China / Hong Kong Company Update

# Fortune REIT

**Bloomberg: 778 HK Equity | Reuters: 0778.HK**

**Refer to important disclosures at the end of this report**

DBS Group Research . Equity

8 Aug 2022

## BUY

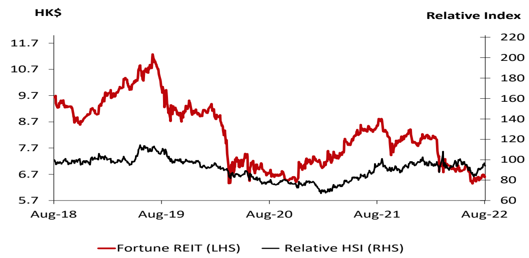
Last Traded Price (5 Aug 2022): HK$6.60 (HSI : 20,202)
Price Target 12-mth: HK$7.95 (21% upside) (Prev HK$7.90)


**Analyst**
Percy Leung +852 36684165 percyleung@dbs.com
Jeff Yau, CFA +852 36684180 jeff_yau@dbs.com


## What's New

- 1H22 distributable income fell 6.9%, in line with our estimate
- Resumed 100% distribution payout ratio
- Venturing into Singapore's retail sector
- Maintain BUY with a DDM-based TP of HK$7.95

**Price Relative**




**Forecasts and Valuation**

| FY Dec (HK$ m) | 2020A | 2021A | 2022F | 2023F |
|---|---|---|---|---|
| Gross Revenue | 1,844 | 1,806 | 1,762 | 1,839 |
| Net Property Inc | 1,376 | 1,340 | 1,286 | 1,360 |
| Net Profit | (3,193) | 1,318 | 729 | 729 |
| Distribution Inc | 922 | 883 | 885 | 889 |
| DPU (HK$) | 0.47 | 0.45 | 0.45 | 0.44 |
| DPU Gth (%) | (8) | (5) | (1) | 0 |
| Div Yield (%) | 7.1 | 6.8 | 6.7 | 6.7 |
| Gross Gearing (%) | 22 | 22 | 23 | 23 |
| Book Value (HK$) | 14.62 | 14.79 | 14.91 | 15.18 |
| P/Book Value (x) | 0.5 | 0.4 | 0.4 | 0.4 |
| | | | | |
| DPU Rev (%): | | | 5 | Nil |
| Consensus DPU (HK$): | | | 0.44 | 0.43 |
| Other Broker Recs: | | B:6 | S:2 | H:2 |

*Source of all data on this page: Company, DBS Bank (Hong Kong) Limited ("DBS HK"), Thomson Reuters*

# Foray into Singapore's retail sector

## Investment Thesis

BUY with HK$7.95 TP. Fortune REIT is trading at distribution yields of 6.7% for FY22-23. Resumption of 100% distribution payout should improve sentiment towards the counter. Ongoing retail market recovery also bodes well for Fortune REIT's reversionary growth.

Resumed 100% distribution payout ratio. On the back of an improved retail scene of late, Fortune REIT has raised its distribution payout ratio back to 100% in 1H22 from FY21's 90%. This signals a more stable outlook on the retail sector and should prompt investors to revisit such a quality retail play.

Venturing into Singapore's retail market. Fortune REIT agreed to acquire the Stars of Kovan property in Singapore, which comprises 36 retail units (GRA: 22,638sf) and one public carpark for S$88m. This fully-let retail property serves mainly the daily needs of residents living nearby. This first overseas acquisition is debt-funded with an initial net property yield estimated at 3.4%. While the acquisition does not provide any immediate material yield accretion, the strong retail market there should bode well for its reversionary growth upon lease renewal with a short WALE of 2 years. Overall, we believe this acquisition allows Fortune REIT to tap on the domestic consumption growth in Singapore fueled by the booming local economy.

**Valuation:**

Our target price is based on Discounted Dividend Model (DDM) using a discount rate of 6.8%.

