Singapore Industry Focus

US Office SREITs

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DBS Group Research . Equity

26 May 2022

The US office reboot

- US office on a firmer footing for recovery in 2022, albeit uneven
- Indicators show that more than 35% of US office SREITs' submarkets have turned positive, with KORE leading its peers, at c.82%
- US office SREITs offer an attractive c.9% yield and yield spread of c.6% vs. SREITs' c.3%
- Prefer KORE, given its stronger submarkets

US office on a firmer footing for recovery in 2022, albeit uneven. After two years of a pandemic-driven correction, the US office market is finally showing positive signs of recovery in 2H2021. Key optimistic datapoints include i) 4Q21 seeing a second consecutive quarter of positive net absorption, with 61% of the submarkets recording positive absorption in 4Q21; ii) the first decline in the vacancy rate since the pandemic; and iii) that construction and sublease activities are declining. The positive momentum continues into 1Q22, but recovery appears uneven across the submarkets.

US office SREIT submarkets with optimistic outlook contribute more than 35% of NPI/CRI, with KORE taking the lead at c.82%. Based on JLL's 1Q2022 US office market insights, US office SREITs' submarkets that are showing positive signs of recovery contribute more than 35% of NPI/CRI. This is led by KORE, with positive submarkets comprising c.82% of NPI, followed by PRIME at 44% and MUST at c.35% of NPI.

US office SREITs' yield spread remains attractive, despite near-term share price overhang from macroeconomic uncertainty; prefer KORE. We maintain our positive stance on US office SREITs but lower our target prices by an average of c.12% to incorporate a higher risk-free rate of 3.5% and roll forward the DCF valuation to FY23F. Despite a DPU revision of c.-4% / c.-6% for FY22F/23F, US office SREITs are currently trading at a c.9.2% yield, offering an attractive yield spread of c.6.2%, vs. SREITs at c.3.3%, especially in a rising interest rate environment. Our preferred pick is KORE amongst the three, given stronger submarkets, a higher growth profile, and lower gearing, implying capacity to deliver an upside surprise from acquisitions. However, we highlight that MUST's share prices have underperformed compared to its peers, falling below the pandemic trough in Mar 2020. Although, while MUST's submarkets appear to have lagged its peers, share price downside risks are possibly limited at this level.

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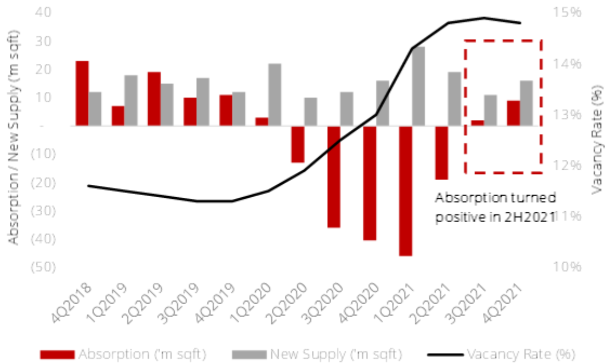
STOCKS

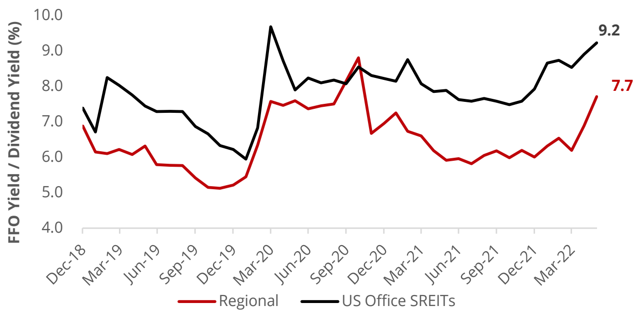
	Price US$	Mkt Cap US$m	12-mth Target Price US$	Performance (%) 3 mth	12 mth	Rating
Manulife US Real Estate Inv	0.59	1,041	0.70	(12.6)	(21.3)	BUY
Prime US REIT	0.72	837	0.88	(9.5)	(15.4)	BUY
Keppel Pacific Oak US REIT	0.69	714	0.86	(6.2)	(6.8)	BUY

Source: DBS Bank, Bloomberg Finance L.P.
Closing price as of 25 May 2022

US office market recorded second consecutive positive net absorption in 4Q21



Yield spread between US office SREITs vs. US office REITs' regional offices remains attractive



Source: DBS Bank, Colliers, Thomson Reuters

The office reboot

US office on a firmer footing for recovery in 2022, albeit uneven.

