Singapore Industry Focus

Singapore REITs

Refer to important disclosures at the end of this report

DBS Group Research . Equity

30 May 2024

Finding alpha amid high rates

- A deep dive into key financial metrics reveals that S-REITs are well prepared to weather an extended period of high interest rates
- Organic growth momentum continues into 2H24, optimistic in retail, logistics, hotels, and Grade A office subsectors
- S-REITs currently trade at attractive valuations of c.0.8x P/B and c.6.7% forward yield
- Early positioning in S-REITs will deliver alpha; pick sub-sectors and names with relative value

S-REITs are well positioned to weather a "higher for longer" interest rates environment. Rising expectations of a delayed and milder cut in interest rates in 2024 has prompted another round of de-rating in S-REITs in recent times. However, a deeper analysis of the overall capital metrics for S-REITs reveals a more positive picture. Across the 5 key credit metrics that we have been tracking, we note that capital management metrics such as (i) interest coverage ratios (ICRs), (ii) gearing levels, (iii) hedging strategies, (iv) refinancing profile; and (v) overall financing costs are showing signs of moderation and should stabilise in 2H24, with upside in 2025. This implies that portfolio costs are substantially "marked to market". We remain constructive that S-REITs have adequate buffers to deliver resilient returns of c.6.7%-6.8% yields even in a bear case scenario of sustained high interest rates.

Robust organic earnings growth; currency headwinds to shift to tailwinds. We remain constructive that the operating metrics for S-REITs are on an upward trend, with most portfolios firmly positioned in a real estate upcycle. Rental reversions for office (+11%) and retail (+14%) remain solid in our view and should see good momentum in 2H24 as tenants look to consolidate their operations in prime spaces (Grade A offices in the CBD) and dominant suburban malls respectively. Within the industrial sector, logistics (+13% reversion) continues to be the standout area amid a surge of new supply entering the market. Hotelier guidance remains optimistic on the back of a robust event line-up and an expected rebound in Chinese travelers to the Asia Pacific region, as indicated by expanding flight capacities in the coming months. Overall, the strong organic growth potential should partially offset the impact of weak currencies against the SGD to-date, which should start to taper off when the FED pivots.

Reiterating our strategy of selecting relative value. With renewed confidence in S-REITs' sound capital structure, we reiterate our strategy of selecting names with relative value. Trading at c.0.8x P/B and dividend yield of c.6.7%, we believe that early positioning in the sector before rate cuts will generate alpha. In order of preference, our sector picks are Retail, Industrial, Hotels followed by Office.

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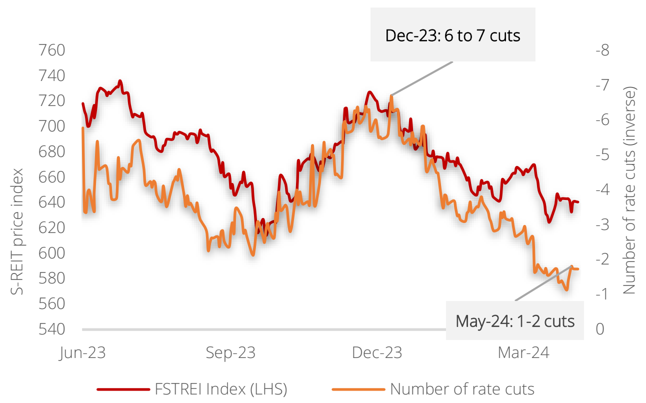
STOCKS

	Price SGD	Mkt Cap USDm	12-mth Target Price SGD	Performance (%) 3 mth	Performance (%) 12 mth	Rating
Frasers Centrepoint Trust	2.17	2,899	2.70	(0.5)	0.9	BUY
LendLease Global Commercial REIT	0.55	969	0.90	(4.4)	(17.3)	BUY
CapitaLand Integrated Commercial Trust	1.95	9,837	2.30	2.6	(2.5)	BUY
Mapletree Pan Asia Commercial	1.22	3,964	1.75	(10.3)	(26.5)	BUY
Capitaland Ascott Trust	0.90	2,181	1.30	0.0	(15.1)	BUY
Digital Core REIT	0.60	798	0.75	(0.8)	45.1	BUY
Frasers Logistics & Commercial Trust	0.99	2,758	1.44	(3.9)	(18.2)	BUY
Mapletree Logistics Trust	1.35	5,043	1.75	(8.2)	(18.2)	BUY
Capitaland Ascendas REIT	2.62	8,171	3.25	(5.1)	(3.3)	BUY

