Singapore Industry Focus

Singapore REITs

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DBS Group Research . Equity

18 Mar 2022

Are S-REITs pressured by inflation and high oil prices?

- Inflation pressures to cut profitability across most real estate classes, warehouses least impacted
- Renewal of utility and maintenance contracts are key pressure points on margins in 2H22
- Sensitivity analysis of a 100% hike in utilities: 10% hike in maintenance implies a 5%-7% drop in distributions
- Growth over yield; add MLT to top picks

Inflation pressures cut into profitability. Persistently high inflation rates due to global supply disruptions coupled with the ongoing geopolitical tensions have driven oil prices above US$100 per barrel. In Singapore, businesses are faced with higher energy costs (utilities, petrol) and labour costs. Landlords are also not spared, as utility and maintenance costs are expected to hike when these contracts are rolled over in 2H22-2023. While some of these cost pressures may be temporary, they add to the challenges that landlords need to manage, amidst the prospect of rising funding costs.

What if utility costs double? We understand that most S-REITs as landlords will have to incur operational costs in maintaining the common areas (i.e., the walking spaces within the malls, lift lobbies for office buildings, common areas in industrial properties) which account for c.5% to 40% of the overall GFA. While some of these costs can be defrayed through service charges, landlords will still have to bear some of the burden going forward. Based on our estimates, utilities and maintenance take up c.2% and c.5% of revenues, respectively, but this may vary, depending on the real estate subsector. Assuming a doubling of utility costs, a 10% hike in maintenance costs, we see a potential c.1% to 4% erosion to net property income ("NPI") margins, translating to an estimated c.2% to c.7% decline in distributions. In our scenario analysis, we have not accounted for scenarios where selected landlords have running contracts that last beyond FY22.

Who is most shielded and where should investors hide? The warehouse sector (mainly ambient warehouses) is the most shielded from the rise in operational costs, given their efficient footprint, and we see the least downside to earnings. Overall, even with these rising cost pressures, we estimate that the sector can still deliver a growth of 7.4% (vs. 8.0% before), with sector yields still attractive at c.6.0%. Our strategy is to stick with "growth sectors", given their ability to deliver higher DPUs despite these costs pressures. In addition, we have added MLT to our top eight names.

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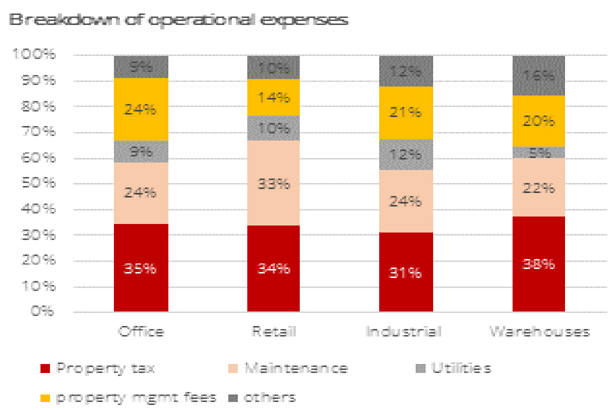
STOCKS

	Price S$	Mkt Cap US$m	12-mth Target Price S$	Performance (%) 3 mth	12 mth	Rating
CapitaLand Integrated Commercial Trust	2.17	10,574	2.45	7.5	0.9	BUY
Suntec REIT	1.70	3,588	1.90	12.8	7.1	BUY
Mapletree Industrial Trust	2.64	5,170	3.35	(3.4)	(2.3)	BUY
Mapletree Logistics Trust	1.82	6,406	2.35	(4.3)	(3.2)	BUY
Frasers Logistics & Commercial Trust	1.45	3,939	1.85	(5.3)	1.4	BUY
Frasers Centrepoint Trust	2.30	2,880	2.90	0.9	(9.2)	BUY
Ascott Residence Trust	1.04	2,513	1.30	2.0	(6.4)	BUY
CapitaLand China Trust	1.16	1,427	1.60	(2.6)	(16.8)	BUY

Source: DBS Bank, Bloomberg Finance L.P.
Closing price as of 17 Mar 2022

Contribution to cost (by line items)



Source: DBS Bank, Bloomberg Finance L.P.