**Where we differ:**

We are more positive on post-COVID recovery of domestic non-discretionary consumption which should benefit Fortune REIT.

**Key Risks to Our View:**

Domestic consumption would be seriously affected if tight social distancing measures last for a longer period, which would impact retail rental income. Faster-than-expected interest rate hikes would adversely affect its valuation.

**At A Glance**

| | |
|---|---|
| Issued Capital (m shrs) | 1,974 |
| Mkt Cap (HKm/US$m) | 13,028 / 1,660 |
| Major Shareholders (%) | |
| Focus Eagle Investments Ltd. | 20.8 |
| Ballston Profits Ltd. | 5.7 |
| Free Float (%) | 73.5 |
| 3m Avg. Daily Val. (US$m) | 1.60 |
| GICS Industry: Real Estate / Equity Real Estate Investment | |



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## WHAT'S NEW

### Resumed 100% distribution payout

Fortune REIT 1H22's distributable income was HK$457m, down 6.9% y-o-y, due to lower rental earnings and higher cash finance cost. The result was broadly in line with our estimate. With an improving retail scene, Fortune REIT resumed a 100% pay-out ratio for 1H22 (FY21: 90%, 1H21: 100%). Interim DPU fell by a larger 7.7% to HK$0.2305.

Total revenue dropped 4.1% to HK$868m. Base rent was 4.5% lower at HK$692m, mainly dragged by rental concessions granted to tenants, negative reversionary growth and lower average occupancy. Despite a 3.4% fall in hourly carpark income due to 12.5% footfall decline, total carpark income was flat at HK$55m in 1H22, aided by resilient monthly car park income.

In view of the fifth wave of the pandemic, Fortune REIT has granted a new round of rental concessions on a case-by-case basis, with priority given to those who were impacted by mandatory closures and dinner restrictions. Compared to 2020, the amount granted this time was much lower.

Rental decline upon renewals further narrowed to c.5% in 1H22 from 2021's 6-8% on the back of an improved retail scene. Tenant retention rate in the period was high at 81%.

With gradual commencement of new committed leases for stage 1 AEI at +WOO Ph2, occupancy at +WOO picked up to 88.6% in Jun-22, from Dec-21's 86.7%. In Jul-22, Fortune REIT has completed the stage 1 AEI at +WOO Ph2. The entire AEI at +WOO Ph2 is slated for completion by the end of 2023 with a budgeted capex of HK$300m.

Meanwhile, reflecting the departure of elderly homes and education tenants, occupancy rates at Jubilee Square and Belvedere Square softened to 95.3% and 91% respectively from Dec-21's 98.3% and 97.9%. Centre de Laguna, which was virtually fully let as of Dec-21, also saw its occupancy moderating to 92% in Jun-22 while that of Metro Town improved to 99% in Jun-22 from Dec-21's 95.3%. Overall, the portfolio was 93.9% let as of Jun-22 (Dec-21: 94.3%).

The gradual easing of social distancing measures since Apr-22 has encouraged the swift return of consumers. Along with distribution of electronic consumption vouchers, mall traffic and hourly carpark income at Fortune REIT's portfolio rebounded 20.3% and 46.9% m-o-m respectively in Apr-22. Recovery momentum was sustained in May-22 and Jun-22.

Property operating expenses increased 2.1% to HK$214m. Savings in utility expenses was partly offset by increase in building management expenses, allowance for credit losses, and advertising and promotion expenses. This, coupled with lower rental receipts, brought the cost-to-income ratio higher at 24.7% (1H21: 23.2%). Hence, net property income fell by a larger 5.9% to HK$634m.

Cash finance cost was 8.5% higher at HK$95m, mainly due to higher average debt level during the period. Effective borrowing cost was flat at 2.2% (1H21: 2.2%).