Source: DBS, Bloomberg
Closing price as of 29 May 2024

Changing interest rate cut expectations



Source: Bloomberg., DBS

Watchlist the stock on Insights Direct to receive prompt updates

ed: JS/ sa:AS, PY, CS

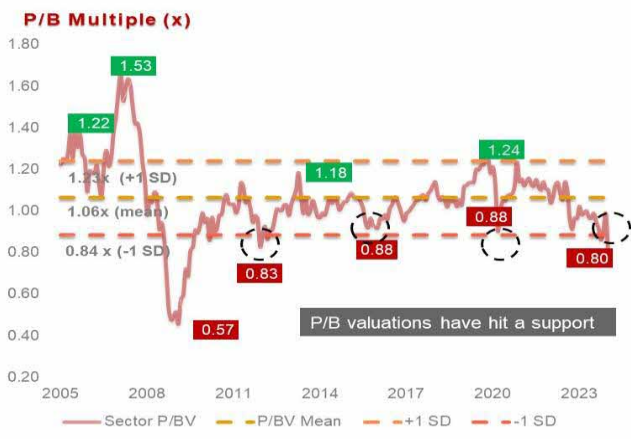
Higher for longer is "in the price "

Market expectations that FED will cut only twice in 2024. The expectations for rate cuts by the FED in 2024 have significantly shifted in recent months. As of now, the market anticipates only one or two rate cuts, possibly beginning with the FOMC meeting in September 2024. This is a stark contrast to the outlook just four months ago, in January 2024, when up to six rate cuts were expected throughout this year. These change in rate cut expectations came on the back of sticky inflation print in the US, contributing to the volatility in S-REITs, which has dropped c.12% since the start of the year.

In the S-REITs space, this volatility has resulted in S-REITs trading at a P/B (price-to-book) multiple of c.0.8x. This valuation is significantly lower, more than one standard deviation below the historical average. S-REITs currently offer an average dividend yield of c.6.7%, which presents a compelling investment opportunity for income-focused investors given the current low valuations.

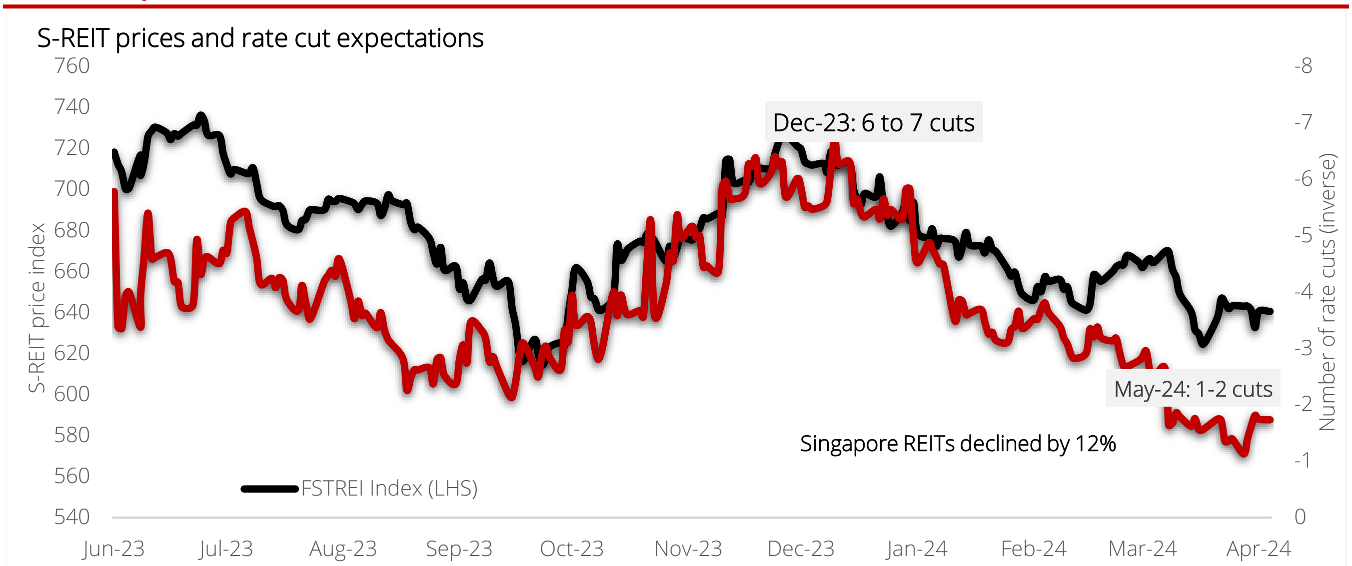
Rewards outweigh risks at current valuations. At current valuations, we believe that markets have substantially priced in the higher for longer interest rates environment with further outflows likely if interest rate cut expectations turn down to zero, which is not the base case view of our economists for now. Conversations with investors suggest that most are looking to add to the sector progressively. In the near term, they are adopting a more cautious "wait-and-see" approach as macro conditions remain fluid (sticky inflation prints have caused the FED to backtrack on their dovish rate view in). That said, most agree that valuations are looking attractive at close to "peak rates".

