLCT,MINT).

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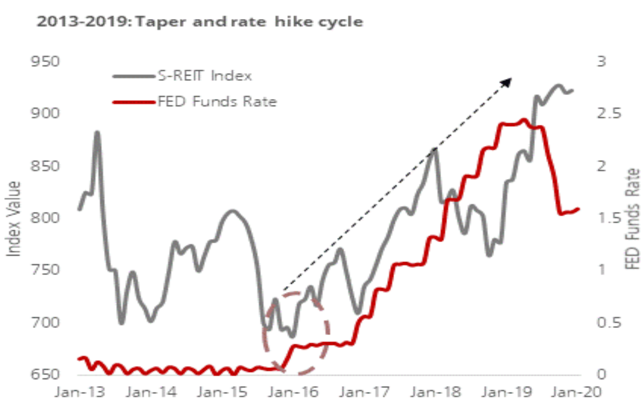
STOCKS

	Price S$	Mkt Cap US$m	12-mth Target Price S$	Performance (%) 3 mth	12 mth	Rating
CapitaLand Integrated Commercial Trust	2.13	10,395	2.45	2.9	1.4	BUY
Suntec REIT	1.66	3,515	1.90	11.4	11.4	BUY
Frasers Centrepoint Trust	2.31	2,902	2.90	1.8	(5.7)	BUY
CapitaLand China Trust	1.16	1,422	1.60	0.9	(14.1)	BUY
Ascott Residence Trust	1.05	2,546	1.30	8.3	5.0	BUY
Frasers Logistics & Commercial Trust	1.45	3,952	1.85	0.0	8.2	BUY
Mapletree Industrial Trust	2.61	5,129	3.35	(0.4)	(0.8)	BUY

Source: DBS Bank, Bloomberg Finance L.P.
Closing price as of 3 Mar 2022

Rates hikes vs S-REIT prices



Source: Bloomberg Finance L.P., DBS Bank

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Stressing balance sheets

In our previous update, we highlighted that a 50-100 basis points ("bps") hike in refinancing rates could drag earnings down by 1.5% to 3.5%. The reason for the more marginal impact is due to the (i) high proportion of fixed rate debt to overall debt, and (ii) a well spread-out debt expiry profile ("WALE"). [Insights Direct - Singapore REITs : Markets mispricing interest rate risk]

Financial metrics: To assess if a hike in interest rates have an impact on a REIT's ability to borrow, we have done a sensitivity on the interest coverage ratio ("ICR") to assess how this changes when interest rates rise. With MAS putting in an ICR ratio floor of 2.5x, S-REITs have the flexibility to gear up to 50%. We note that 4 out of the 37 REITs under our coverage clear this requirement as of financials at end-Dec 21. Even assuming a 1% hike in interest rate, the ICR of most S-REITs would still be above the 2.5x threshold with the sector averaging 4.3x (a drop from 4.9x). The sector's interest rates is expected to increase by only by 30 basis points given low renewal risks in the medium term.

