Regional Industry Focus

Regional Real Estate

DBS Group Research . Equity 10 Aug 2022

May the best man win Mercatus

- Bids are in for Mercatus retail portfolio; key retail-focused landlords in Singapore and Hong Kong are reportedly interested
- Positive implications for CICT; tapping sponsor for capital a likely strategy
- Link REIT has financial muscle to be competitive, with enough debt-funded headroom for this deal
- We believe that other potential contenders (FCT, LREIT-led consortiums) could be conservative in their bids given the significant equity commitment

Bids are in! Since our last report (Singapore Retail REITs - prized portfolio up for grabs), we understand that interested buyers including CICT, Link REIT, and FCT have taken a close look at this portfolio and bids have been received. Given the rare opportunity to gain (or deepen) one's foothold in Singapore's suburban retail landscape, we believe that a transaction (if materialised) will likely be at a tight cap rate. We look at the potential impact on the parties that are reportedly interested in this portfolio:

CICT (BUY, TP S$2.70): Will it try on its own? A portfolio in its "own backyard", we see it as a good fit with CICT's portfolio and believe that they can be competitive and have the financial muscle to undertake this deal. That said, the REIT may need to raise close to S$1.2bn in equity (8% of market cap), which may be a tough endeavour in our view, given the current market conditions. That said, we believe that the likely strategy is to tap into its sponsor/third-party capital to reduce its own capital commitment in pursuing this deal. On its own, CICT can deliver an accretion of up to 0.3% but could see gearing heading towards 45%.

Link REIT (BUY, TP HK$81.80): First foray in Singapore. If Link REIT turns out on top, we believe that investors will reward Link REIT with higher valuations, given its pivot back to retail (c.71% from 68% of assets), while improving the overall resilience of its earnings profile. A fully debt-funded deal will bring gearing to c.32%, with accretion ranging between 2.1%-2.8% of FY3/24F DPUs, based on our estimates. That said, we believe that Link will likely look to tap into third-party capital (or vendor) to keep its gearing <30% in the medium term in order to maintain its credit rating.

Other potentially interested parties (FCT/LREIT, amongst others). While we believe that the portfolio fits FCT "like a glove" in terms of suburban exposure and will enable it to further entrench itself in the suburban retail space. That said, the size of the deal, at c. S$4.0bn implies significant equity fund raising requirements that may mean relying on their sponsor for more capital. Meanwhile, though this deal is a strategic move, LREIT management recently took themselves out of the running for this portfolio.

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STOCKS

	Price LCY	Mkt Cap US$m	12-mth Target LCY	Performance (%) 3 mth	Performance (%) 12 mth	Rating
CapitaLand Integrated Commercial Trust	2.10	10,097	2.70	(5.8)	(2.3)	BUY
Link REIT	65.55	17,621	81.80	(1.3)	(11.2)	BUY
Frasers Centrepoint Trust	2.31	2,851	2.90	1.3	(3.4)	BUY
LendLease Global Commercial REIT	0.82	1,354	1.15	5.8	(5.2)	BUY

Source: DBS Bank, DBS HK, Bloomberg Finance L.P.
Closing price as of 8 Aug 2022

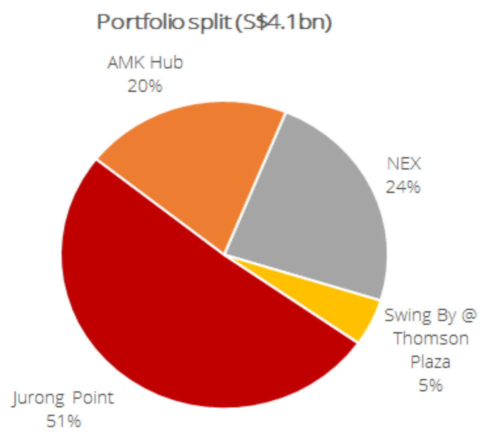
ed: BM/ sa: PY, CS

Is the Mercatus portfolio a value-accretive deal?

Who has the will and means to win? In the second instalment of our analysis of the potential transaction involving the Mercatus retail portfolio, we look at the potential impact on the parties reportedly interested in acquiring it. Since media reports in late Jun 22-early Jul 22 and our report Singapore Retail REITs - prized portfolio up for grabs, it has been reported that the likes of CapitaLand Integrated Commercial Trust ("CICT"), Link REIT ("Link"), and Frasers Centrepoint Trust ("FCT") together with its sponsor, amongst others, are the parties interested in bidding for this portfolio.