Valuations have hit "support levels"



Source: Bloomberg, DBS

Rate cut expectations have turned hawkish



Source: Bloomberg, DBS

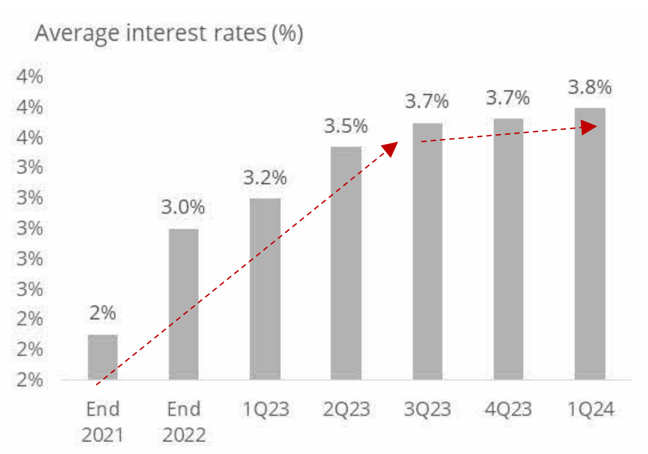
Strategies to weather extended periods of high interest rates

S-REITs are well-positioned to weather the prolonged period of higher interest rates. In the past 12-18 months, S-REITs have actively managed their capital positions to mitigate the impact of rising interest rates and strengthen their financials. S-REIT managers are being more proactive in their financial management strategies such as:

1. High hedge ratios: Increasing the proportion of loans hedged to fixed-rates: S-REITs have been hedging a greater portion of their loans to fixed rates to shield themselves from interest rate volatility.
2. Early debt refinancing: Many S-REITs have engaged in early negotiations to refinance debt that is due, securing more favourable terms ahead of time.
3. Asset enhancement initiatives (AEIs) and redevelopments: These efforts aim to recalibrate their portfolios by upgrading properties and redeveloping assets to command higher rents, thereby boosting revenue. In response to the lack of accretive acquisition opportunities, S-REITs have been increasingly carrying out improvement works on their existing portfolios to drive organic earnings growth.
4. Divestment of lower yielding assets: S-REITs have also been selling lower-yielding properties to reduce high-cost debt, improving their overall debt profile, in line with our strategy that assets remain a key currency for them to deleverage and fund growth initiatives.

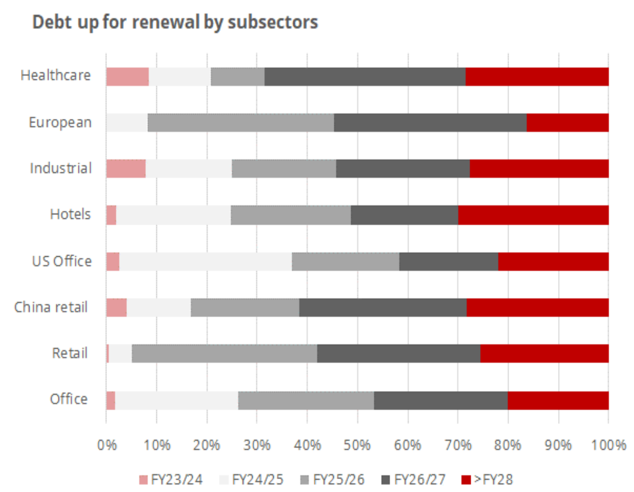
While borrowing costs are expected to continue rising, the most significant increases have probably already occurred, in our view. Our estimates suggest that borrowing costs for S-REITs could rise by an additional c.40bps in FY24 if interest rates stay at current levels as they refinance maturing loans. As these financing costs increase, there may be further pressure on the balance sheets of some segments within the S-REIT market, particularly those with higher leverage or less flexible financial structures. However, the proactive capital management strategies employed by S-REITs should help mitigate some of these pressures and support overall stability in the sector.

Average cost of debt increase tapering off



Source: Companies, DBS

Diversified refinancing profile



Source: Companies, DBS

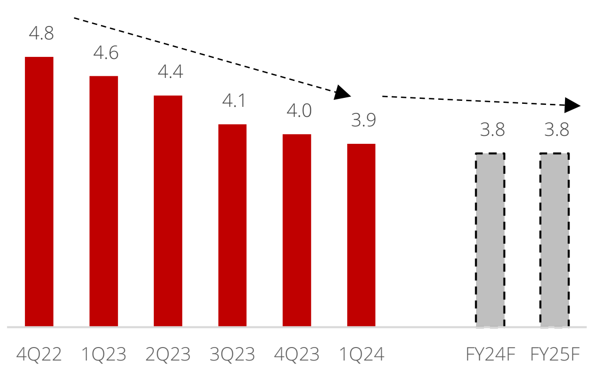
Metric 1: Interest Coverage Ratio (ICR) is basing out

ICR has weakened but basing out. The interest coverage ratio (ICR) for S-REITs has deteriorated over the past two years, now averaging around 3.9x. This decline in ICR, which has fallen by more than 1.8x in the last eight quarters, is primarily due to higher financing costs and a decrease in EBITDA due to inflationary pressures on operating costs.

The Retail and Healthcare segments have experienced the largest declines in ICR. While experiencing a decline (mainly weighed down by the dip in ICR for PREIT), the Healthcare segment still maintains the highest average ICR at approximately 7.7x. in contrast, the Office and US Office segments have the lowest ICRs among S-REITs, at 2.7x and 2.8x respectively. Despite their low levels, the ICRs have remained relatively stable q/q.