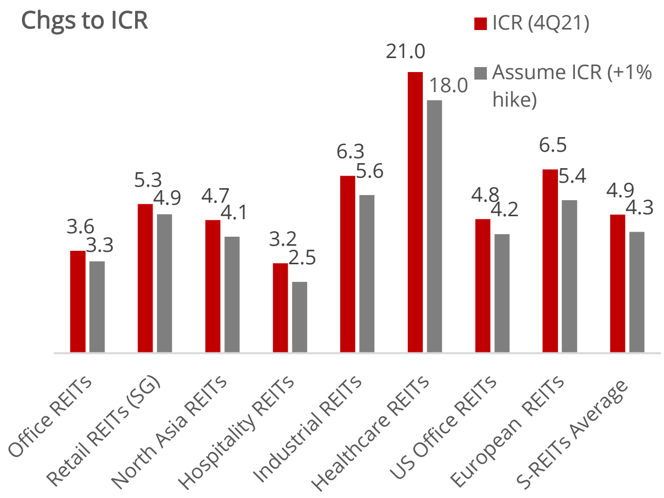
Key financial ratios for S-REITs

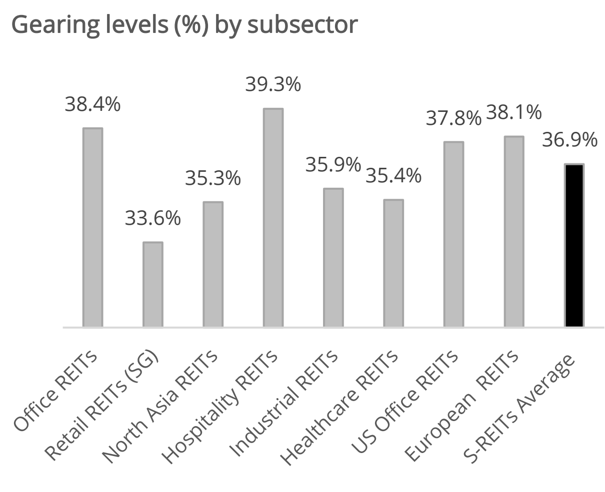
Key Observations:

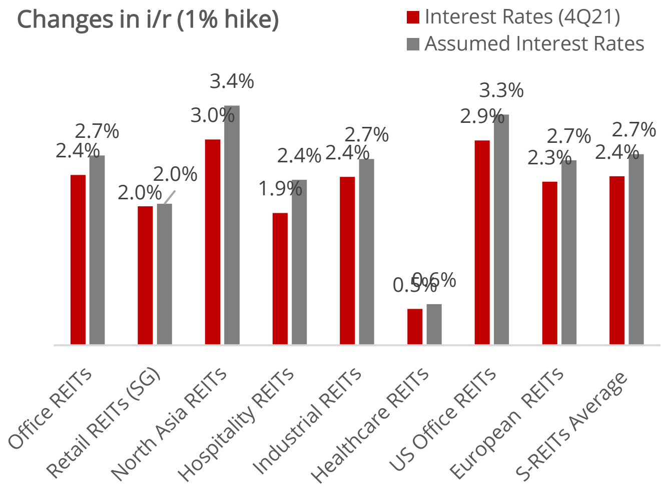
Gearing: Overall gearing remains low at c.37% with most subsectors at 33% - 39%.

Interest rate sensitivity: A 1% hike in refinancing costs over FY22-23F will see a 30-basis point increase in overall cost of debt.

ICR ratio changes: The average for the sector remains comfortable at 4.9 years, going down to 4.3 years. The weakness in hospitality S-REITs should improve as earnings rebound.







Source: companies, DBS Bank

ICR ratio sensitivity to 1% hike in refinancing costs

REITs	Gearing	Interest Rate (%)	% debt expiring (FY22-23F)	% Chg in interest rate (+1% cost)	ICR (4Q21)	Assuming 1% hike	
						ICR (FY22)	ICR (FY23)
Office REITs (Singapore)							
CICT	37.2%	2.3%	30.0%	2.6%	4.1	3.6	3.6
KREIT	38.4%	2.0%	23.6%	2.2%	3.9	3.5	3.5
OUECT	38.7%	3.2%	31.7%	3.5%	2.8	2.5	2.5
Suntec REIT	43.7%	2.4%	30.7%	2.7%	2.6	2.3	2.3
Average	38.4%	2.4%	28.0%	2.7%	3.6	3.3	3.3
Retail REITs (Singapore)							
FCT	34.5%	2.2%	31.8%	2.5%	5.8	5.1	5.1
SPH REIT	30.3%	1.8%	37.3%	2.1%	7.3	6.5	6.5
SGREIT	36.1%	3.0%	27.3%	2.5%	3.1	3.7	3.7
Average	33.6%	2.0%	27.8%	2.0%	5.3	4.9	4.9
Retail REITs (Overseas)							
CLCT	37.7%	2.6%	30.3%	2.9%	4.9	4.4	4.4
Sasseur REIT	26.1%	4.4%	100.0%	5.4%	5.1	4.2	4.2
Average	35.3%	3.0%	48.6%	3.4%	4.7	4.1	4.1
Hospitality REITs							
ARA US	48.2%	3.4%	27.4%	3.7%	2	1.3	1.3
ART	37.1%	1.6%	55.5%	2.2%	3.7	2.7	2.7
CDLHT	39.1%	2.0%	49.1%	2.5%	3.3	2.6	2.6
FEHT	38.3%	1.9%	36.8%	2.4%	3.4	2.7	2.7
FHT	42.5%	2.1%	39.5%	2.5%	2.4	2.0	2.0
Average	39.3%	1.9%	45.2%	2.4%	3.2	2.5	2.5