We are not surprised by the strong interest from investors (including retail mall operators in Singapore and from overseas), given the significant operational scale offered, coupled with the scarce availability of suburban assets for sale in Singapore. With these assets, a buyer can gain a strong foothold in the suburban retail landscape in Singapore.

Portfolio split



So

According to our previous report (Singapore Retail REITs - prized portfolio up for grabs), we understand that the portfolio had delivered resilient performance over the past few years. Based on the portfolio valuation of close to S$4.1bn, FY21 initial yield is estimated to be 4.3%-4.4%. However, assuming a recovery back to pre-COVID trading conditions, we estimate yields to head up towards 4.6%-4.8% in the longer term.

Our analysis of the potential bidders.
We look at both the qualitative and quantitative aspects of the impact of the Mercatus portfolio on the potentially involved parties, taking CICT, Link, FCT, and Lendlease Global Commercial REIT (LREIT) as examples. While there could be other third-party bidders (listed and non-listed), given the lack of access to financials (for some), we have focused on the companies under our coverage that we believe are the best fit.

With a potentially competitive bid and the significant size of the portfolio, we believe that the winning bidder will need to possess both financial muscle and access to capital, either from the sponsor and/or third-party capital, in order to digest this portfolio.

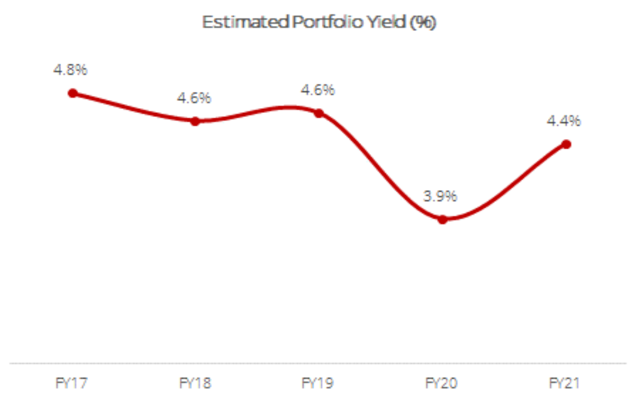
We have assumed the metrics of a S$4.1bn valuation, an initial yield of 4.5%, and 3.5% in debt-funding costs in our overall financial analysis.

Summary of asset metrics

Properties	Jurong Point (100% Stake) AMK Hub (100% stake) Swing By @ Thomson Plaza (100% stake) NEX (50% stake)
Valuation	S$4.1bn
Est. Yield (FY21)	4.3%-4.4%
Est. Stabalised yield	4.6%-4.8%

Source: Company, DBS Bank

Historical NPI yield trend



Source: Company, DBS Bank.

What does it mean for the interested parties?

The first factor we considered is whether the portfolio is an attractive fit with the various parties. Amongst the bidders, we note that most are incumbents, with only Link REIT making its entry into the Singapore suburban retail space. We believe that the income resiliency of the suburban space is attractive to the various potential parties. Amongst the four parties, we believe that CICT and FCT will see the closest fit to their existing portfolio of assets in Singapore, while LREIT will take a giant leap to be a major player in the suburban landscape, although managemetn have ruled themselves out in the running. While this portfolio will represent Link REIT's first foray into Singapore, the pivot to more retail exposure is expected to be positive overall, as Link REIT has significant scale and expertise managing such assets in Hong Kong.

Impact on portfolio and potential investor views:

Potential party	Size of current portfolio (S$ bn)	% of portfolio	Presence in Singapore retail	Potential investors' responses
CICT	24.6	17%	Yes, leading player	• Deepen exposure to Singapore retail landscape and pull ahead of peers. • Pivot to more retail, offering stability. • Size as a % of portfolio is significant.
Link REIT	40	68%	No	• Well received with a pivot back to retail subsegment, in which Link has management expertise. • New to Singapore market, but expertise can be bought.
FCT	5.9	69%	Yes, leading suburban player	• Will catch up with CapitaLand group in terms of scale. • Seamless fit in terms of exposure and tenancy type. • Size may be a stumbling block with sponsor, and capital partner needed.
LREIT	3.6	114%	Yes, emerging player	• An emerging player in the retail scene and will catch up with its peers. • Size may be a stumbling block, therefore, tapping on its sponsor and capital partners needed.