While the overall ICR for S-REITs has weakened due to higher financing costs and operational challenges, the pace of deterioration has recently slowed and our projections for FY24-25F imply that we are likely to stabilize at around current levels. The most significant declines in ICRs were observed in FY22. However, the rate of decline had slowed in FY23, with the past two quarters showing a more stable trend. The average decline in S-REITs' ICRs have slowed in the past two quarters, after a decline of more than 1.6x over the prior seven quarters.

ICR ratios should base out at close to 3.8x on average



Source: Companies, DBS

ICRs for all sectors remain healthy, above the 2.5x threshold

ICR	1Q22	2Q22	3Q22	4Q22	1Q23	2Q23	3Q23	4Q23	1Q24
Office	3.7	3.8	3.5	3.1	2.9	2.8	2.8	2.7	2.7
Retail	5.2	6.2	4.6	4.2	4.2	3.6	3.2	3.1	3.0
China retail	4.9	4.9	4.7	4.0	3.8	3.7	3.1	3.8	3.8
US Office	4.4	4.4	4.3	3.7	3.4	3.1	3.0	3.0	2.8
Hotels	3.5	3.5	3.7	3.8	3.7	3.7	3.6	3.4	3.3
Industrial	5.8	6.5	6.3	5.1	5.3	5.2	4.8	4.7	4.5
European	7.1	6.7	6.7	5.9	5.5	5.2	4.4	4.6	4.6
Healthcare	12.8	12.7	12.5	11.7	9.4	9.0	8.3	7.6	7.7
Average	*5.5*	*5.8*	*5.5*	*4.8*	*4.6*	*4.4*	*4.1*	*4.0*	*3.9*

**Green boxes are denoted to be "healthier" and above MAS floor of 2.5x.*
Source: Companies, DBS

Metric 2: Gearing trends have held steady; asset re-cycling strategy to deleverage

Overall gearing still below 40% with industrial, hotels and China retail REITs the lowest. Over the past two years, gearing ratios for S-REITs have increased by about 3.0ppts, primarily due to declining asset values in the US Office and European segments, where capitalisation rates have expanded by up to 250 basis points (bps). However, the Hotels segment has seen an average gearing improvement of 2.6ppts since 1Q22, driven by strong revenue per available room (RevPAR) numbers.

Overall, S-REITs maintain relatively healthy gearing ratios, with some segments (i.e. hotels) improving as property values recover from COVID-19 lows. The most significant gearing increases occurred in FY22, averaging 170bps, but slowed to 60bps in FY23.

Watch commercial (i.e. office REITs). The US Office segment remains the most challenged, with average gearing exceeding 50% due to ongoing cap rate expansion and downward pressure on operating metrics, leading to further asset write-offs. Manulife US REIT (MUST) and Keppel Pacific Oak US REIT (KORE) have both suspended dividend distributions, while Prime US REIT (PRIME) has reduced its payout ratio to only c.10%.

While S-REITs' gearing ratios have generally increased, the impact varies by segment. The Hotels and Industrial segments have shown improvements, but the US Office segment continues to face significant challenges, requiring strategic debt management where most of the US Office REITs have either paused dividend payments to ride out internal cashflow needs in the interim.

Gearing for the US Office segment remains stretched, leading to the need to recapitalise and suspend dividend distribution

Gearing	1Q22	2Q22	3Q22	4Q22	1Q23	2Q23	3Q23	4Q23	1Q24
Office	39.2%	38.9%	40.4%	40.0%	40.5%	40.4%	40.6%	40.0%	40.2%
Retail	33.6%	35.1%	34.8%	34.9%	36.4%	36.8%	36.9%	36.2%	36.3%
China retail	31.9%	32.6%	32.9%	33.6%	32.9%	33.2%	33.9%	33.4%	33.0%
US Office	37.8%	39.1%	39.5%	43.0%	44.0%	46.1%	46.3%	51.7%	51.7%
Hotels	38.0%	37.4%	36.3%	35.8%	35.8%	36.0%	35.0%	35.1%	35.4%
Industrial	35.1%	35.1%	35.1%	35.7%	36.1%	36.1%	35.7%	35.5%	36.4%
European	35.3%	37.1%	37.1%	39.1%	39.8%	40.2%	39.1%	39.7%	39.9%
Healthcare	35.6%	34.1%	34.1%	37.5%	38.3%	37.0%	37.5%	37.2%	37.2%
Average	36.0%	36.2%	36.4%	37.2%	37.7%	37.9%	37.7%	38.0%	38.3%

Source: Companies, DBS

Metric 3: Hedging: Is it time to drop interest rate hedges?

Maintaining high level of interest hedges. Most S-REITs have increasingly hedged their debt to fixed rates, with the average proportion rising by 1.9ppts over the past two years. This shift aims to mitigate the impact of rising financing costs for loans on floating rates and has worked to an extent as interest rates remained high throughout 2023 and likely in 1H24 as well. Currently, more than 76% of S-REITs' loans are hedged to fixed rates, a level considered comfortable, in our opinion. The Industrial sector has been particularly proactive, increasing its fixed-rate debt proportion by 9.5ppts over this period.