ed: BM/ sa: JC, PY, CS

High energy costs push utility costs higher

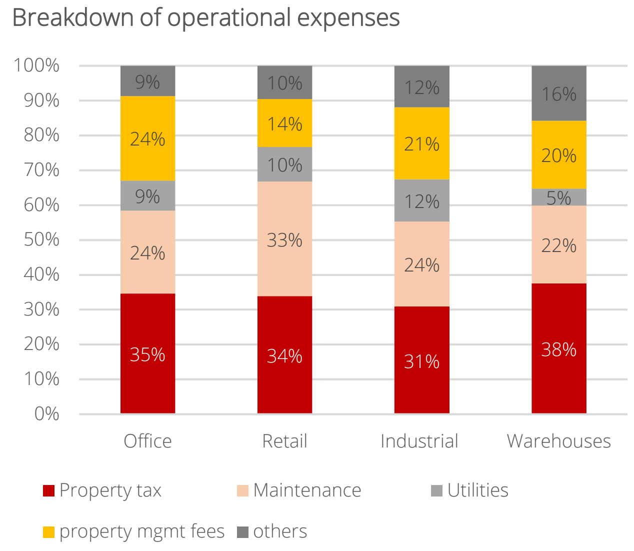
Watch out for inflationary pressures on profitability. Inflation pressures due to supply bottlenecks and the current Ukraine crisis are expected to drive global energy prices higher, and Singapore's energy costs will also spike as a result. In the most recent meetings, we see more questions surrounding the impact of higher utilities and maintenance contracts on net operating income ("NPI") and distributions. In our analysis and engagement with various companies, the spike in utilities and maintenance will indeed be an overhang but overall impact is varied and manageable. We believe that the ability to continue growing revenues strongly at c.20% in FY22 will be a key mitigator to the rise in operational costs. Our key findings are as such:

Utilities is not a major cost component for operational expenses; most expenses are passed on to tenants. We understand that most S-REITs as landlords will have to incur operational costs in maintaining the common areas (i.e., the walking spaces within the malls, lift lobbies for office buildings, common areas in industrial properties), spaces which are managed and maintained by the landlord. Some of these costs are rechargeable to the tenants through service charges that are built in rental contracts, which help to defray some of these costs incurred. For spaces that are occupied by tenants, utility costs are reimbursed by the tenants.

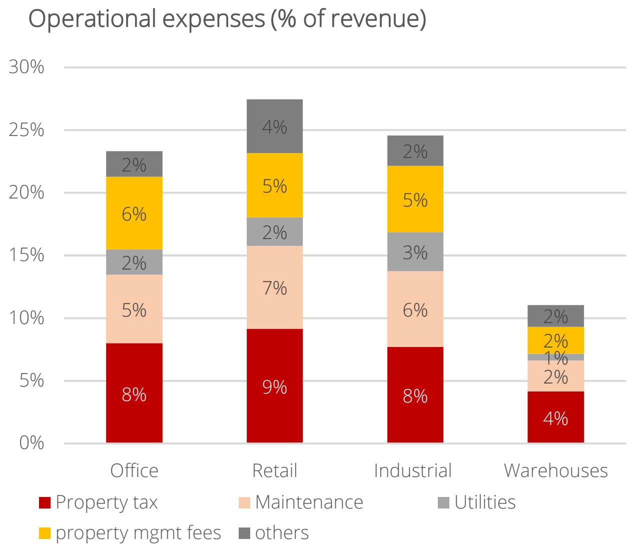
Breaking down the exposure to major cost items for the various subsectors, we found that in terms of percentages of operational costs, property tax was at c.35% of operational costs, and maintenance at c.14%-24% of overall costs, with utilities at c.5% to c.14% of overall costs, with a majority of subsectors incurring <10% of overall costs.

From a percentage of revenue perspective, we estimate that the landlords will spend 11% to 27% of revenue on operational expenses (translating to a margin of 73% to 89%) with 4%-9% on property taxes, c.5% to c.7% on maintenance costs, and c.1%-c.3% on utilities.

An illustration on the breakdown of operational cost components for various sectors*



Source: Companies, DBS Bank



Source: Companies, DBS Bank

** We have not included hospitality S-REITs, as most of the operational costs are borne by the hotel operators*
** Office: We have used CICT, KREIT; retail: FCT, CMT; industrial: AREIT, MINT; warehouses: MLT as a guide*

What is the potential impact on margins?

Impact of higher costs will be more gradual, as expiry of contracts are well spread out. Based on discussions with various landlords, most landlords expect to see some upward pressure in costs of maintenance and utilities when these contracts are renewed in the coming quarters.