Source: companies, DBS Bank

ICR ratio sensitivity to 1% hike in refinancing costs (continued)

REITs	Gearing	Interest Rate (%)	% debt expiring (FY22-23F)	% Chg in interest rate (+1% cost)	ICR (4Q21)	Assuming 1% hike	
						ICR (FY22)	ICR (FY23)
Industrial REITs							
AIMS APAC REIT	37.3%	2.8%	9.7%	2.9%	3.3	3.2	3.2
AIT	35.0%	5.2%	61.2%	5.8%	3.7	3.3	3.3
ECW REIT	38.2%	4.1%	100.0%	5.0%	2.92	2.4	2.4
FLCT	34.3%	1.6%	17.1%	1.8%	8.4	7.6	7.6
KDC REIT	34.6%	1.6%	25.9%	1.9%	10.8	9.3	9.3
MINT	39.9%	2.3%	26.3%	2.6%	5.9	5.3	5.3
MLT	34.7%	2.2%	20.0%	2.4%	4.3	3.9	3.9
Sabana REIT	35.0%	3.1%	0.0%	3.1%	4.4	4.4	4.4
DHLT	37.7%	0.9%	15.7%	1.3%	9.2	6.4	6.4
Digital Core REIT	26.5%	1.0%	0.0%	1.0%	12.2	12.2	12.2
Average	35.9%	2.4%	22.1%	2.7%	6.3	5.6	5.6
Healthcare							
P-life REIT	35.4%	0.5%	7.2%	0.6%	21.5	18.9	18.9
US Office REITs							
KORE	37.2%	2.8%	36.1%	3.2%	5.1	4.5	4.5
MUST	42.8%	2.8%	21.2%	3.2%	3.4	3.0	3.0
Prime US REIT	33.5%	3.2%	35.2%	3.6%	5.8	5.2	5.2
Average	37.8%	2.9%	30.8%	3.3%	4.8	4.2	4.2
European / UK REITs							
Cromwell	36.6%	1.7%	19.4%	1.9%	5.8	5.2	5.2
Elite REIT	42.4%	2.0%	44.6%	2.3%	6.0	5.1	5.1
IREIT Global	35.8%	1.8%	0.0%	1.8%	7.7	7.7	7.7
Average	38.1%	2.3%	33.4%	2.7%	6.5	5.4	5.5