Is it time to drop them? However, several REITs have reported a decline in the proportion of loans hedged, largely due to the maturity of loans or interest rate hedges. For those with maturing loans or swaps in the past 2-3 quarters, there has been a strategic balance between the costs of new swaps and the reduced need for high hedging levels as interest rates appeared to have peaked, with some opting to drop the hedges in view of peaking interest rates.

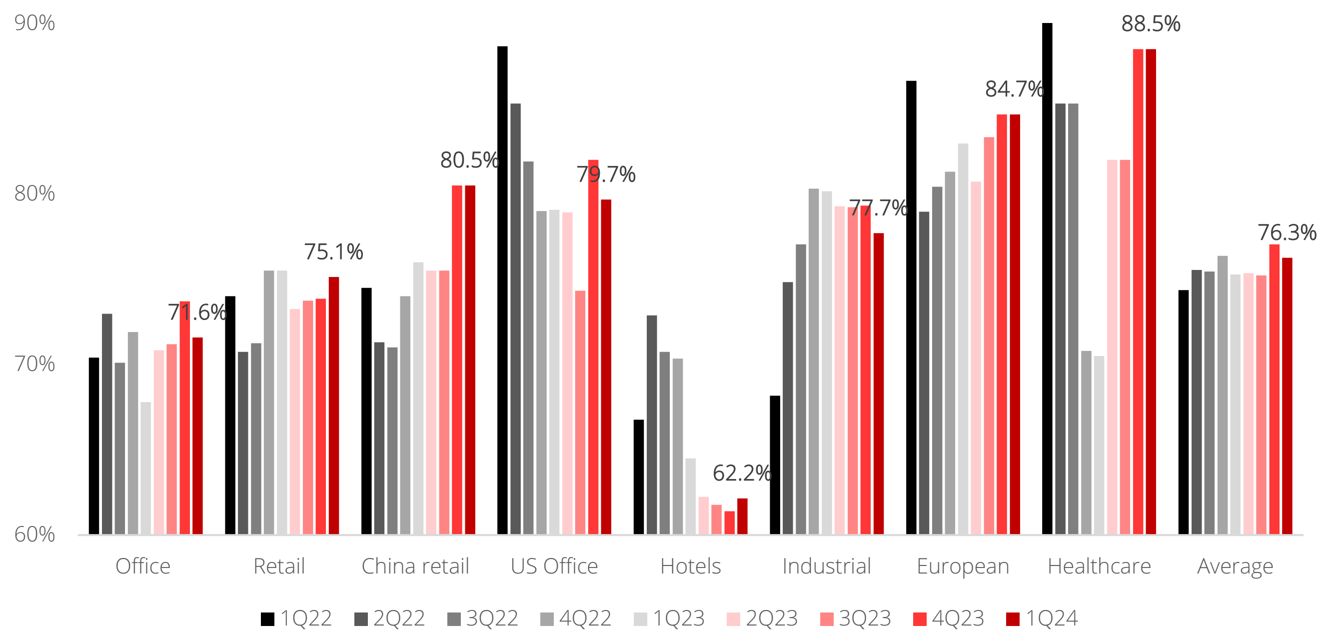
That strategy could turn out well, if interest rates turn into a downtrend, which the market expects sometime in Sept'24 onwards. As interest rates are anticipated to drop, reducing the proportion of fixed-rate loans could be advantageous, allowing S-REITs to benefit from lower financing costs immediately.

REITs with lower hedge ratios (as of 1Q24)

REIT	Hedge ratio
Suntec REIT	61%
OUE REIT	70%
Lendlease REIT	61%
Elite Commercial REIT	66%
CDL HT	49%
Far East Hospitality Trust	43%
ESR Logos REIT	63%
Sector Average	75%

Source: Companies, DBS

Interest rate swaps are a double-edged sword with potential delays in savings from potential future rate cuts