US office showing positive signs of recovery in 2H2021 sets the stage for an inflection point in 2022. After two years of a pandemic-driven correction, the US office market is finally showing positive signs of recovery in 2H2021. With economic recovery and further reopening globally, we believe the US office market is on a firmer footing for recovery in 2022.

According to Colliers' 4Q2021 Office Market Outlook, key metrics show more optimistic datapoints, pointing towards a steady recovery.

- Second consecutive quarter of positive net absorption recorded in 4Q2021, which is a turnaround after six consecutive quarters of negative absorption since the pandemic started
- Vacancy rate saw its first decline in 4Q21, though small, at -10 bps to 14.8%. The vacancy rate started to stabilise in 3Q2021, which peaked at 14.9%, vs. the low of 11.3% in 4Q2019
- Asking rents mostly held firm, despite rising concessions
- Sublease space declined further after recording its all-time high in 2Q21
- Construction activities continue to slow (at 120.5m sqft; -26% from the peak of 164m sqft), thus reducing supply-side risk

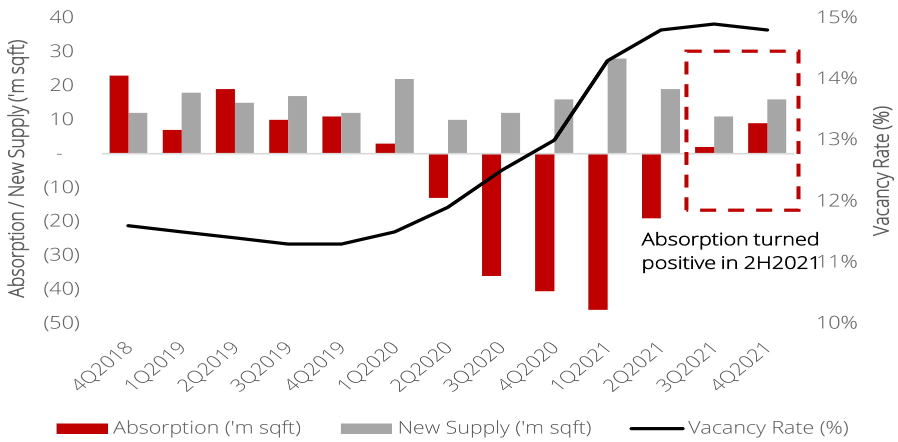
Broad-base recovery across US office, with 61% of the markets with positive absorption. By end-2021, the recovery appears to be broad based across the majority of the US office markets. As at 4Q21, 61% of the markets in the US recorded positive absorption vs. 56% in 3Q21, 34% in 2Q21, and 21% in 4Q20.

Positive momentum continues into 1Q2022, but recovery appears uneven. After recording a strong positive absorption in 4Q21, 1Q2022 absorption stabilised with a slight decline in occupancy, according to JLL. With reopening, office tours and leasing activities have picked up, as corporations and organisations have set clearer targets on returning to office and hybrid work policies. As such, tenants have better clarity to plan for their longer term space needs and are more willing to make longer term commitments.

Despite a broad-based recovery across the different markets in the US, recovery appears to be uneven. While some tenants are expanding their office footprints, there were also tenants looking to downsize, given hybrid work policies. As such, markets with higher vacancies, sublease inventories, and upcoming new supply may experience a slower recovery compared to markets with tighter supply. Expanding tenants vs. contracting tenants could be mismatched in a particular location. In addition, in the shadows are geopolitical tensions and macroeconomic uncertainty that could change the office landscape should the macroeconomic environment take a sudden turn.

In conclusion, while we believe US office is at an inflection point this year, the pace of recovery is volatile and is dependent on submarkets with stronger fundamentals.

US office market: Supply, demand, & vacancy rate



Source: Colliers, DBS Bank

Return-to-office exodus is finally happening.