Source: companies, DBS Bank

Valuations to see upside despite rising interest rates

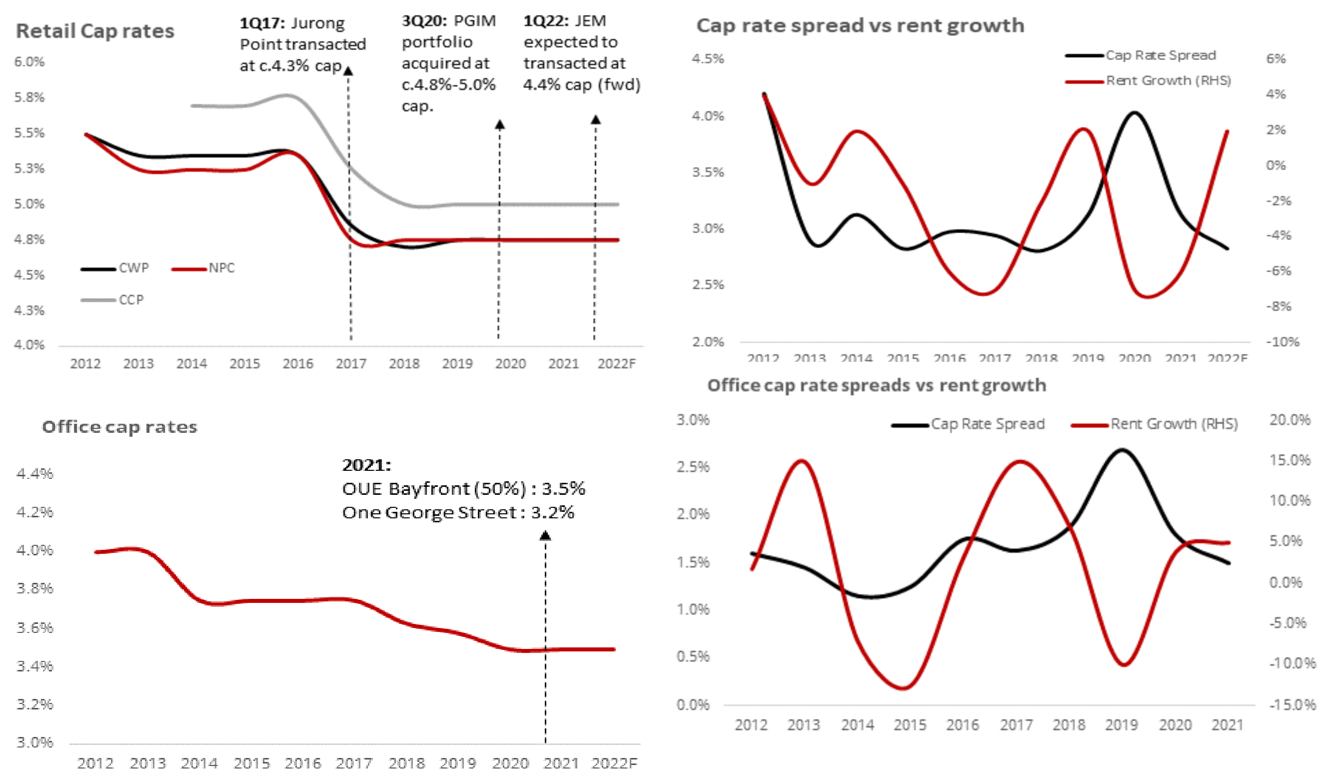
Valuations likely to remain stable; to re-rate when net operating cashflows rise. While most investors expect valuations may face some downward pressure as cap rates expand following an increase in base rates (or an increase in 10-year yields), we believe that this may not always be the case. Looking ahead, an increase in 10-year yields from current levels on the back of higher inflation prospects, we believe that cap rate spreads (cap rate minus 10-year yields) which are still within historical averages offer buffers for valuations. While retail sector cap spreads are below historical average, the prospects for rental growth coupled with ample liquidity will likely lead to cashflow-driven write-back in valuations as COVID-19 related impairments are deemed to be temporary and should fade.

Retail cap rates are supported by transactions and rental growth. We have used Frasers Centrepoint Trust's ("FCT") portfolio cap rates of their key suburban malls – Causeway Point ("CWP"), Northpoint City ("NPC") and Changi City Point ("CCP). While cap rates have declined from an average of c.5.5% (pre-2014) to c.4.8% (2021), it is expected to stay low based on major transactions through the years which were done at 4.4% to 4.85% cap rates.

Looking at retail cap rate spreads, we found that forward spread of about c.2.8% is close to the multi-year low. Hence, we believe spreads can continue to remain stable on rising expectations of higher rent growth.

Office valuations to see upside. Similarly, we see upside for office capital values on the back of stronger economic growth driving higher rental growth in 2022. Consultants are expecting to see rents rising by c.5%-10% given the lack of supply. Forward cap rate spreads of c.1.5% are not excessive, with the sector seeing cap rate spreads declining to c.1.2% before.

