Singapore Company Update

Keppel DC REIT

Bloomberg: KDCREIT SP | Reuters: KEPE.SI

Refer to important disclosures at the end of this report

DBS Group Research . Equity

29 Jan 2024

BUY

Last Traded Price (26 Jan 2024): S$1.76 (**STI :** 3,159.53)
Price Target 12-mth: S$2.20 (25% upside) (Prev S$2.45)

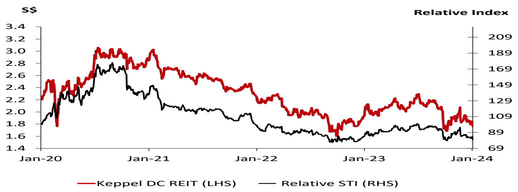
Analysts

Dale LAI +65 66823715 dalelai@dbs.com
Derek TAN +65 6682 3716 derektan@dbs.com

What's New

- FY23 DPU of 9.383 Scts missed our projections by c.6%, entirely due to the rental default at Guangdong DCs
- KDCREIT is prioritising a collaborative but firm approach in its discussions with the tenant rather than litigation
- Revised estimates assume absence of income from Guangdong DCs in FY24; c.15% downward revision in DPU
- Maintain BUY but lowered TP to S$2.20

Price Relative



Forecasts and Valuation

FY Dec (S$m)	2022A	2023A	2024F	2025F
Gross Revenue	277	281	295	318
Net Property Inc	253	245	251	271
Total Return	231	119	153	170
Distribution Inc	185	168	159	173
EPU (S cts)	9.47	8.52	8.91	9.89
EPU Gth (%)	(2)	(10)	5	11
DPU (S cts)	10.2	9.38	8.70	9.50
DPU Gth (%)	4	(8)	(7)	9
NAV per shr (S cts)	140	134	135	135
PE (X)	18.6	20.7	19.7	17.8
Distribution Yield (%)	5.8	5.3	4.9	5.4
P/NAV (x)	1.3	1.3	1.3	1.3
Aggregate Leverage (%)	35.9	37.0	36.9	36.9
ROAE (%)	6.9	6.2	6.6	7.3
Distn. Inc Chng (%):			(16)	(13)
Consensus DPU (S cts):			10.8	11.5
Other Broker Recs:		B: 7	S: 1	H: 6

Source of all data on this page: Company, DBS Bank Ltd, Bloomberg Finance L.P.

Collaboration instead of litigation

Investment Thesis:

Keppel DC REIT has a portfolio of quality DCs in major markets. KDCREIT's portfolio of data centres (DCs) in APAC and Europe continue to benefit from the structural tailwinds of the sector. Its reputation and capability to manage DC assets is reflected in its consistently high occupancy rates. In addition, KDCREIT benefits from the support of its sponsor, which provides it with pipeline assets and DC development capabilities to further grow its portfolio.

Accretive acquisitions and AEIs to drive organic growth. Accretive acquisitions over the past year will drive earnings, and recently completed AEIs will generate organic growth. For FY23, the full-year contribution from acquisitions will support earnings growth, and the protracted completion of Guangdong DC 3 will lead to a higher income contribution from the asset.

Resumption of accretive acquisitions will be the main catalyst. Although KDCREIT continued its acquisitions over the past year, the rate at which it does this has slowed down notably due to stubbornly low cap rates and rising financing costs. As such, we have not priced any acquisition assumptions into our estimates. But with interest rate hikes seeming to have slowed and potentially stabilising, KDCREIT could resume accretive acquisitions in the near future.

BUY recommendation with a lower TP of S$2.20 (vs. S$2.45 previously). Despite the lower TP after the revision of our earnings estimates, we will be maintaining our BUY recommendation. Our revised TP assumes forward target yields of c.4.0%-4.5% (in line with the historical average). Further catalysts to our projections will come from accretive acquisitions as well as an earlier-than-anticipated resolution to the ongoing rental defaults for the Guangdong DCs.

Key Risks

Absence of income from the Guangdong DCs that stretches beyond 12 months will lead to a further downside to our projections.