Rising physical occupancy to drive more optimism and leasing activities. Although the outbreak of the Delta and Omicron variants delayed the much-anticipated return-to-office exodus in 2H2021, we believe plans to move back to the office are more certain in 2022 and have begun since the start of the year. In the unforeseen circumstance of the outbreak of a new variant, which may delay return-to-office plans again, we believe returning to normalcy is the key theme for 2022, as the world is reopening the economy and travel borders, emerging out of the pandemic.

We note that physical occupancy rates for most markets in the US are hovering at an average of 30% to 40% as at 2021 year-end. We expect this number will likely trend north in 2022 as companies encourage workers to return to office, albeit adopting a hybrid work arrangement. Based on Colliers' report, Houston, Austin, and Dallas are leading the office physical occupancy rates at above 40%, surpassing the average of 31.2%.

With more returning to the office, we believe this will drive more optimism, more office tours, and leasing activities, which is likely to drive down vacancies over time. This will bode well for the office market.

Tech markets continue to lead growth. As US office continues on its road to recovery, Colliers expects the tech markets will continue to lead the growth in medium-sized tech-centric cities such as Austin, Nashville, Salt Lake City, and Florida. On the other hand, JLL believes that that Sun Belt markets, such as Atlanta, Austin, Charlotte, Dallas, Miami, Nashville, Phoenix, and Raleigh, will continue to lead leasing activities, with some of these markets approaching pre-pandemic levels.

The rise of hybrid work may see a more volatile recovery in the near term. Post the pandemic, employers are responding to the needs of their employees and will likely consider incorporating some form of hybrid work. According to CBRE's 2021 Occupier Sentiment Survey, 87% of large companies plan to adopt a hybrid work approach.

As such, we expect 1H2022 to likely still be volatile as companies consider new work practices and recalibrate the office space requirements while balancing with flexible workspaces.

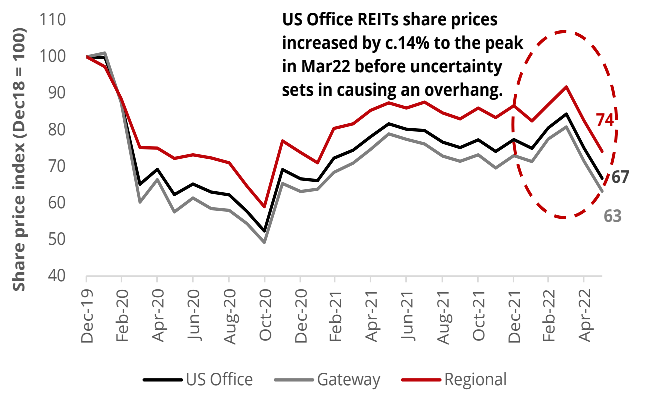
The spread between US office SREITs and US office regional office peers remains above the historical average, despite concerns of macroeconomic uncertainty casting a near-term overhang.

US office REITs have started to rise since the end of 2021, led by gateway offices, while US office SREIT share prices declined. US office REIT share prices started to move upwards since the end of 2021. US office REITs have increased by c.14% to the peak, with gateway offices leading the rise of c.16% vs. regional offices having increased by c.10% to the peak. However, it fell again, wiping almost all its gains following the looming macroeconomic uncertainty.

On the other hand, US office SREIT share prices have diverged, declining since the end of last year by c.12% YTD. MUST has been the underperformer among its peers and is now trending below the pandemic through in Mar 20, while KORE's share price has held up better than its pees.

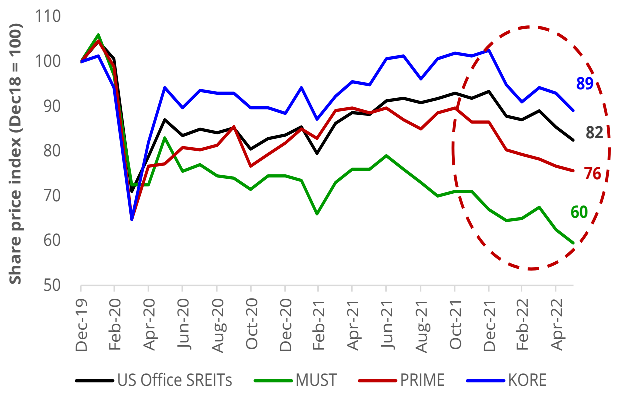
The spread between US office SREITs and US office regional office peers remains above the historical average of 1.1ppt, at 1.5ppt. Given the diverging trends, the yield spread between US office REITs and US office regional office peers has widened to 2.3ppt at the peak before trending down to 1.5ppt. Despite the spread having narrowed, it remains above the historical average of 1.10ppt.