Analysis of cap rates and cap rate spreads for retail and office sectors

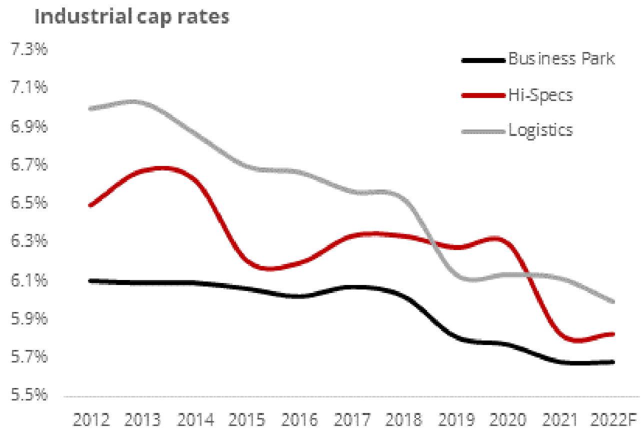


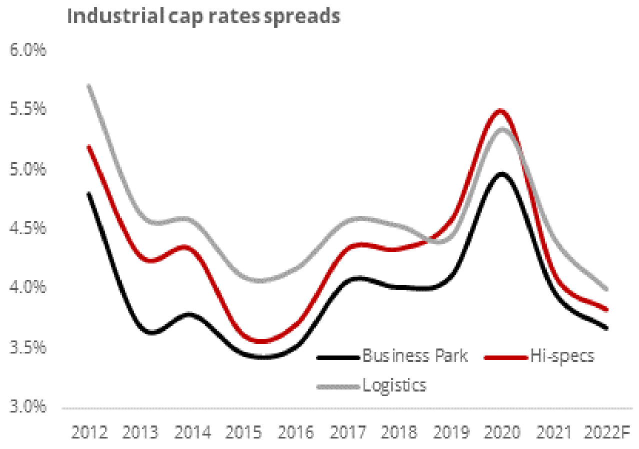
Source: Company, DBS Bank

Industrial cap rates have compressed, "new economy theme" to support valuations. Using Ascendas REIT's portfolio cap rates of its key industrial sub-segments of Business Parks, Hi-Specifications and Logistics properties as a proxy for Singapore industrial cap rates, we note that overall cap rates have declined between 40 basis points to 90 basis points over the past 10 years. The logistics subsector saw the tightest compression in cap rates given its resilience throughout COVID-19, while increasing capital allocation into the logistics sector, coupled with lack of supply drove valuations higher. Overall, with rental growth returning for most industrial subsegments come 2022 – 2023, we believe that valuations will remain stable, despite headline cap rates falling to multi-year lows.

Looking at industrial cap rate spreads, we found that forward spreads range between 3.7% to 4.0%, with the tightest seen in the business parks space and the widest in the logistics subsector. Cap rate spreads, while close to multi-year lows, are likely to remain at current levels or possibly compress further as capital allocation to the sector remains strong.

Analysis of cap rates and cap rate spreads for industrial sector





Source: Company, DBS Bank

Steady during volatility

SREITs outperformed in Feb'22. S-REITs outperformed in Feb'22, rising by 2.1% against the 0.2% drop in the STI. The risk of geopolitical uncertainties is driving a risk-off trade within the market and S-REITs are a beneficiary. With a number of stocks hitting 52-week lows in Jan'22, we saw bargain hunting opportunities, with Office S-REITs leading the recovery (+3.5% month-on-month) followed by Hospitality (+1.1% month-on-month) and Office (EUR), which increased by 1.4% month-on-month. Industrial S-REITs' performance was generally flattish at +0.3% while Healthcare S-REITs declined by 6.7% month on month, followed by Hospitality S-REITs (-3.7% month-on-month) and the US Office REITs (-1.5% month-on-month).

Our views

Positive read in results reflected in the diversity in performance. The sector's relatively stable share price is positive in our view. This highlights that investors will return to the sector at the right price. While we have seen outflows owing to tactical repositioning within and out of S-REITs in recent times, the uncertainty in the market has resulted in investors taking a reverse strategy. Rising geopolitical risks are driving investors to seek shelter in yields once again. With most of the S-REITs already reporting earnings by mid- Feb'2022, we note that earnings growth momentum has improved on top of a strong growth in DPUs. We remain comforted that most S-REIT managers continue to offer an optimistic outlook for 2022. With the FED's FOMC meeting just a couple of weeks away, all eyes will be on the pace of rates hikes that the FED will take in view of sticky inflation rates coupled with uncertainties from the geopolitical tensions between Russia and Ukraine. We maintain our view that S-REITs will bottom out once FED hikes lift off.

S-REITs still trade close to 52-week lows; selected S-REITs are close to -1 standard deviation in terms of yields. Despite the rise in prices, we note that the sector is still trading near 52-week lows, with close to 15 (19 last month) out of 44 S-REITs trading within 5% of their 52-week low prices. Six out of the top 15 S-REITs by market cap are within 5% of their 52-week lows, with a majority in the industrial sector. We would look to add at current levels, with FY22F yields expanding to 5.8%, implying a spread of 4.0% (10-year yields at 1.8% as of 1 March 22). Even if we assume 10-year yields will rise to c.2.0% in the longer term, we are still looking at an attractive yield spread of 3.8% (in line with historical mean).