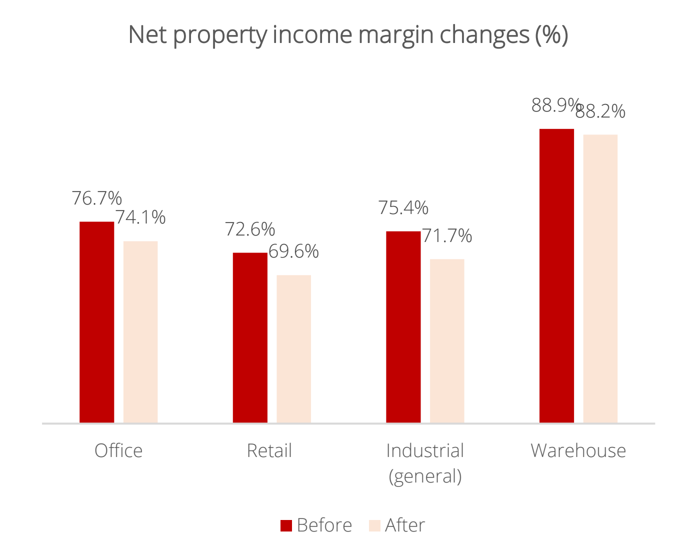
While some of the S-REITs are exposed to the spot electricity tariff and will start feeling the impact in 2H22, we understand that most have locked in contracts for the next few years, thereby substantially shielding the REIT from these cost hikes in the near term. Meanwhile, we believe a part of the rise may be temporary (e.g., high oil prices driven higher by geopolitical crisis, supply disruption).

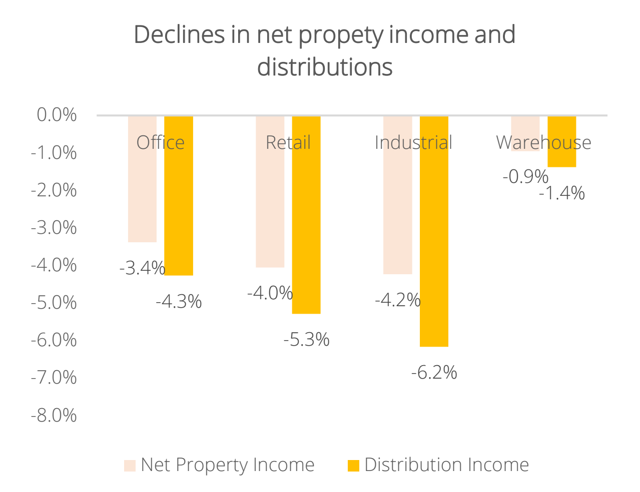
Therefore, the impact of these higher costs may be spread out over several years, depending on the timing of the expiry of the current maintenance and utility contracts.

What is the potential impact to margins if utilities rise 100% and maintenance cost by 10%? In our sensitivity analysis, assuming a c.100% rise in utility costs and 10% rise in maintenance costs, we estimate that the net property income margins may reduce by -0.8ppt to -3.7%, with a larger decline seen industrial-focused S-REITs due to their bigger exposure to both maintenance and utilities.

This translates to a possible c.1.8%-6.7% drop in distributions, with the warehouse sector seeing the lowest declines of c.1.8%.

Impact to margins, net property income and distribution





Source: Companies, DBS Bank

Source: Companies, DBS Bank

Potential impact by subsectors

Sectors	Potential impact – point form
Office	• Majority of the utility cost is borne by tenants, while the utility cost for the common areas will be reimbursed via a service charge to tenants (which is typically fixed during the lease period) • Common area utility costs are typically c.9% to 10% of operational expenses • Some office landlords could have locked in a utility rate for one to two years to mitigate the rising rates • In addition, green buildings with energy-saving features may reduce the utility cost
Retail	• Utility contracts help to hedge the effect of utility hikes for up to one to two years • The service charge paid by tenants can be used to defray costs incurred for common areas • Utility costs borne by retail landlords typically stand at c.40% of mall GFA • Tenant service charges typically help to partially pay off utility charge • Utilities make up c.10% of operational expenses and c.2% of revenue on a net basis
Industrial	General (Business Park, Hi-Tech) • Most utility costs are recoverable from tenants • Generally has more common space and services compared to other industrial property types, and will be most impacted Logistics focused • Ambient warehouses have minimal impact as they are very space efficient and have minimal common spaces • Climate-controlled warehouses may be impacted if utility charges are set on a fixed rate Data centres • Minimal impact, as leases are either triple-net or utility costs are charged directly to tenants
Hospitality	• Impact not material on the hospitality S-REITs and mostly borne by the master lessor • Hike in utility costs are more prominent in geographies like Europe and US • Similar to the other subsectors, some properties have secured fixed rates with energy brokers to mitigate the impact of a utility cost hike • Longer stay lodging assets typically come with a cap on utility usage whereby guests will pay if they exceed the utility cap