US office REIT share prices increased c.14% to the peak in Mar 22 before overhang sets in from increased uncertainty



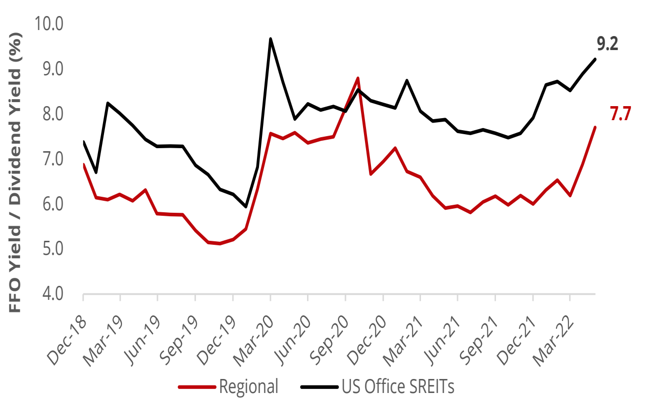
Source: Thomson Reuters, DBS Bank

Conversely, US office SREITs showed a diverging declining trend (-12% YTD) with MUST hitting below the pandemic trough



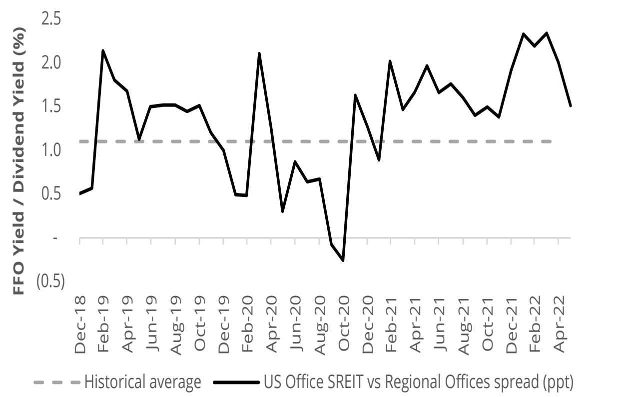
Source: Thomson Reuters, DBS Bank

Yield spread between US office SREITs and US office REITs' regional offices remains above the historical average



Source: Thomson Reuters, DBS Bank

Yield spread at 1.5ppt is above the historical average of 1.1ppt



Source: Thomson Reuters, DBS Bank

Similarly, US office SREITs' submarkets are showing positive signs of recovery.

US office SREITs' submarkets, which contribute more than 35% of NPI/CRI, are showing positive signs of recovery, with KORE leading the trend. Based on JLL's 1Q2022 US office market insights, we note that US office SREITs' submarkets that are showing positive signs of recovery contribute more than 35% of NPI/CRI. We will term these markets "positive submarkets".

KORE leads its SREIT peers with positive submarkets, contributing c.82% of NPI, mainly from the Seattle market, which comprises 44% of KORE's NPI. This is followed by PRIME, with positive submarkets contributing c.44%, mainly from Atlanta. Lastly, MUST is at 35%, mainly from Atlanta.

Submarkets contributing more than 30% have recorded positive net absorption in 1Q2022. Similar to the overall US office market trends, US office SREITs' submarkets have started to record positive net absorption in 1Q2022, one of the key signs of market recovery.

Once again, KORE leads its SREIT peers with submarkets recording positive net absorption, contributing c.74% of NPI. This is followed by PRIME (58%) and lastly, MUST (31%).

Average occupancy in key submarkets remained above 90%, with KORE's occupancy more resilient than its peers. Despite the pandemic and the delays in return-to-office, we saw that portfolio occupancy in key submarkets has remained above 90%, with KORE's occupancy being more resilient compared to its peers.

KORE's average occupancy in key submarkets has inched up to 94% in 1Q2022, vs. 93% since 2019 and held stable till 2021. MUST's average occupancy in 2021 is 4.0ppt below that of 2019 (pre-pandemic), while PRIME's average occupancy is 5.1ppt below that of 2019 (pre-pandemic).

