CIO Perspectives

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Equities

EQUITY STRATEGY

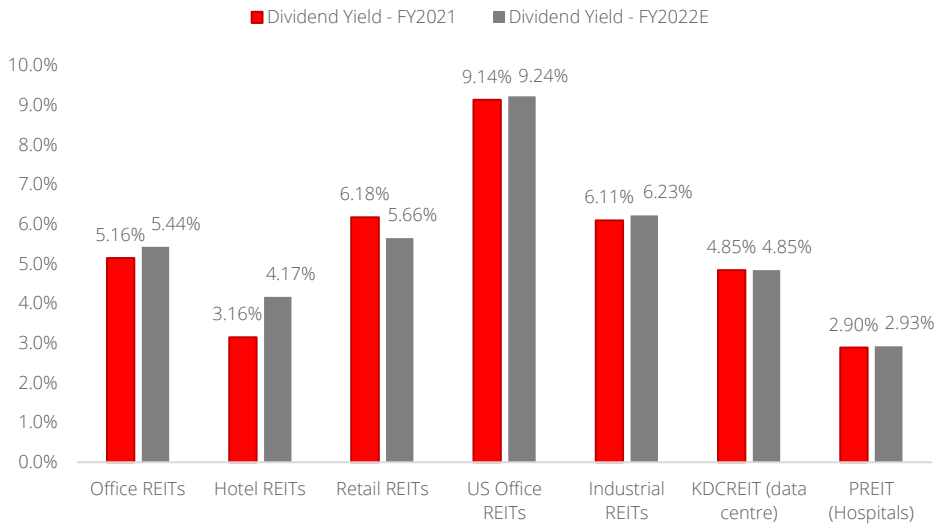
S-REITS: Withstanding the test of time

Key points

- Along with the post-pandemic reopening of economies, S-REITs serve as a good inflation hedge while remaining fertile hunting ground for dividend yields
- While S-REITs are not spared by the rising interest rate environment, risks to DPU are mitigated by healthy gearing levels, high proportion in fixed rate debts, and staggered debt maturities over the next two years
- Opportunities include reopening plays which benefit from strong pent-up demand to travel, and quality names for long-term resilience
- The sector remains an essential component in the income part of our barbell portfolio construct

The hunt for yield in an inflationary environment. Despite the wall of worries surrounding new Covid variants, Fed tapering, and a sticky inflationary backdrop, there is also a sense of optimism as the world reopens to live in a new normal with more effective treatments and vaccines. Along with the post-pandemic reopening of economies, the Singapore Real Estate Investment Trusts (S-REITs) are well positioned for steady growth, and remain fertile hunting ground for recurring income and dividend yields (5-6%).

Figure 1: S-REITs distribution yield by sub-sector



Source: Bloomberg, DBS

The outlook for the S-REITs sector remains robust, led by tight supply across subsectors and improving demand momentum. Take the Central Business District's (CBD) Grade A office segment for instance, the current rental rates of SGD9.60 psf is above the 10-year average of SGD9.20 psf and according to property consultancy firm JLL, rental growth of 25-30% is expected between now and 2025.

Singapore continues to be the preferred location for companies looking to set up regional headquarters and such a trend will underpin rental momentum across the retail and commercial segments within S-REITs. Strong demand, particularly from Tech giants amid tight supply, continues to support positive rental reversions. For instance, the upcoming Central Boulevard is turning into a CBD tech hub with Amazon potentially its first anchor tenant. Other tech giants like Meta and ByteDance are also potentially exploring options at Central Boulevard.

Furthermore, pent up demand to travel is recovering fast as economies reopen, as evident in the broad-based recovery in revenue available per room (RevPar) for hotel REITs and improving occupancy rates and traffic footfalls across retail REITs in 1Q22.

GLOBAL CROSS ASSETS

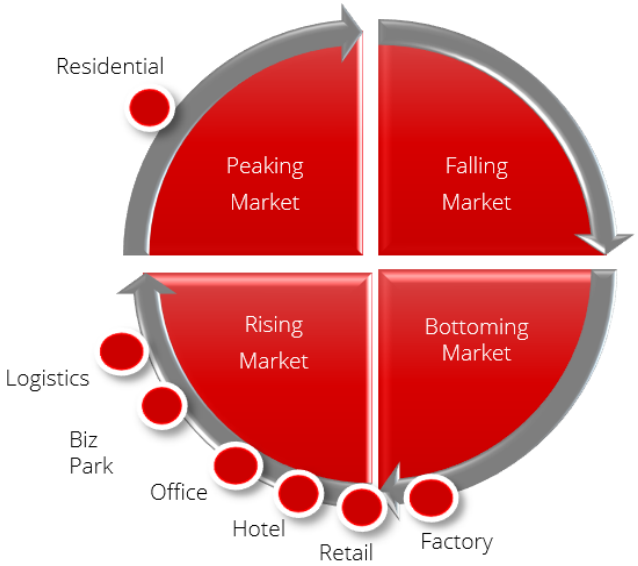
Returns of cross assets around the world