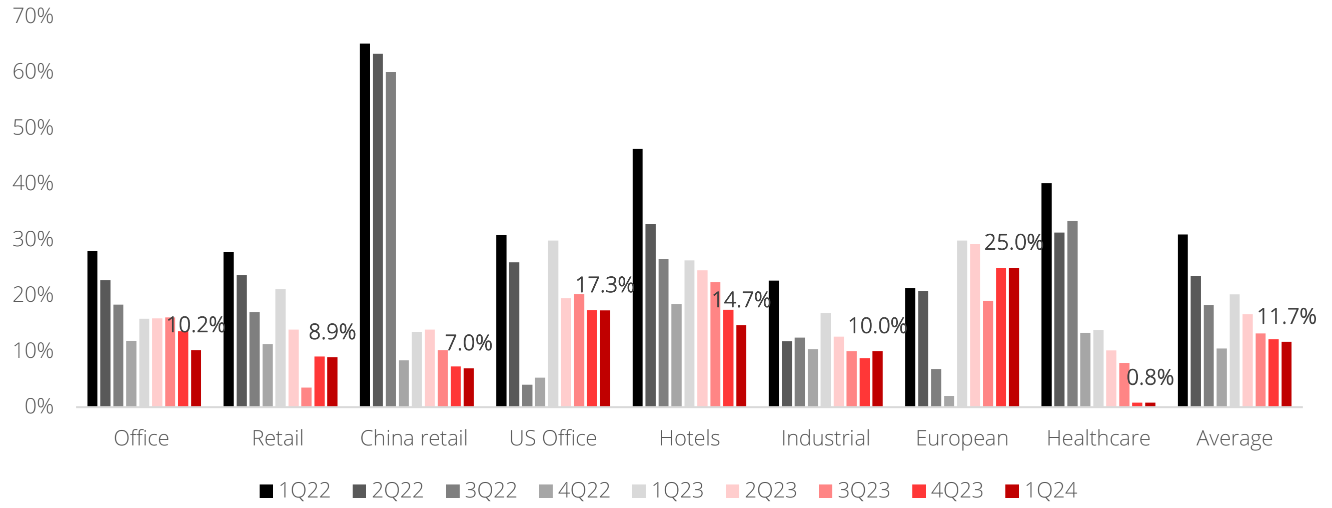
Source: Companies, DBS

Metric 4: Minimal refinancing concentration in 2024-2025

Minimal concentration risk as loans are "marked to market" progressively. S-REITs have faced varying increases in financing costs, influenced by the proportion of loans hedged to fixed rates and the refinancing of loans at higher rates. S-REITs in general have spread out their refinancing profiles to c.20%-25% of overall loans expiring annually. While S-REITs have benefited from the low rates since 2020, these loans when refinanced in 2023-2024 are seeing close to c.3% spike in costs.

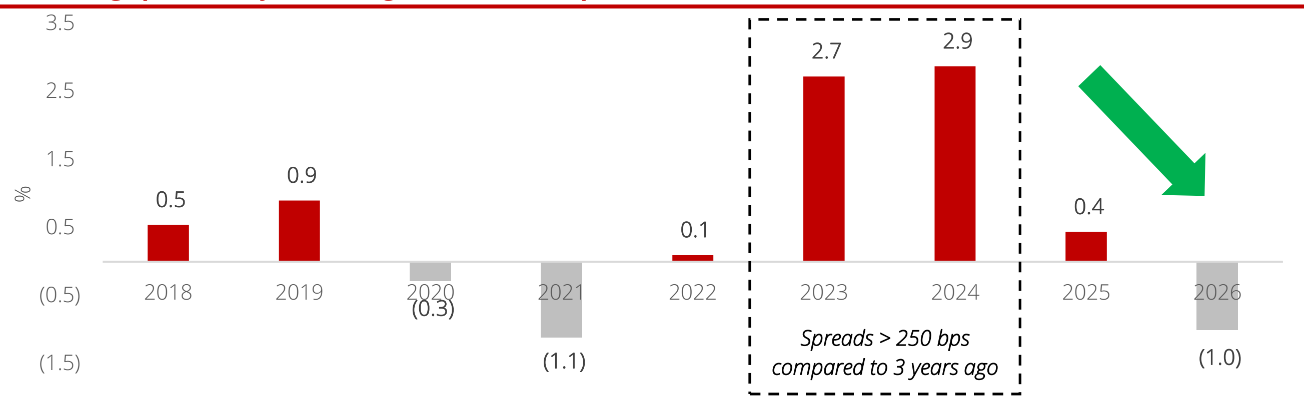
An earnings upgrade cycle? While loans are being "marked-up to market" in 2024, it is likely to turn flattish in the coming year 2025 and "savings" come 2026, aligning with expected interest rate cuts by the end of this year. However, our projections have already priced in a higher-for-longer interest rate scenario, meaning any rate cuts would provide upside potential to our estimates. This conservative approach ensures that S-REITs are prepared for ongoing financing challenges while remaining poised to benefit from eventual reductions in borrowing costs.

S-REITs have c.12% of their loans due for refinancing in the near-to-medium-term, down from c.31% in FY22