Please refer to the tables below.

US office SREITs' submarkets showing positive signs of recovery

Contribution to NPI (%)	MUST 1Q2022	MUST 2021	PRIME 1Q2022	PRIME 2021	KORE 1Q2022	KORE 2021
Positive	**19%**	19%	**33%**	38%	**56%**	62%
Improving	**16%**	30%	**11%**	6%	**25%**	12%
Neutral	53%	23%	37%	36%	2%	9%
Negative	12%	28%	19%	19%	17%	17%
Positive/improving submarkets	**35%**	49%	**44%**	45%	**82%**	74%
Positive net absorption in 3Q / 4Q 2021	**31%**	42%	**58%**	47%	**74%**	57%
Vacancy < 20%	**23%**	38%	**32%**	49%	**71%**	82%

Source: JLL, DBS Bank

KORE's average occupancy in key submarkets is more resilient compared to its peers

Key Office Markets	Contribution to NPI (%)	Portfolio Occupancy 1Q22	2021	2020	2019	q-o-q
MUST						
Atlanta	19%	92%	93%	95%	98%	-0.9 ppt
Jersey City	15%	96%	98%	95%	96%	-2.1 ppt
Orange County	11%	89%	87%	84%	90%	2 ppt
Los Angeles	11%	87%	89%	93%	94%	-1.2 ppt
Sacramento	10%	87%	88%	93%	94%	-0.9 ppt
Total / Average	66%	**90%**	91%	92%	94%	-0.6 ppt
PRIME						
Salt Lake City	11%	96%	92%	95%	96%	3.7 ppt
Atlanta	11%	92%	93%	86%	97%	-1 ppt
Washington	11%	90%	90%	97%	99%	-0.8 ppt
Sacramento	10%	88%	88%	93%	na	0 ppt
Denver	9%	82%	82%	83%	99%	0 ppt
San Diego	8%	98%	100%	na	96%	-1.8 ppt
St Louis	8%	95%	97%	98%	96%	-1.5 ppt
Total / Average	68%	**92%**	92%	92%	97%	-0.2 ppt
KORE						
Seattle (Bellevue / Redmond)	44%	94%	94%	95%	96%	-0.5 ppt
Denver	13%	98%	99%	97%	97%	-0.4 ppt
Houston	10%	89%	89%	84%	82%	-0.6 ppt
Dallas	10%	94%	91%	95%	96%	3.4 ppt
Total / Average	76%	**94%**	93%	93%	93%	0.5 ppt

Source: JLL, DBS Bank

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US office SREITs' average occupancy in key submarkets is performing better than submarket occupancy

Key Office Markets	Contribution to NPI (%)	Submarket 1Q22	Submarket 2021	Submarket 2020	Submarket y-o-y	1Q2022 occupancy vs submarket
MUST						
Atlanta	19%	79%	81%	84%	-3 ppt	13.1 ppt
Jersey City	15%	84%	81%	86%	-5.3 ppt	12 ppt
Orange County	11%	79%	79%	81%	-1.9 ppt	10 ppt
Los Angeles	11%	81%	81%	82%	-1 ppt	6.8 ppt
Sacramento	10%	93%	93%	94%	-1.3 ppt	-5.5 ppt
Total / Average	66%	83%	83%	86%	-2.5 ppt	7.3 ppt
PRIME						2021 occupancy vs submarket
Salt Lake City	11%	na	87%	89%	-2.3 ppt	5.2 ppt
Atlanta	11%	na	85%	90%	-4.9 ppt	7.9 ppt
Washington	11%	na	91%	88%	3.7 ppt	-0.9 ppt
Sacramento	10%	na	93%	95%	-1.8 ppt	-4.8 ppt
Denver	9%	na	74%	82%	-8 ppt	8.7 ppt
San Diego	8%	na	93%	na	na	6.7 ppt
St Louis	8%	na	91%	84%	7.3 ppt	5.8 ppt
Total / Average	68%	na	88%	88%	-0.1 ppt	4.1 ppt
KORE						
Seattle (Bellevue / Redmond)	44%	97%	96%	95%	0.9 ppt	-2.7 ppt
Denver	13%	88%	88%	91%	-3.6 ppt	10 ppt
Houston	10%	79%	79%	85%	-5.8 ppt	9.9 ppt
Dallas	10%	75%	75%	78%	-3.5 ppt	19.3 ppt
Total / Average	76%	85%	84%	87%	-3 ppt	9.1 ppt

Source: JLL, DBS Bank

Attractive yield spread despite rising interest rates; prefer KORE over its peers.