Index	Close	Overnight	YTD
DJIA	32,990.12	-0.7%	-9.2%
S&P 500	4,132.15	-0.6%	-13.3%
NASDAQ	12,081.39	-0.4%	-22.8%
Stoxx Europe 600	443.35	-0.7%	-9.1%
DAX	14,388.35	-1.3%	-9.4%
CAC 40	6,468.80	-1.4%	-9.6%
FTSE 100	7,607.66	0.1%	3.0%
MSCI AxJ	687.91	1.3%	-12.8%
Nikkei 225	27,279.80	-0.3%	-5.3%
SHCOMP	3,186.43	1.2%	-12.5%
Hang Seng	21,415.20	1.4%	-8.5%
MSCI EM	1,077.67	1.2%	-12.5%
UST 10-yr yield*	2.84	10.6	133.4
JGB 10-yr yield*	0.24	0.4	17.0
Bund 10-yr yield*	1.12	6.7	130.2
US HY spread*	4.06	-6.0	123.0
EM spread*	383.07	-7.2	52.8
WTI (USD)	114.67	-0.3%	52.5%
LMEX	4,537.00	-1.5%	0.8%
Gold (USD)	1,837.35	-1.0%	0.4%

Source: Bloomberg
* Changes in basis points

DBS

Figure 2: Singapore Property Clock (2022)



Source: DBS

Table 1: Singapore property market to strengthen as the impact of the pandemic wears off

Sector	2021 Outlook	2022 Outlook	DBS Research View	Potential risk factors:	Potential upside surprises
Office	**Px:** +1% **Rents*:** -5% (+3% YTD)	**Px:** +2%-3% **Rents*:** +8% to +10%	• Strong demand returning with tech and MNCs relocation, banks expanding again. • Delay in supply completions to support downside risks.	• A slower than expected pick-up in GDP. • Transitional office space could alleviate near term supply outlook.	• Potential conversion of older office buildings in CBD
Retail Malls	**Px:** -1% to -2% **Rents*:** -5% (Orchard); 0% (suburban)	**Px:** +1% **Rents*:** +2-5% (Orchard); +2%-3% (suburban)	• Expect tenant sales to rebound faster in Orchard ahead of suburban (stable). • Malls with dominant presence to outperform overall market.	• Utilities & labour shortage impact to landlord and tenants. • Selective assistance could be disbursed to impacted trades.	• New supply is constricted generally in 2022-2023, to provide stability to a soft demand market
Industrial	**Px:** -2% to +2% **Rents*: (1H+1%)** -3% (all) +2% (BP) +2% (WH)	**Px:** 0% to +2% **Rents*:** 1% (all) +0%-2% (BP) +2%-3% (WH)	• Industrial market is in an excess supply situation, especially in the multi-user factor segment. • Overall occupancy stable; rental rates to rise by 0% to 3%. • Business Parks & Warehouse to outperform.	• Widespread closures especially the factories (SMEs) after the government support tapers. • Demand drop off if economic growth tapers.	• Business Parks and modern logistics properties which support new-economy firms and sectors. • Conversion of older industrial properties to high specs.
Hotels	**Px:** -3% to +5% RevPAR: +20%	**Px:** +2% RevPAR: +30%	• RevPAR growth of 30%-45% in 2022. • Re-opening of Singapore borders to more countries.	• Emergence of a global subsequent waves of infections.	• Restart of MICE events earlier than expected. • Pent-up travel demand (leisure).

Rents Outlook: Refer to spot rents and sources that we track are CBRE CBD rents (office); CBRE rents (retail); JTC rental indices

Source: DBS

An inflation hedge. S-REITs serve as a good inflation hedge given that rental and property values tend to rise in tandem with rising inflation. Importantly, the ability of S-REITs in paying dividends is less impacted by rising interest rates due to their reasonable levels of gearing (averaging around 38%) and high proportion in fixed rate borrowings (c.75%).