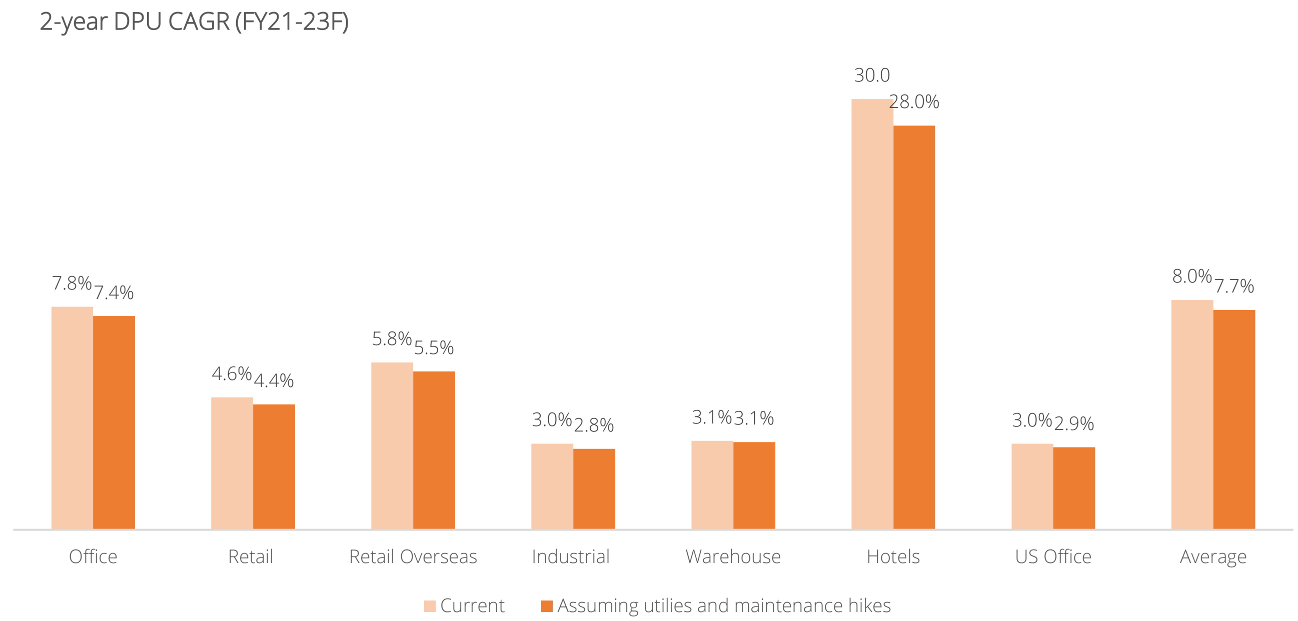
Source: Companies, DBS Bank

Our sensitivity analysis indicates that S-REITs can still deliver a 2-year DPU CAGR of 7.4%

Potential 40 basis point cut in growth trajectory. Expanding our analysis throughout the various subsectors and assuming the highest 3.0% cut in margins for other sectors (overseas-focused REITs, healthcare, and hospitality), we find that the growth trajectory for the sector is potentially marginally reset lower by 30 basis points, to 7.7% (ranging 2.8% to 28.0%) from 8% (ranging 3% to 30%). As such, we remain comforted that the S-REITs' growth trajectory remains intact for most sectors, despite the worrying trend of higher operational costs remaining an overhang for the sector in the near term.

Based on our sensitivity analysis, every 100% hike in utilities, in our estimates, will cut our DPU by 4.0% and growth trajectory by 40 basis points.