We maintain our positive stance on the US office SREITs, but lower our target prices by an average of c.12% to incorporate a higher risk-free rate of 3.5% vs. 2.5% previously, and roll forward our DCF valuation to FY23F. We lowered our US office SREITs' FY22F and FY23F DPU estimates by an average of c.4% and 6%, respectively, to incorporate a slower pace of recovery.

Despite our earnings revision, the US office SREITs are trading at attractive yields of c.9.2% and a yield spread of c.6.4%, above SREITs' average yield spread of c.3.3%.

Given the rising interest rate environment and the US turning hawkish in its tone, we believe US office SREITs, which are on the route to recovery and trading at high yields, could still provide an attractive yield spread above the SREITs' average yield spread.

Our economists forecast that the US 10-year treasury yield is expected to rise to 3.40% by end-2022 and reduce to 2.90% by end-2023.

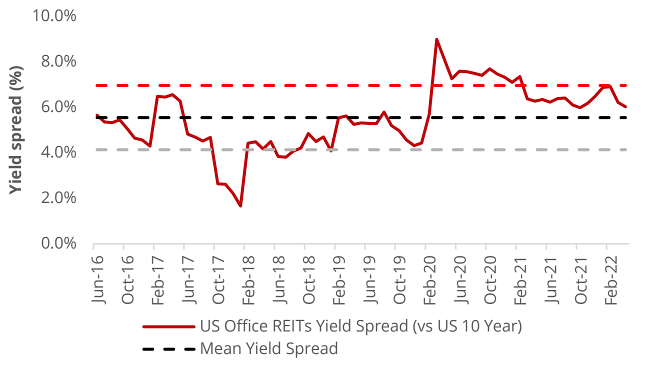
Assuming the US 10-year treasury yield could rise to 3%, at the current yield, we estimate that US office SREITs could still provide a yield spread of c.6.2%, slightly above its historical mean and still above the historical mean of the sector's average yield spread of c.3.0%.

When the Fed starts to turn hawkish in its interest rate hikes, we note that there could be some rotational interest, out from lower yielding SREITs into higher yielding SREITs. As such, we believe that US office SREITs are an attractive play on rising interest rates in the SREIT space, given its attractive yield spread.

Among the US office SREITs, we prefer KORE over its peers, given that the majority of its submarkets (contributing c.82% of NPI/CRI) are leading the recovery and continue to show positive signs compared to its peers (PRIME at 44% vs. MUST at 35%). In addition, its WALE is the shortest that could ride on a potential upward trend in rents as the office market recovers. Gearing is also the lowest among its peers and that provides some debt headroom for potential inorganic growth.

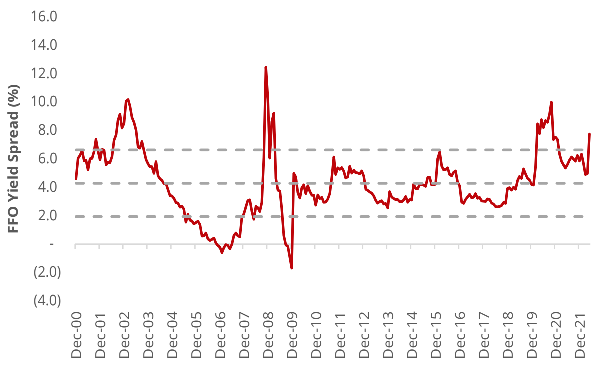
However, we do highlight that MUST's share prices have underperformed its peers, falling below the pandemic trough in Mar 2020. While MUST's submarket metrics appear to lag its peers in terms of recovery, which could pose some potential downside risks, at this level of share price, a share price downside is possibly limited should the market take a turn for the better in 2H2022.