At A Glance

Issued Capital (m shrs)	1,720
Mkt. Cap (Sm/USm)	3,027 / 2,257
Major Shareholders (%)	
Keppel Corp Ltd	20.4
BlackRock Inc	7.5
Free Float (%)	72.1
3m Avg. Daily Val (US$m)	10.3

GIC Industry : Real Estate / Equity Real Estate Investment (REITs)

WHAT'S NEW

Collaboration instead of litigation

Revenues remained stable while NPI hit by provisions for uncollected rents. FY23 revenues amounted to S$281.2m, reflecting a 1.4% increase y-o-y. This growth can be primarily attributed to acquisitions completed in the preceding year, coupled with positive rental reversions and escalations. However, this upward trajectory in revenues was partially offset by reduced contributions from certain Singapore colocation assets. The decrease was attributed to escalated facility expenses, particularly higher utility costs.

Conversely, NPI declined 3.0%, totaling S$245.0m. This dip in NPI was primarily a consequence of provisions made for uncollected rents from the Guangdong DC, amounting to more than S$10.5m in FY23. Additionally, there were further provisions, totaling S$0.7m (in other trust expenses), specifically allocated for uncollected coupon payments from Guangdong DC 3.

Portfolio occupancy rates remained stable q-o-q at 98.3%. Portfolio occupancy rates for FY23 remained steady q-o-q at 98.3%. While there was a minor dip in occupancies in some of the Singapore data centres, it was effectively offset by an improvement in occupancy at KDC Dublin 1.

Looking ahead, it's noteworthy that c.50% of leases, based on rental income, are set to expire over the next two years. Specifically, 27.5% of leases are due for renewal in FY24, with an additional 22.9% slated for renewal in FY25. Despite this upcoming lease turnover, we believe there is potential for positive rental reversions given the current upward trajectory in rents.

Gearing and borrowing costs inched up to 37.4% and 3.6% in 4Q23. In 4Q23, the gearing ratio marginally increased by 20bps q-o-q to 37.4%. Simultaneously, borrowing costs saw a modest rise of 10bps to 3.6% as a result of higher floating rates. With c.74% of loans hedged to fixed rates, we do not anticipate any further significant movements in overall costs in the medium term.

Looking ahead, while we expect borrowing costs to continue inching up as loans are refinanced, we expect the impact to be minimal, as only c.4.0% of loans will be due in FY24.

Portfolio valuations held up in most markets. In the valuation assessment at end-December 2023, certain regions experienced marginal declines, including Australia, China, Malaysia, Germany, and the UK. These declines were primarily attributed to the prevailing high interest rate environment and translation losses incurred. Despite this, the portfolio demonstrated resilience with an overall revaluation gain observed in Singapore and the Netherlands, effectively offsetting the losses incurred in the other markets. The collective revaluation gains for the entire portfolio amounted to c.S$15m, underscoring the diversified nature of KDCREIT's assets and its ability to navigate regional variations.

Despite ongoing challenges with the master leases at the Guangdong DCs, the valuation of the assets held up relatively well. This stability is attributed to the valuation being based on existing lease agreements, without accounting for current rental arrears by tenants. It's important to note that the valuation might face a substantial impact if the master leases were to be removed, reflecting the potential vulnerability of the valuation metrics to changes in lease agreements.

Positive development regarding litigation against DXC Technology. DXC's current lease with KDCREIT at Keppel DC Singapore 1 extends until March 2025, covering approximately 20,300sqft or about 18.5% of the property's NLA. Despite DXC's request to return a portion of the space in April 2021, KDCREIT has not granted approval, resulting in annual rent arrears of about S$3.7m for the contested area, and S$14.8m for the four years of the lease.

Following a recent High Court ruling in favour of KDCREIT, acknowledging their claim for outstanding rents in FY21, it was also affirmed that KDCREIT has the right to reject DXC's proposal for downsizing its space. The trial, slated to begin in February 2024, assumes crucial significance as the initial court decision strongly suggests KDCREIT's high likelihood of securing the complete rental payment from DXC. Nevertheless, KDCREIT has displayed prudence by making provisions for the unpaid rents, which thus constitutes less than 2% of DPU. Any amounts successfully claimed from DXC would serve as a positive boost to KDCREIT's overall DPU.