In Aug-22, Fortune REIT entered into a sale and purchase agreement with its major shareholder, Cheung Kong Asset Holdings (CKAH), to acquire the Stars of Kovan property in Singapore. Total consideration amounted to S$88m (HK$501m), representing a 7.4% discount from the appraised property value of S$95m as of Jun-22. This not only marks its maiden venture outside Hong Kong but also the first acquisition since it purchased Laguna Plaza in 2015. The acquisition is expected to be completed in Oct-22.

Completed in 2019, the property comprises 36 retail units with a GRA of 22,638sf and a public carpark in Stars of Kovan, a mixed-use development built by CKAH. The property is located within the residential neighbourhood in the Hougang area with close proximity to the Kovan Station on the MRT North-East Line. This makes it well positioned to capture the daily needs of residents nearby. As of Jun-22, the property was 100% let with >90% of its rental income derived from non-discretionary trades including F&B, medical, education and beauty. Over 47% of its leases, in terms of net rental income, is up for renewal by the end of 2023 with another 19% in 2024. Most of the current leases are under the first leasing cycle and were signed during the trough of market in 2019-21. Hence, on the back of strong retail market, favourable rental growth is expected upon renewal. Fortune REIT could also further improve the income from this asset through optimizing the trade and tenant mix.

Initial net property yield is estimated at 3.4%. The acquisition is not expected to offer any significant yield accretion immediately. However, we believe it allows Fortune REIT to tap on the domestic consumption growth in Singapore fueled by the booming local economy. The consideration will be fully debt funded. Fortune REIT will raise a new ESG loan of S$93m to fund the acquisition.

Following the completion of the acquisition of the Singapore retail asset, its gearing is expected to rise to 23.4% from Jun-22's 22.4%. There is still plenty of room for Fortune REIT to conduct more yield-accretive acquisitions. The Singapore asset will account for 1.4% of its portfolio valuation with the remaining in Hong Kong.

Over 40% of its total debt is linked to sustainability features. About 70% of its interest cost has been hedged to fixed rate as of Jun-22. This should help mitigate finance cost risk amid interest rate hikes. In addition, the REIT has no refinancing requirements until Oct-23.

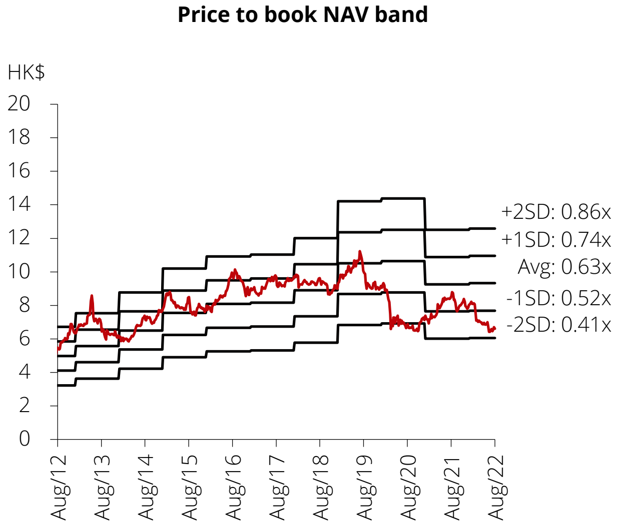
We have revised up our FY22 DPU forecast by 5% as we raised the assumed payout ratio to 100% from 95% previously.