US office SREITs yield spread



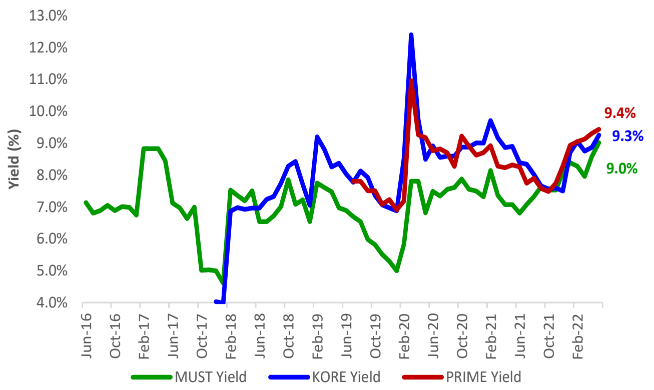
Source: Thomson Reuters, Company, DBS Bank

US office REITs yield spread



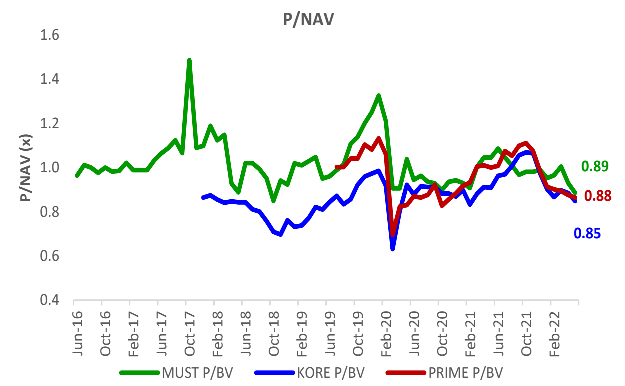
Source: Thomson Reuters, Company, DBS Bank

US office SREITs yield



Source: Thomson Reuters, Company, DBS Bank

US office REITs P/NAV



Source: Thomson Reuters, Company, DBS Bank

Snapshot of US office SREITs

As at Mar 2022	MUST	PRIME	KORE
AUM (US'm)	2,184	1,653	1,456
No of properties	12	14	15
NLA (sqft)	5,447,845	4,376,625	5,087,052
Committed occupancy	91.7%	89.9%	91.7%
WALE	5.0	4.2	3.7
Lease expiries - 2022	6.4%	9.5%	8.7%
Lease expiries - 2023	13.1%	17.6%	17.0%
Built-in average annual rental escalations	2.0%	n/a	2.4%
Rental reversions (1Q22)	3.9%	3.4%	2.4%
Gearing	42.8%	37.9%	37.5%
All-in average Cost of Debt	2.9%	3.1%	2.9%
Average Term to maturity (years)	2.6	2.7	2.9
Interest coverage ratio	3.4	5.2	5.0

Source: Company, DBS Bank

Revised estimates incorporating higher risk-free rate of 3.5% and DCF valuation roll forward to FY23F

	Old Estimates				New estimates			
	Target Price	Rating	DPU - FY22F	DPU - FY23F	Target Price	Rating	DPU - FY22F	DPU - FY23F
MUST	0.88	BUY	5.70	6.03	0.70	BUY	5.36	5.41
Prime	1.00	BUY	7.10	7.29	0.88	BUY	6.87	6.90
KORE	0.90	BUY	6.56	6.65	0.86	BUY	6.40	6.52

Source: Company, DBS Bank

Peer valuation

	Price (S$)	Market Cap (S$'m)	Target Price (S$)	Rating	Yield			P/NAV	DPU growth (%)
					FY21	FY22F	FY23F	FY21	2-yr CAGR
MUST	0.60	1,052	0.70	BUY	9.0%	9.0%	9.1%	0.88	0.7%
Prime	0.73	857	0.88	BUY	9.3%	9.4%	9.5%	0.86	0.9%
KORE	0.70	726	0.86	BUY	9.1%	9.2%	9.4%	0.88	1.4%
Average					9.1%	9.2%	9.3%	0.88	1.0%

Source: Thomson Reuters, Company, DBS Bank

DBS Bank recommendations are based on an Absolute Total Return* Rating system, defined as follows:
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*

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Sources for all charts and tables are DBS Bank unless otherwise specified.

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