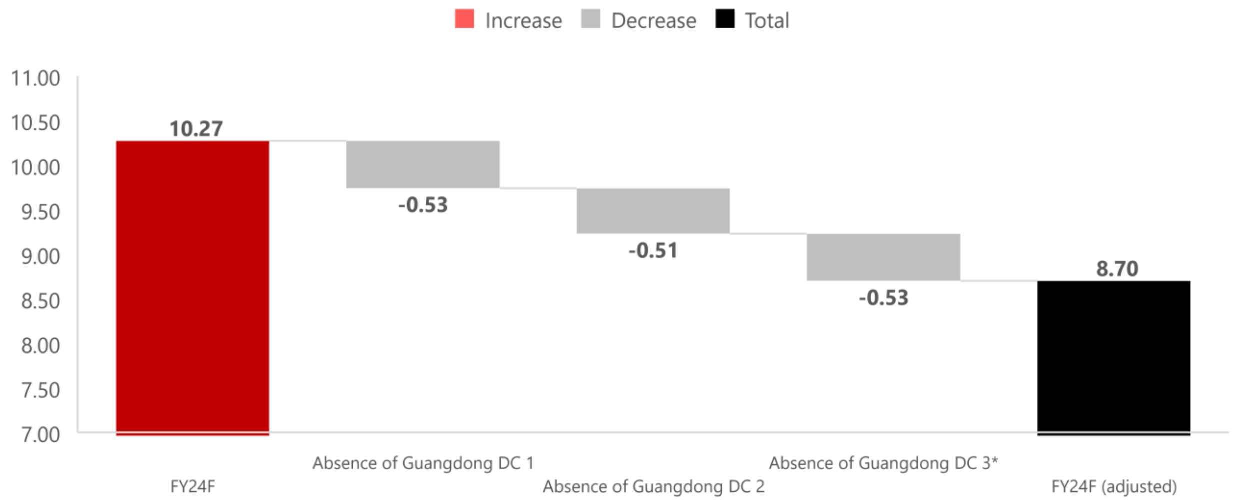
Working with Guangdong DCs' tenant on a recovery roadmap. The master tenant, Neo Telemedia, at KDCREIT's three data centres in Guangdong has been in default of rents since September 2023. In response, KDCREIT issued a letter of demand in December 2023, seeking a total of c.S$15.1m from Neo Telemedia, which includes rent arrears, late payment interest, and real estate taxes, as well as a top-up of security deposits.

Additionally, the completion of the fitting-out of Guangdong DC 3, initially slated for 2023, has faced delays. Out of the total property value of RMB760m, KDCREIT has deposited RMB100m. While KDCREIT retains the option to cancel the acquisition and seek a refund of the deposits paid, no such action has been taken thus far.

We understand that KDCREIT is currently in active discussions with the master tenant on the uncollected rents and future rental obligations. At this point, the REIT has not provided any concrete plans or timeline on the recovery of arrears, but we understand that the tenant remains very willing to collaborate and iron out plans. As highlighted previously, the absence of income from all three Guangdong DCs could have a significant 15%-16% impact on our FY24 DPU projections.

Some other alternatives that could be considered are the sale of the Guangdong DCs to third parties, or intervention by KDCREIT or their sponsor to assume leasing responsibilities for the affected data centres. However, it's crucial to note that these are just potential alternatives that KDCREIT could consider in the event the recovery roadmap negotiations with the tenant hit a roadblock.

FY24F DPU waterfall chat: Absence of income from Guangdong DCs



Source: DBS Bank estimates
** Our previous projections assume that the fit-out and acquisition of Guangdong DC 3 would have been completed by 31 December 2023 and would contribute full-year income from 1 January 2024.*

Our view

The healthy portfolio occupancy and positive rental reversions present encouraging indicators, especially considering the upcoming renewal of approximately 50% of leases in the next two years. This demonstrates the resilience of KDCREIT's portfolio amid market fluctuations. The global demand for data centres remains strong, ensuring low vacancy rates and supporting the growth in rents, which bodes well for the REIT.

Despite facing challenges on the capital management front, KDCREIT has maintained a relatively stable gearing of 37.4% and borrowing costs are at 3.6%. The expectation of a marginal increase in borrowing costs is tempered by limited refinancing due in FY24 and a significant proportion of loans already hedged to fixed rates.

In response to the ongoing situation with the Guangdong DCs, we have revised our estimates to assume no income contribution from it for the entirety of FY24. Earnings are projected to resume in FY25, with underlying utilisation starting at 50% and gradually improving in subsequent years. This adjustment has led to a slightly more than 15% reduction in our FY24 DPU estimates and cuts ranging from 8%-11% over the subsequent years.