On utility cost guidance from the S-REITs sector, utility costs typically comprise only between 1-3% of revenue, except for hospitality, where it ranges between 3-5%. Industrial and office sector utility costs are largely borne by the tenants. While hospitality may bear the brunt of the high costs, these could be passed on via room rates, given the strong demand and that these rates see ongoing adjustments. Retail landlords may have to bear higher utility costs as the pass-through mechanism may have some timing issues. Nevertheless, some of these costs could be offset with the return of atrium sales and parking income.

In the near term, as energy prices have spiked since the Russian-Ukraine war started, most S-REITs have relooked at their utility contracts to ensure the rates are substantially locked in to minimise the utility cost impact in FY22.

Interest rates sensitivity: According to DBS Group Research, based on management guidance and sensitivity analysis, a 25 bps increase in interest rates is estimated to have a 0.4-2.3% impact on FY22F distribution per unit (DPU).

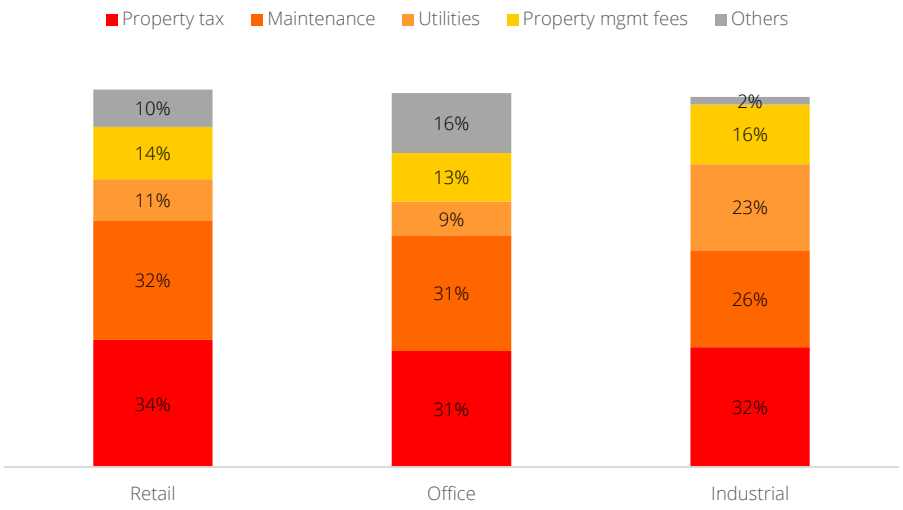
Figure 3: S-REITs correlation vs inflation

	Correlation vs Inflation	
Subsectors	10-yr	5-yr
Industrial	-0.57	0.05
Retail	-0.39	0.27
Office	0.04	0.46
Logistics	-0.45	0.02
Hospitality	-0.16	0.36
S-REIT Index	-0.55	0.32
STI	-0.04	0.58
Developers	0.50	0.54

Source: DBS

Reopening S-REITs – Paid to Wait. The reopening of international borders and travel is poised to accelerate surely but unevenly. Globally, high and improving vaccination rates have enabled this shift by substantially reducing the risks of severity and fatality. Hospitality and retail S-REITs are well placed to be reopening beneficiaries that are trading at compelling valuations, with both subsectors trading at below 1x Price-to-book (P/B) multiples, below the historical mean since 2010. Moreover, at around 0.9x P/NAV, hospitality S-REITs are trading at SGD700,000-800,000 per key, compared to recent transactions for Singapore hotels located in the CBD at a valuation of SGD1.8m per key (or per room).