Source: Companies, DBS Bank, DBS HK.

Potential changes to asset/geography mix

Potential party/assets	Breakdown by geography (%)			Breakdown by asset class (%)		
	Geography	Before	After	Asset class	Before	After
CICT (c.S$24.6bn assets)	Singapore	92%	93%	Retail	30%	40%
	Germany	3%	3%	Office	41%	35%
	Australia	5%	4%	Integrated developments	29%	25%
	Total	100%	100%	Total	100%	100%
Link REIT (HK$228bn/c.S$40bn assets)	Hong Kong	75%	68%	Retail	68%	71%
	China	17%	16%	Office	13%	12%
	Overseas	8%	16%	Others (including carparks)	19%	17%
	Total	100%	100%	Total	100%	100%
FCT (c.S$5.9bn assets	FCT is a pure Singapore play			FCT is a pure retail play		
LREIT (c.S$3.6bn assets)	Singapore	88%	94%	Retail	75%	88%
	Italy	12%	6%	Office	25%	12%
	Total	100%	100%	Total	100%	100%

Source: Companies, DBS Bank, DBS HK.

Who has the financial capacity?

Equity fundraising needs range between 8%-200% of market cap. A deal of this size could mean that potential buyers will be likely lining up debt financing (and/or equity) in order to fund this proposed acquisition. Upon assuming that the REITs are willing to gear up to their respective maximum debt levels of 35%-45%, we found that most S-REITs will likely need to tap the market for new equity.

The amount of equity needed to be raised ranges from c.8% of market cap for CICT to c.37% and c.200% for FCT and LREIT, respectively. This implies that these S-REITs will find it tough to undertake this acquisition on their own and may look to tap into their sponsors' balance sheets and third-party capital in order to reduce their own capital outlay.

That said, while CICT has the capacity to undertake this deal on its own, we believe it is unlikely the manager will want to gear up to 45% or raise >S$1.2bn in equity in a choppy equity market. Therefore, the actual equity exposure will likely be larger, or the REIT will likely tap into its sponsor to co-invest in this portfolio, if it does come out on top.

Link REIT has significant debt capacity and stands tall amongst peers. On the other hand, Link REIT has debt headroom of >HK$35bn (c.S$6.2bn) for acquisitions before reaching a gearing level of 35%. In fact, a fully debt-funded deal for the Mercatus portfolio will bring its gearing to only c.32%, which is well below the statutory limit of 50%. That said, any hike in gearing levels of >30% may trigger a credit rating downgrade, which could lead to higher borrowing cost. Therefore, while Link REIT has significant debt-funded capacity, our analyst, Percy Leung believes that Link REIT will likely seek a capital partner in this potential acquisition and divest non-core assets in Hong Kong when the opportunity arises.

Overall, we believe that the current volatile markets could mean that it may not be the most opportune time to tap the equity markets for new capital, and that there could have an impact on accretion levels. That said, we believe that most bidders will most likely tap third-party capital or their sponsors for additional firepower in order to limit their equity fundraising needs.

Debt capacity

Potential party	Gearing level (%)	Headroom to 35%*/ 45%	EFR required / % market cap	Need to tap sponsor for capital?	What are our thoughts?
CICT	c.40.6%	S$2.8bn	S$1.2bn/8% of market cap	Likely	• A serious contender in our view, but we believe that a likely route will be acquiring the portfolio with a JV with the sponsor/third-party capital partner in order to reduce the REIT's own capital commitment on this deal. • Sponsor has significant financial muscle to co-invest.
Link REIT*	c.25%	$6.2bn	No, sufficient debt capacity	Nil	• Well positioned with significant debt-funded capacity. However, Link REIT could also explore teaming up with a third-party capital partner to reduce its overall commitment to keep gearing <30%. • Asset recycling strategy to be scaled up.
FCT	c.33%	S$2.5bn	S$1.5bn/37% of market cap	Very likely	• The significant equity needed to be raised could mean teaming up with the sponsor to co-invest or a third-party capital partner.
LREIT**	c.39%	S$2.0bn	S$2.0bn/200% of market cap	Very likely	• Unlikely candidate, given that the target portfolio will entail a significant equity fundraising outlay and that it will need to tap third-party capital and its sponsor. • Given the short lead time, it could be tough for the REIT to find partners.