Impact of high operational costs on DPU growth profile



Source: Companies, DBS Bank

Impact of high operational costs on DPU growth profile

	NPI Margin			DPU CAGR	NPI		DPU drop	Growth	Drop
REIT	FY21	FY22	FY23	(%)	FY22F	FY23F	FY22/23	2-yr CAGR	
Office									
CICT	72.9%	73.9%	74.2%	8.9%	71.4%	71.7%	-4.3%	8.5%	-0.4%
Suntec REIT	71.1%	74.0%	73.0%	11.6%	71.5%	70.5%	-4.3%	11.1%	-0.5%
Keppel REIT	79.7%	79.9%	77.1%	4.2%	77.3%	74.6%	-4.3%	4.0%	-0.2%
OUE CT	81.7%	80.6%	80.9%	3.9%	78.1%	78.3%	-4.3%	3.8%	-0.2%
Retail									
FCT	72.3%	72.8%	72.9%	5.2%	69.9%	69.9%	-5.3%	5.0%	-0.3%
SPH REIT	73.1%	71.5%	72.1%	2.7%	68.5%	69.1%	-5.3%	2.6%	-0.1%
Starhill Global REIT	74.3%	73.2%	73.2%	0.7%	70.3%	70.3%	-5.3%	0.4%	-0.3%
Overseas focused									
CLCT	69.1%	69.9%	70.2%	5.6%	66.9%	67.2%	-5.3%	5.3%	-0.3%
Sasseur REIT	100.0%	100.0%	100.0%	8.3%	97.1%	97.1%	-5.3%	7.8%	-0.4%
Hospitality									
ARA US HT	29.1%	30.9%	31.4%	20.0%	27.2%	27.6%	-5.3%	18.9%	-1.1%
ART	47.4%	53.0%	52.2%	33.5%	49.3%	48.5%	-5.3%	31.7%	-1.8%
CDL HT	54.6%	61.1%	61.8%	27.2%	57.4%	58.1%	-5.3%	25.7%	-1.4%
Frasers HT	67.4%	74.0%	75.5%	20.1%	70.3%	71.8%	-5.3%	19.0%	-1.1%
Far East HT	90.3%	88.5%	88.9%	66.8%	84.8%	85.1%	-5.3%	63.3%	-3.5%
Industrial									
AIMS APAC REIT	71.4%	72.0%	74.0%	6.3%	68.3%	70.3%	-6.7%	5.9%	-0.4%
AREIT	75.1%	76.3%	76.5%	2.8%	72.6%	72.8%	-6.7%	2.6%	-0.2%
AIT	80.8%	77.0%	77.0%	7.8%	73.3%	73.3%	-6.7%	7.3%	-0.5%
DHLT	78.3%	78.2%	78.2%	1.0%	77.4%	77.4%	-1.8%	0.8%	-0.2%
DCR	63.1%	64.1%	66.1%	6.4%	60.4%	62.4%	-6.7%	6.0%	-0.4%
EC REIT	90.1%	90.0%	90.0%	1.7%	86.3%	86.3%	-6.7%	1.6%	-0.1%
KDC REIT	91.5%	85.6%	85.6%	6.5%	84.8%	84.8%	-6.2%	6.1%	-0.4%
FLCT	78.1%	81.0%	81.0%	1.8%	80.2%	80.2%	-1.8%	1.7%	-0.1%
MINT	78.5%	77.3%	75.9%	2.9%	73.6%	72.2%	-6.7%	2.7%	-0.2%
MLT	88.9%	85.4%	85.3%	2.0%	84.6%	84.5%	-1.8%	1.9%	-0.1%
US Office									
MUST	63.3%	63.7%	64.5%	4.1%	61.2%	61.9%	-4.3%	3.9%	-0.2%
KORE	61.3%	61.4%	61.5%	6.1%	58.8%	58.9%	-4.3%	5.9%	-0.3%
Prime	66.9%	68.6%	68.6%	2.9%	66.0%	66.0%	-4.3%	2.7%	-0.1%
European focused									
Cromwell REIT	65.0%	65.4%	65.5%	1.6%	62.9%	62.9%	-4.3%	1.5%	-0.1%
IREIT Global	81.4%	86.5%	86.5%	10.3%	83.9%	83.9%	-4.3%	9.9%	-0.4%
Elite REIT	97.1%	97.2%	97.2%	-3.9%	94.6%	94.6%	-4.3%	-4.4%	-0.5%
Healthcare									
Plife REIT	92.2%	92.9%	93.0%	1.6%	92.9%	93.0%	0.0%	1.6%	0.0%

Source: Companies, DBS Bank

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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*

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