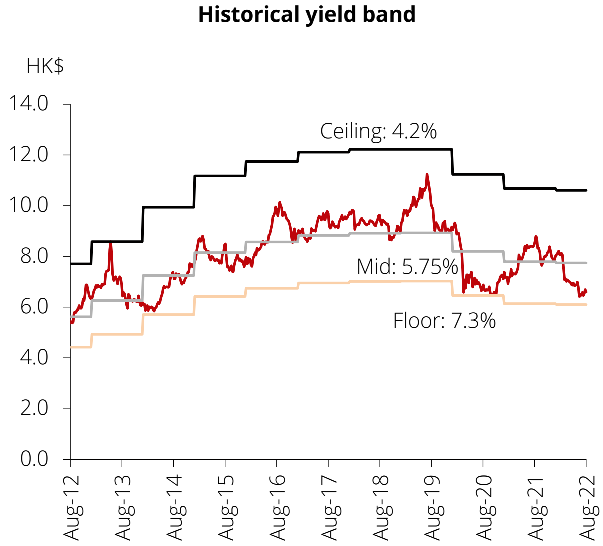
Fortune REIT offers distribution yields of 6.7% for FY22-23. Resumption of 100% payout ratio should indicate a more stable outlook towards the REIT and prompt investors to revisit such a quality play. Meanwhile, the Hong Kong economy is exhibiting signs of recovery with a revival of business activities and falling unemployment rate. This, coupled with the distribution of consumption vouchers, should continue to underpin domestic consumption recovery, and bodes well for Fortune REIT's reversionary growth. The acquisition of the community mall in Singapore should allow Fortune REIT to participate in the retail sector's growth there. Maintain BUY with DDM-based TP of HK$7.95.

## Company Background

Fortune REIT owns 16 suburban malls in Hong Kong with a gross rental area of c.3m sf. The malls are mostly located near densely populated residential areas which ensure a certain level of foot traffic.

## Price to book NAV band and historical yield band




*Source: Bloomberg Finance L.P. DBS HK*

## Result Summary

| FY Dec (HK$m) | 1H21 | 1H22 | *% Chg* | Comments |
|---|---|---|---|---|
| Total revenue | 904.4 | 867.5 | *(4)* | 1H22: dragged by negative rental reversion, rental concession and lower average occupancy |
| Property operating expenses | (209.5) | (213.9) | *2* | 1H22: higher building management expenses, allowance for credit losses and maketing expenses were partially offset by savings in utility expenses |
| Manager's performance fee | (20.8) | (19.6) | *(6)* | |
| Net property income | 674.1 | 634.0 | *(6)* | 1H22: Cost-to-income ratio rose to 24.7% from 1H21's 23.2% |
| Manager's base fee | (58.0) | (58.5) | *1* | |
| Interest income | 0.03 | 0.02 | *(52)* | |
| Trust expense | (7.8) | (2.6) | *(67)* | |
| Change in fair value of investment properties | (257.9) | (382.6) | *48* | 1H22: due to lower rental projection amid a softer retail environment, average cap rate remained unchanged |
| Net property income before finance costs | 350.4 | 190.3 | *(46)* | |
| Borrowing costs | (43.0) | 294.3 | *n.a.* | 1H22: Cash finance cost was 8.5% higher at HK$95m mainly due to higher average debt level |
| Profit before tax | 307.4 | 484.6 | *58* | |
| Tax | (102.9) | (95.5) | *(7)* | |
| Net profit | 204.5 | 389.0 | *90* | |
| Distributable income | 490.8 | 456.9 | *(7)* | |
| Distribution income | 490.8 | 456.9 | *(7)* | 1H22: 100% Payout ratio (1H21: 100%) |
| Interim DPU (HK$) | 0.2496 | 0.2305 | *(8)* | |

*Source: Fortune REIT*

**Key Assumptions (%)**

| | 2022F | 2023F |
|---|---|---|
| Retail Rental (Shopping Center) - HK | 0 | 5 |

*Source: Company, DBS HK*

**Segmental Breakdown (HK$ m)**

| FY Dec | 2019A | 2020A | 2021A | 2022F | 2023F |
|---|---|---|---|---|---|
| Revenues (HK$ m) | | | | | |
| Base rent & other income | 1,713 | 1,600 | 1,567 | 1,527 | 1,596 |
| Charge-out collections | 247 | 244 | 239 | 236 | 243 |
| Total | 1,960 | 1,844 | 1,806 | 1,762 | 1,839 |