Performance by subsectors based on rolling 6 months to Feb'2022

	Sep'21 % chg	Oct'21 % chg	Nov'21 % chg	Dec'21 % chg	Jan'22 % chg	Feb'22 % chg	2021 % chg
Office	1.7%	4.3%	-1.2%	-0.8%	-5.2%	3.5%	2.6%
Retail	0.9%	3.3%	-1.6%	0.9%	-5.0%	-0.7%	15.9%
Industrial	-1.2%	-0.4%	-1.3%	0.7%	-8.0%	0.3%	9.9%
Hospitality	-5.4%	9.1%	-4.5%	1.1%	-3.7%	1.1%	-7.6%
Hospitality (US)	-4.0%	1.0%	-2.1%	5.3%	-3.0%	3.1%	11.1%
Healthcare	-3.9%	0.2%	7.3%	2.6%	-6.6%	-6.7%	34.6%
Office (US)	1.6%	1.3%	-2.6%	-1.1%	-6.1%	-1.5%	2.3%
Office (EUR)	3.0%	1.5%	-3.4%	1.2%	-5.3%	1.4%	4.0%
Retail (Others)	-7.1%	5.4%	-2.2%	-3.0%	-4.3%	0.8%	-14.4%
FSTREI	-1.2%	2.7%	-1.9%	-0.3%	-6.3%	2.1%	0.3%
FSSTI	1.0%	3.6%	-2.4%	0.1%	4.0%	-0.2%	9.7%

Source: Bloomberg Finance L.P., DBS Bank

Yields vs historical trading range

	FY22 Yield (%)	Mean	+1 SD	-0.5 SD	-1 SD
Office					
CICT	5.4%	5.4%	4.3%	5.9%	7.1%
KREIT	5.2%	5.0%	3.9%	5.4%	6.9%
Suntec	5.7%	5.7%	4.6%	6.3%	7.5%
OUECT	6.6%	7.1%	6.5%	7.4%	7.8%
Retail					
FCT	5.6%	5.2%	4.4%	5.6%	6.3%
SPH REIT	5.5%	5.7%	5.5%	5.9%	6.0%
SGREIT	6.6%	6.3%	5.4%	6.8%	7.8%
Retail Overseas					
CLCT	8.3%	6.4%	5.4%	6.9%	7.9%
SASSEUR	8.1%	7.5%	[redacted]		
Hotels					
ART	5.5%	6.6%	6.0%	6.9%	7.3%
CDREIT	5.2%	5.4%	4.7%	5.7%	6.3%
FEHT	6.1%	5.6%	4.8%	6.0%	6.7%
FHT	6.7%	6.0%	5.7%	6.2%	6.4%
Industrials					
a-itrust	7.2%	7.3%	6.5%	7.7%	8.3%
MINT	5.6%	5.6%	6.4%	5.8%	6.7%
MLT	4.8%	6.2%	5.6%	6.5%	7.0%
KDCREIT	4.9%	5.2%	4.4%	5.6%	6.3%
AIMS	7.0%	7.0%	7.5%	6.8%	7.3%
FLT	5.6%	5.6%	6.0%	5.5%	6.3%
Healthcare					
P-Life	3.2%	5.0%	4.4%	5.3%	5.7%
US Office					
KORE	9.1%	7.8%	7.0%	8.4%	8.8%
MUST	8.8%	7.5%	6.6%	7.0%	8.1%
Prime	9.3%	7.3%	6.8%	7.5%	7.9%

Source: Bloomberg Finance L.P., DBS Bank

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STRONG BUY (>20% total return over the next 3 months, with identifiable share price catalysts within this time frame)
BUY (>15% total return over the next 12 months for small caps, >10% for large caps)
HOLD (-10% to +15% total return over the next 12 months for small caps, -10% to +10% for large caps)
FULLY VALUED (negative total return, i.e., > -10% over the next 12 months)
SELL (negative total return of > -20% over the next 3 months, with identifiable share price catalysts within this time frame)

**Share price appreciation + dividends*

Completed Date: 4 Mar 2022 06:35:55 (SGT)
Dissemination Date: 4 Mar 2022 07:16:32 (SGT)

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