Our TP has been lowered to S$2.20 in light of the revised earnings estimates. However, the BUY recommendation is maintained, driven by the positive outlook for the rest of KDCREIT's portfolio, which continues to benefit from the structural growth in the data centre space. Additionally, the potential for a sooner-than-anticipated resolution to the rental defaults serves as an immediate catalyst, emphasising the REIT's potential for recovery, with it having declined approximately 14% since concerns first surfaced.

Key areas to watch: i) Resolution regarding the rental defaults by Bluesea for the Guangdong DCs, ii) further downside to our projections if the absence of income from the Guangdong DCs extends beyond FY24, iii) resolution on the litigation with DXC (will help provide some buffer), and iv) any impact to its portfolio valuations and gearing if the Guangdong DCs are vacated.

Company Background

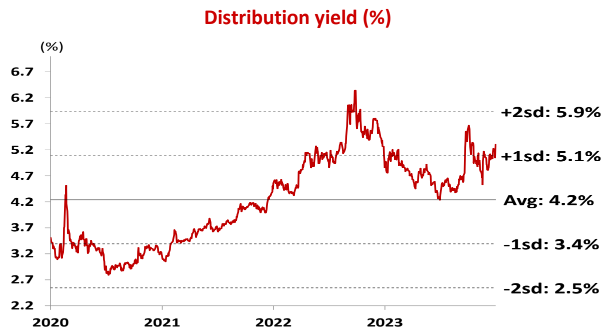
KDC REIT (KDC REIT) is a Singapore-based real estate investment trust (REIT). It was established with the principal investment strategy of investing, directly or indirectly, in a portfolio of income-producing real estate assets that are used primarily for data centre purposes, with an initial focus on Asia Pacific and Europe.

Interim Income Statement (S$m)

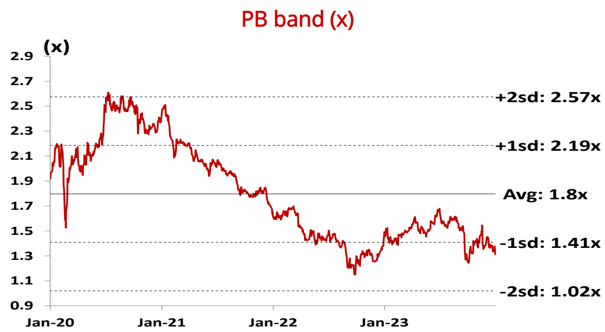
FY Dec	2H2022	1H2023	2H2023	% chg yoy	% chg hoh
Gross revenue	142	140	141	(0.7)	0.2
Property expenses	(12.5)	(13.1)	(23.1)	85.6	76.5
Net Property Income	129	127	118	(9.1)	(7.7)
Other Operating expenses	(13.6)	(18.0)	(15.4)	13.1	(14.2)
Other Non Opg (Exp)/Inc	0.0	0.0	0.0	-	-
Associates & JV Inc	(9.0)	(2.4)	(5.9)	34.5	144.6
Net Interest (Exp)/Inc	(12.8)	(17.2)	(20.4)	(59.0)	(19.0)
Exceptional Gain/(Loss)	0.0	0.0	0.0	-	-
Net Income	93.9	89.8	75.9	(19.2)	(15.5)
Tax	(21.9)	(7.8)	(7.8)	(64.5)	(0.6)
Minority Interest	(1.7)	(1.6)	2.09	nm	nm
Net Income after Tax	70.2	80.4	70.2	(0.1)	(12.7)
Total Return	139	80.4	42.3	(69.5)	(47.4)
Non-tax deductible Items	(44.8)	10.9	38.3	nm	252.2
Net Inc available for Dist.	93.7	91.3	80.6	(14.0)	(11.7)
Ratio (%)					
Net Prop Inc Margin	91.2	90.7	83.6		
Dist. Payout Ratio	100.0	100.0	100.0		

Source of all data: Company, DBS Bank Ltd

Historical PE and PB band



Source: Bloomberg Finance L.P., DBS Bank Ltd estimates



Source: Bloomberg Finance L.P., DBS Bank Ltd estimates

Income Statement (S$m)