** We have pegged Link's maximum capacity to 35%, given management's preference to keep gearing <35% in order to maintain their credit rating*
*** LREIT management have guided in a recent call have ruled themselves out in the running for this portfolio*
Source: Companies, DBS Bank, DBS HK.

Will the deal be accretive?

In this section, we look at the potential accretion to DPUs and NAVs in the scenarios of a (i) 100% stake and (ii) 50% stake (assuming a JV) of the Mercatus portfolio. Our analysis is as such:

Cost of funds are a hurdle for most. With the Fed hiking rates, funding costs have increased significantly since the start of 2022. Assuming three to five-year swap rates, we believe that funding costs will be at least 3.5%.

Up to 0.3% accretion for CICT. While we believe CICT has the capacity to take on this deal on its own, it will push its gearing limits to above 45%, closer to 50%, which may not be wise in a rising interest rate environment. In our estimates, to acquire a 100% stake of the Mercatus portfolio, we assume gearing is raised to 45%.

We estimate an accretion of c.0.3% for CICT, given the positive spread between our estimated asset yield (4.5%) and assumed funding costs (3.5%).

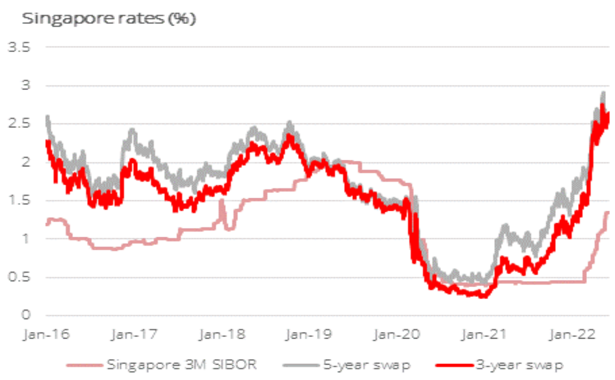
Up to 2.8% accretion for Link REIT. We estimate an accretion of c.2.8% for Link REIT, given the positive spread between our estimated asset yield (4.5%) and assumed funding costs (3.5%). Every 25bps change in asset yields (i.e., 4.25%) will cut accretion by c.0.7%.

Dilution for FCT and LREIT. We estimate that, given the significant fundraising need (as a percentage of market cap for both REITs), the REITs will have to tap their respective sponsors for a larger slice of the deal. That said, LREIT management has indicated that they did not participate in the bid for the portfolio.

Scenario parameters

Returns:	
Target Asset Size:	S$4.1bn
NPI Yield:	4.5%
Assumed Funding Cost	
SG Debt	3.5%

Cost of funds (3M SIBOR, 3-year, 5-year swap)



Source: Bloomberg Finance L.P., DBS Bank

Estimated impact to NAV and DPUs, assuming 50%-100% of target portfolio

Potential party	100% of target portfolio		50% of target portfolio		What are our thoughts?
	NAV accretion	DPU accretion	NAV accretion	DPU accretion	
CICT	0.3%	1.1%	0.1%	0.8%	Summary: • The portfolio is complementary to CICT, with an opportunity to further expand its suburban retail malls to reap further synergies and economies of scale. However, gearing may be stretched to above 40% and may cause some concerns in a rising interest rate environment. Risk: • Given the stretched gearing of 45% in a rising rate environment, a partial stake would be more suited for CICT's balance sheet, with estimated gearing at 43%.
Link REIT*	n.a.	c.2.8%	n.a.	n.a.	Summary: • We believe that Link is able to take on this deal on its own, although chances of tapping a capital partner are likely, so its credit rating can be maintained at <30%.
FCT	-3%	-7%	-2%	-5%	Summary: • The significant equity fundraising exposure could mean that FCT will have to rely on its sponsor to contribute a larger proportion of the deal. • We estimate that FCT's NAV and DPU maybe diluted by between -2% to -3% (NAV) and -5% to -7% (DPU), but the REIT has to gear up towards 45%.
LREIT	-4%	-18	-3%	-8%	Summary: • The significant equity fundraising exposure could mean that LREIT is unlikely to be bidding on its own and would rely on its sponsor to contribute a larger proportion of the deal. • We estimate that LREIT's NAV and DPU may be diluted by between -3% to -4% (NAV) and -8% to -19% (DPU) but gearing would be >45%.

Source: Companies, DBS Bank, DBS HK.

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**Share price appreciation + dividends*

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