Source: Companies, DBS

Refinancing spreads (3-year rolling) will start to taper off in late-2025



Source: Bloomberg, DBS

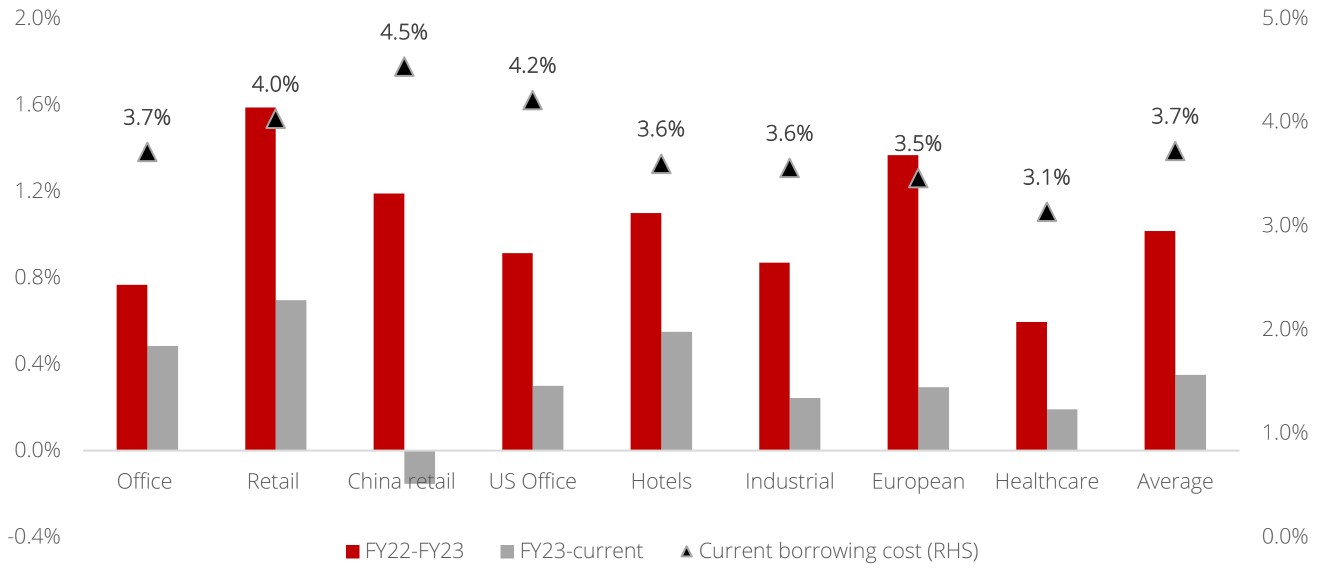
Metric 5: Rate of increase in borrowing costs is tapering off

Spike in interest rates is largely behind us. Since interest rates began hiking in March 2022, the all-in financing costs for S-REITs have been gradually rising and likely to remain on an uptrend the rest of the year. On average, borrowing costs for S-REITs have increased by c.1.4 ppts. The steepest increase occurred in FY22, with borrowing costs rising by c.1.0 ppts, while FY23 saw a more modest increase of only c.0.4 ppts.

Of the various segments, the Retail sector experienced the highest increase in borrowing costs over the past two years, rising by 2.3 ppts. The Hotels and European-focused segments followed, each reporting a 1.7 ppt increase in borrowing costs. The China Retail segment currently has the highest all-in financing cost at c.4.5%, primarily due to the higher cost of RMB loans. However, as RMB loan costs have decreased, the China Retail segment saw a 0.2 ppt reduction in borrowing costs over the past year. The next segment with the highest financing cost is the US Office segment, influenced by 525 basis points of interest rate hikes in the past two years.

Portfolio average interest rates are largely marked-to-market. Given that refinancing spreads remain elevated for now, we expect that overall borrowing costs for S-REITs to continue rising, though at a slower pace. Looking ahead, we have priced in an additional 0.2ppt-0.3ppt increase in our estimates before these taper off in 2025.

Rate of increase in borrowing costs have slowed in FY23 compared to FY22



Source: Companies, DBS

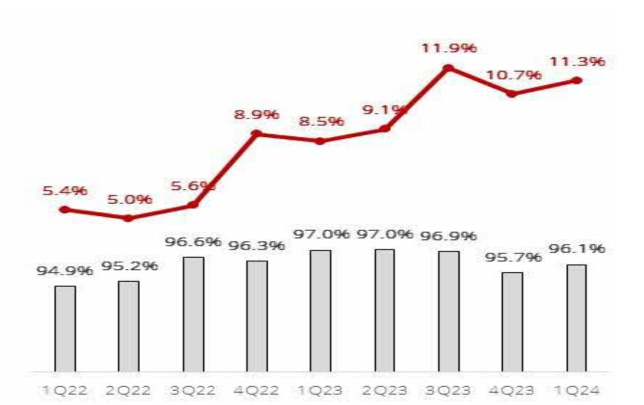
Strengthening organic growth momentum

Operating metrics remain strong on a continued upward trajectory. We remain positive that operating metrics for S-REITs remain on an upward trend. While there have been slight q/q declines in occupancy rates, these are mainly transitional as expiring leases will largely be backfilled over the course of the year. Overall, occupancy rates have held firm for most real estate sectors backed by high retention rates.