FY Dec	2021A	2022A	2023A	2024F	2025F
Gross revenue	271	277	281	295	318
Property expenses	(22.9)	(24.8)	(36.3)	(44.5)	(46.7)
Net Property Income	248	253	245	251	271
Other Operating expenses	(31.3)	(33.5)	(32.4)	(32.8)	(33.7)
Other Non Opg (Exp)/Inc	4.40	8.63	(1.0)	0.0	0.0
Associates & JV Inc	(1.0)	(9.0)	(8.3)	0.0	0.0
Net Interest (Exp)/Inc	(20.7)	(21.8)	(37.6)	(40.5)	(40.8)
Exceptional Gain/(Loss)	0.0	0.0	0.0	0.0	0.0
Net Income	200	197	166	177	197
Tax	(29.2)	(31.0)	(15.6)	(19.8)	(21.9)
Minority Interest	(7.9)	(3.3)	(3.7)	(4.0)	(4.4)
Preference Dividend	0.0	0.0	0.0	0.0	0.0
Net Income After Tax	162	163	146	153	170
Total Return	314	231	119	153	170
Non-tax deductible Items	(142)	(46.0)	49.2	5.71	2.79
Net Inc available for Dist.	172	185	168	159	173
Growth & Ratio					
Revenue Gth (%)	2.1	2.3	1.4	4.9	7.7
N Property Inc Gth (%)	1.6	1.8	(3.0)	2.3	8.2
Net Inc Gth (%)	(3.0)	0.1	(9.9)	4.7	11.0
Dist. Payout Ratio (%)	94.7	95.0	94.5	94.1	94.5
Net Prop Inc Margins (%)	91.5	91.1	87.1	84.9	85.3
Net Income Margins (%)	59.9	58.6	52.1	52.0	53.6
Dist to revenue (%)	63.3	66.7	59.6	53.9	54.4
Managers & Trustee's fees	11.6	12.1	11.5	11.1	10.6
ROAE (%)	7.7	6.9	6.2	6.6	7.3
ROA (%)	4.6	4.1	3.6	3.8	4.2
ROCE (%)	5.3	4.8	4.8	4.9	5.3
Int. Cover (x)	10.5	10.0	5.7	5.4	5.8

Assumes zero contribution from all three Guangdong DCs in FY24.

Source: Company, DBS Bank Ltd

Interim Income Statement (S$m)

FY Dec	2H2021	1H2022	2H2022	1H2023	2H2023
Gross revenue	136	136	142	140	141
Property expenses	(11.6)	(12.3)	(12.5)	(13.1)	(23.1)
Net Property Income	124	123	129	127	118
Other Operating	(12.5)	(11.2)	(13.6)	(18.0)	(15.4)
Other Non Opg (Exp)/Inc	0.0	0.0	0.0	0.0	0.0
Associates & JV Inc	(1.0)	0.0	(9.0)	(2.4)	(5.9)
Net Interest (Exp)/Inc	(10.6)	(9.0)	(12.8)	(17.2)	(20.4)
Exceptional Gain/(Loss)	0.0	0.0	0.0	0.0	0.0
Net Income	100	103	93.9	89.8	75.9
Tax	(20.1)	(9.1)	(21.9)	(7.8)	(7.8)
Minority Interest	(6.3)	(1.5)	(1.7)	(1.6)	2.09
Net Income after Tax	73.8	92.4	70.2	80.4	70.2
Total Return	226	92.4	139	80.4	42.3
Non-tax deductible Items	(139)	(1.2)	(44.8)	10.9	38.3
Net Inc available for Dist.	87.4	91.2	93.7	91.3	80.6
Growth & Ratio					
Revenue Gth (%)	1	0	5	(1)	0
N Property Inc Gth (%)	0	(1)	5	(2)	(8)
Net Inc Gth (%)	(17)	25	(24)	15	(13)
Net Prop Inc Margin (%)	91.5	90.9	91.2	90.7	83.6
Dist. Payout Ratio (%)	100.0	100.0	100.0	100.0	100.0

Includes c.S$10.5m in allowances for uncollected rents from Guangdong DCs.

Balance Sheet (S$m)