*Source: Company, DBS HK*

**Income Statement (HK$ m)**

| FY Dec | 2019A | 2020A | 2021A | 2022F | 2023F |
|---|---|---|---|---|---|
| Gross revenue | 1,960 | 1,844 | 1,806 | 1,762 | 1,839 |
| Property expenses | (479) | (468) | (466) | (476) | (479) |
| Net Property Income | 1,481 | 1,376 | 1,340 | 1,286 | 1,360 |
| Other expenses | (151) | (137) | (131) | (134) | (141) |
| Interest (Exp)/Inc | (265) | (246) | (193) | (230) | (295) |
| Exceptionals | 631 | (3,981) | 505 | 0 | 0 |
| Pre-Tax Profit | 1,696 | (2,987) | 1,521 | 922 | 924 |
| Tax | (219) | (206) | (204) | (193) | (195) |
| Net Profit | 1,477 | (3,193) | 1,318 | 729 | 729 |
| Distribution income | 994 | 922 | 883 | 885 | 889 |
| | | | | | |
| Revenue Gth (%) | 1 | (6) | (2) | (2) | 4 |
| NPI Gth (%) | 1 | (7) | (3) | (4) | 6 |
| Dist. Inc Growth (%) | 1 | (7) | (4) | 0 | 1 |
| DPU Growth (%) | 0 | (8) | (5) | (1) | 0 |

*Source: Company, DBS HK*

**Balance Sheet (HK$ m)**

| FY Dec | 2019A | 2020A | 2021A | 2022F | 2023F |
|---|---|---|---|---|---|
| Fixed Assets | 42,820 | 39,075 | 39,500 | 40,749 | 41,764 |
| Other LT Assets | 8 | 0 | 21 | 21 | 21 |
| Bank Balance/Cash & Liquid | 136 | 177 | 118 | 64 | 25 |
| Debtors | 85 | 84 | 77 | 117 | 118 |
| Other Non Cash Current | 0 | 0 | 9 | 9 | 9 |
| Total Assets | 43,049 | 39,336 | 39,725 | 40,960 | 41,937 |
| ST Debt | 3,499 | 3,595 | 1,600 | 430 | 0 |
| Creditors | 1,239 | 1,199 | 1,078 | 1,112 | 1,119 |
| Other Current Liab | 193 | 35 | 0 | 0 | 0 |
| LT Debt | 4,980 | 5,165 | 7,241 | 9,089 | 9,669 |
| Deferred Tax Liabilities | 501 | 531 | 562 | 562 | 562 |
| Other LT Liabilities | 14 | 180 | 61 | 61 | 61 |
| Unitholders' funds | 32,624 | 28,632 | 29,183 | 29,707 | 30,526 |
| Total Capital | 43,049 | 39,336 | 39,725 | 40,960 | 41,937 |
| Share Capital (m) | 1,941 | 1,959 | 1,974 | 1,992 | 2,011 |
| Gross Debt | (8,479) | (8,759) | (8,841) | (9,519) | (9,669) |
| Working Capital | (4,709) | (4,568) | (2,474) | (1,352) | (967) |
| Book NAV (HK$) | 16.81 | 14.62 | 14.79 | 14.91 | 15.18 |
| Gross Gearing (%) | 20 | 22 | 22 | 23 | 23 |