Figure 4: Cost component of REITs

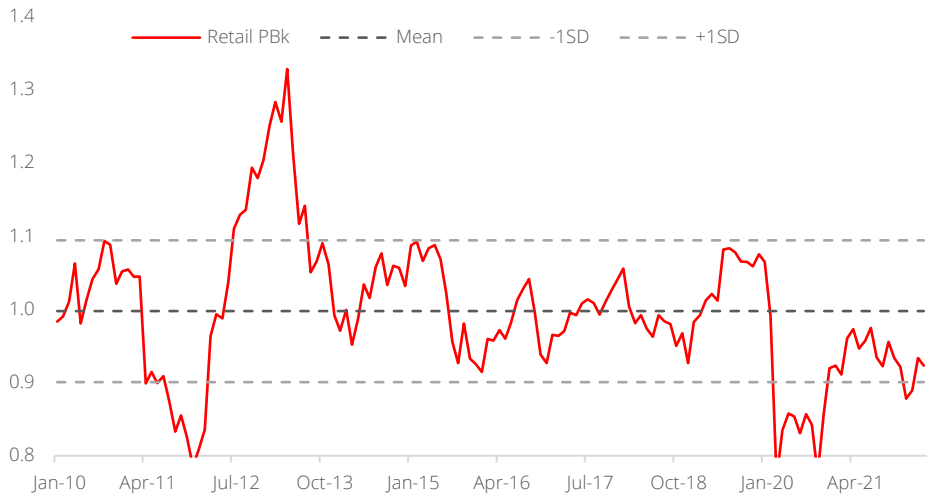


Source: DBS

In addition, operating trends are improving with Retail REITs continue to record improving footfalls and higher occupancy rates, while hotel REITs continue to record broad-based improvement in RevPAR (Revenue Per Available Room) across the regions. We saw green shoots in 1Q22 with RevPARs rising by 1-34% despite a slight setback from an increase in Omicron infections in many countries. The longer-term recovery trajectory for RevPARs remains strong with the return of leisure travel and strong pent up demand.

Hospitality S-REITs' key markets like (i) Singapore (c.40% of asset value) have substantially opened its borders with a robust line-up of MICE events in 2H22, while staycations are still key, (ii) Europe (c.15%) and Australia (14%) will likely shrug off the Omicron impact as international travel return. In Asia, we await the re-opening of Japan (c.13%) to tourists, and China, which are the next catalysts to drive a further hike in RevPARs.

Figure 5: Retail REITs valuation trend (price-to-book)



Source: Bloomberg, DBS

Stick to Quality REITs. For long-term investors who are looking for stable passive investment income streams, our preference is to stick with quality S-REITs with a track record of sustaining recurring dividend growth and resilient income streams. When it comes to stock selection, we use our proprietary ABCD rank-based scorecard to position in the top quality S-REITs. Our quality selection of "ABCD" REITs takes into account REITs with strong Asset Quality, Business Mix, Competitive Edge, Debt Resilience. We believe a combination of these quality metrics will drive resilience to earnings and DPU, enabling S-REITs to emerge from market downturns stronger due to scale, strategic assets, and strong financials.

Key Risks:

Key risk on the S-REITs remains a prolonged and persistent spike in interest rates. We believe this will be largely mitigated by:

- Healthy gearing at around 38% vs the regulatory gearing limit of 50%
- High proportion in fixed rate debt (c.75% of interest cost)
- Low refinancing risks over the next two to three years, with staggered debt maturities of <11% of overall debt expiring in 2022 and <17% of debt expiring in 2023

Table 2: "ABCD" quality S-REITs metrics

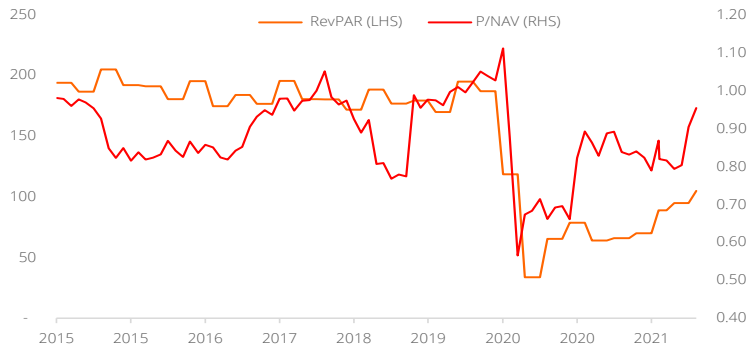
"ABCD" S-REITs for Quality Yields and Earnings Resilience			
Asset Quality	Business Mix	Competitive Edge	Debt Resilience
• Freehold asset • Long WALE • Consistently high occupancy rate	• Sector preference; suburban retail, data centres, business parks, high-specs industrial • High domestic exposure • High tech exposure	• Strong sponsor • Low gearing and large headroom to grow • High proportion of debt hedged in fixed rates • Low management fees (% of AUM)	• Low % of debt maturing in next three years • Long term to maturity (years) • Low cost of debt

Source: DBS

Figure 6: Hospitality REITs valuation trend (price-to-book)

Source: Bloomberg, DBS

Figure 7: Improving RevPAR trends



Source: Bloomberg, DBS

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