FY Dec	2021A	2022A	2023A	2024F	2025F
Investment Properties	3,401	3,639	3,656	3,666	3,677
Other LT Assets	117	206	141	141	141
Cash & ST Invts	196	190	150	151	166
Inventory	0.0	0.0	0.0	0.0	0.0
Debtors	50.4	61.4	53.9	72.7	78.4
Other Current Assets	15.9	10.8	5.83	5.83	5.83
Total Assets	3,780	4,108	4,007	4,037	4,068
ST Debt	163	175	72.5	72.5	72.5
Creditor	50.1	62.6	70.2	64.7	69.6
Other Current Liab	7.43	6.57	5.89	19.9	22.1
LT Debt	1,136	1,300	1,408	1,417	1,427
Other LT Liabilities	87.6	106	95.7	95.7	95.7
Unit holders' funds	2,293	2,414	2,311	2,320	2,330
Minority Interests	42.4	42.8	43.0	47.0	51.4
Total Funds & Liabilities	3,780	4,108	4,007	4,037	4,068
Non-Cash Wkg. Capital	8.68	2.99	(16.4)	(6.0)	(7.5)
Net Cash/(Debt)	(1,103)	(1,285)	(1,331)	(1,338)	(1,334)
Ratio					
Current Ratio (x)	1.2	1.1	1.4	1.5	1.5
Quick Ratio (x)	1.1	1.0	1.4	1.4	1.5
Aggregate Leverage (%)	34.4	35.9	37.0	36.9	36.9

Approximately S$15m uplift in portfolio valuations.

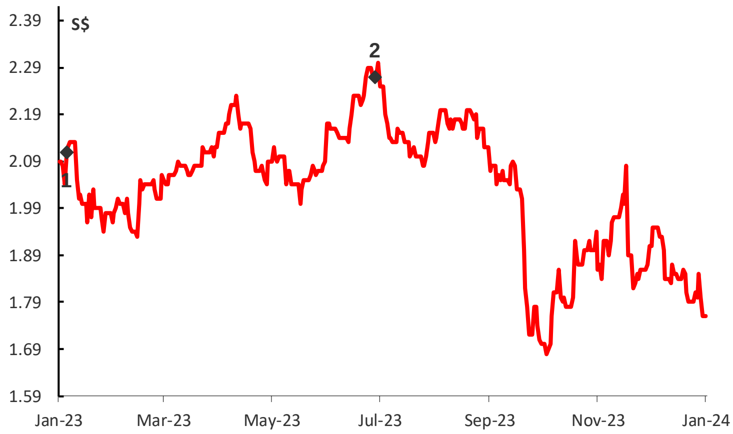
Source: Company, DBS Bank Ltd

Cash Flow Statement (S$m)

FY Dec	2021A	2022A	2023A	2024F	2025F
Pre-Tax Income	200	197	166	177	197
Dep. & Amort.	0.0	0.0	0.0	0.0	0.0
Tax Paid	(7.0)	(6.5)	(6.6)	(5.7)	(19.8)
Associates &JV Inc/(Loss)	1.00	8.98	8.28	0.0	0.0
Chg in Wkg.Cap.	(21.9)	(4.4)	(13.9)	(24.5)	(0.6)
Other Operating CF	(142)	(46.0)	49.2	5.71	2.79
Net Operating CF	29.7	149	203	153	179
Net Invt in Properties	(282)	(295)	(26.4)	(10.3)	(11.1)
Other Invts (net)	(26.4)	0.0	0.0	0.0	0.0
Invts in Assoc. & JV	(89.7)	0.0	0.0	0.0	0.0
Div from Assoc. & JVs	0.0	0.0	0.0	0.0	0.0
Other Investing CF	23.6	(3.7)	11.0	0.0	0.0
Net Investing CF	(374)	(299)	(15.4)	(10.3)	(11.1)
Distribution Paid	(185)	(150)	(179)	(150)	(164)
Chg in Gross Debt	143	266	(8.8)	9.10	9.89
New units issued	202	0.0	0.0	0.0	0.0
Other Financing CF	(24.8)	(33.1)	(48.8)	0.0	0.0
Net Financing CF	135	83.7	(236)	(141)	(154)
Currency Adjustments	(0.5)	(8.8)	0.15	0.0	0.0
Chg in Cash	(210)	(75.0)	(48.7)	1.69	14.1
Operating CFPS (S cts)	3.08	8.93	12.6	10.3	10.4
Free CFPS (S cts)	(15.1)	(8.5)	10.3	8.27	9.75

Source: Company, DBS Bank Ltd

Target Price & Ratings 12-mth History



S.No.	Date of Report	Closing Price	12-mth Target Price	Rating
1:	01 Feb 23	2.11	2.35	BUY
2:	25 Jul 23	2.27	2.45	BUY

***Note** : Share price and Target price are adjusted for corporate actions.*

Source: DBS Bank Ltd

Analysts: Dale LAI
Derek TAN

DBS Bank Ltd 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 Ltd unless otherwise specified.

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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: Andy Sim
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
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