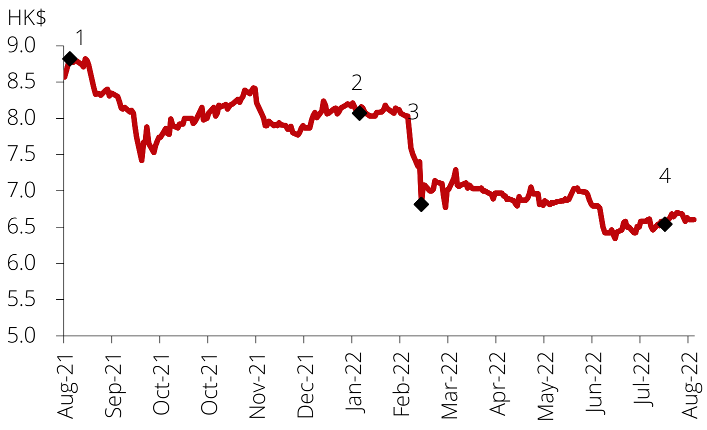
*Source: DBS HK*

**Cash Flow Statement (HK$ m)**

| FY Dec | 2019A | 2020A | 2021A | 2022F | 2023F |
|---|---|---|---|---|---|
| Pre-Tax Income | 1,696 | (2,987) | 1,521 | 922 | 924 |
| Tax Paid | (13) | (340) | (209) | (193) | (195) |
| Chg in Wkg.Cap. | (59) | (47) | (27) | (9) | 5 |
| Other Non-Cash | (238) | 4,355 | (194) | 353 | 421 |
| Operational CF | 1,385 | 980 | 1,091 | 1,073 | 1,155 |
| Net Capex | (157) | (55) | (67) | (150) | (150) |
| Net change in asso/jv | 0 | 0 | 0 | (528) | 0 |
| Other Investment CF | 2 | 0 | 0 | 0 | 0 |
| Investment CF | (156) | (55) | (67) | (678) | (150) |
| Net Chg in Debt | (399) | 260 | 62 | 678 | 150 |
| Distribution Paid | (987) | (929) | (972) | (897) | (899) |
| Other Financing CF | (249) | (215) | (173) | (230) | (295) |
| Financing CF | (1,636) | (884) | (1,083) | (449) | (1,044) |
| Chg in Cash | (406) | 41 | (59) | (54) | (39) |

*Source: Company, DBS HK*

## Target Price & Ratings History




| S.No. | Date | Closing Price | 12-mth Target Price | Rating |
|---|---|---|---|---|
| 1: | 9-Aug-21 | HK$8.57 | HK$9.32 | Buy |
| 2: | 25-Jan-22 | HK$8.06 | HK$9.34 | Buy |
| 3: | 2-Mar-22 | HK$7.40 | HK$8.88 | Buy |
| 4: | 22-Jul-22 | HK$6.55 | HK$7.90 | Buy |

*Source: DBS HK*

*Analyst: Percy Leung*
*Jeff Yau, CFA*

| |
|---|
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**Share price appreciation + dividends*

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DBS Bank (Hong Kong) Limited

13th Floor One Island East, 18 Westlands Road, Quarry Bay, Hong Kong

Tel: (852) 3668-4181, Fax: (852) 2521-1812

DBS Regional Research Offices

HONG KONG
DBS Bank (Hong Kong) Ltd
Contact: Dennis Lam
13th Floor One Island East,
18 Westlands Road, Quarry Bay, Hong Kong
Tel: 852 3668 4181
Fax: 852 2521 1812
e-mail: dbsvhk@dbs.com

SINGAPORE
DBS Bank Ltd
Contact: Paul Yong
12 Marina Boulevard,
Marina Bay Financial Centre Tower 3
Singapore 018982
Tel: 65 6878 8888
e-mail: groupresearch@dbs.com
Company Regn. No. 196800306E

INDONESIA
PT DBS Vickers Sekuritas (Indonesia)
Contact: Maynard Priajaya Arif
DBS Bank Tower
Ciputra World 1, 32/F
Jl. Prof. Dr. Satrio Kav. 3-5
Jakarta 12940, Indonesia
Tel: 62 21 3003 4900
Fax: 6221 3003 4943
e-mail: indonesiaresearch@dbs.com

THAILAND
DBS Vickers Securities (Thailand) Co Ltd
Contact: Chanpen Sirithanarattanakul
989 Siam Piwat Tower Building,
9th, 14th-15th Floor
Rama 1 Road, Pathumwan,
Bangkok Thailand 10330
Tel. 66 2 857 7831
Fax: 66 2 658 1269
e-mail: research@th.dbs.com
Company Regn. No 0105539127012
Securities and Exchange Commission, Thailand