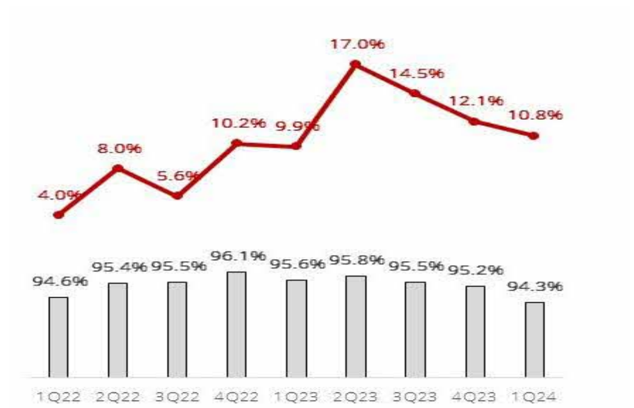
Rental reversions are positive and continue to trend upward across segments. In the Office segment, rental reversions rose to +11.3% in 1Q24, more than doubling the levels seen two years ago. The Industrial segment, while experiencing a tapering off since mid-2023, still enjoys very healthy rental reversions at +10.8%. These strong reversions are expected to continue as expiring rents, mostly signed during the COVID-19 pandemic, are renewed at higher current rates. The Retail segment is seeing strong rental reversions at +14.1%, driven by retail assets located in the Orchard Road belt catching up to previously outperforming malls in suburban locations. The Hotel segment's RevPAR is also on an uptrend, surpassing pre-COVID levels, with q/q fluctuations primarily due to seasonal factors, with better performance typically seen in the second half of the year.

Overall, despite some transitional challenges, the operating metrics for S-REITs indicate strong performance and growth potential, particularly with the sustained strong positive rental reversions.

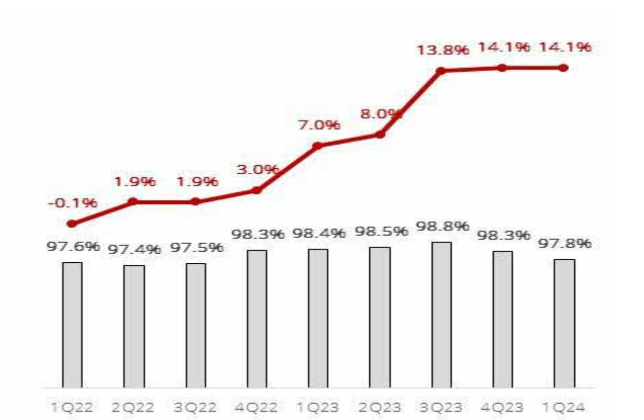
Office reversions are >10%



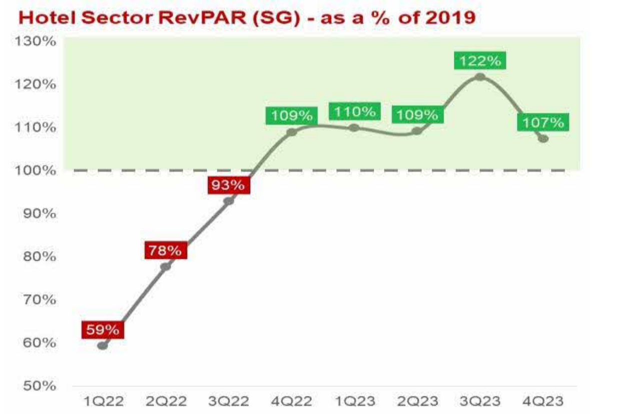
Industrial reversions softening but still >10%



Robust retail reversions driving organic growth



Hotel RevPAR has surpassed pre-COVID levels



Source: Companies, DBS

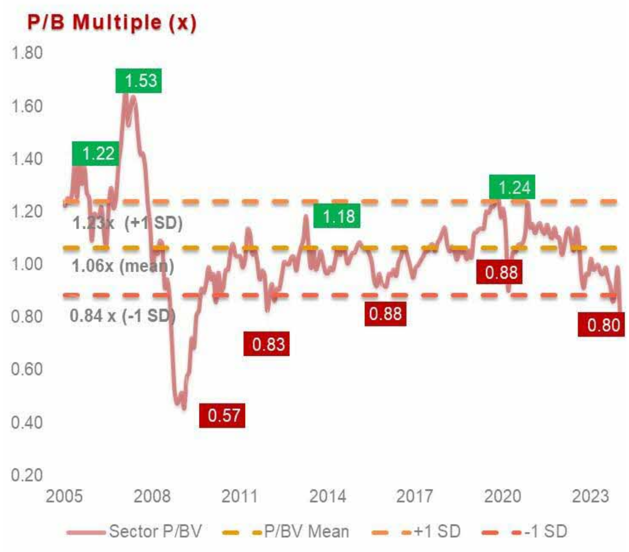
Our thoughts
As we adjust to a higher-for-longer interest rate environment, S-REITs have been proactively managing their capital management strategies. Despite increases in metrics such as ICR and gearing over the past two years, most S-REITs maintain a healthy position with sufficient buffers to navigate elevated interest rates.

Proactive capital management has helped mitigate some of the impact on borrowing costs. Many S-REITs have hedged a larger proportion of their loans to fixed rates, limiting the impact of rising interest rates. Only REITs with a significant portion of loans due for refinancing in the near to medium term will experience a more pronounced increase in borrowing costs.

Operating metrics for S-REITs remain robust and continue to improve. As financing cost pressures plateau, the pressure on REITs' capital management metrics is likely to ease, while the upward trend in operating metrics is expected to translate into earnings growth.

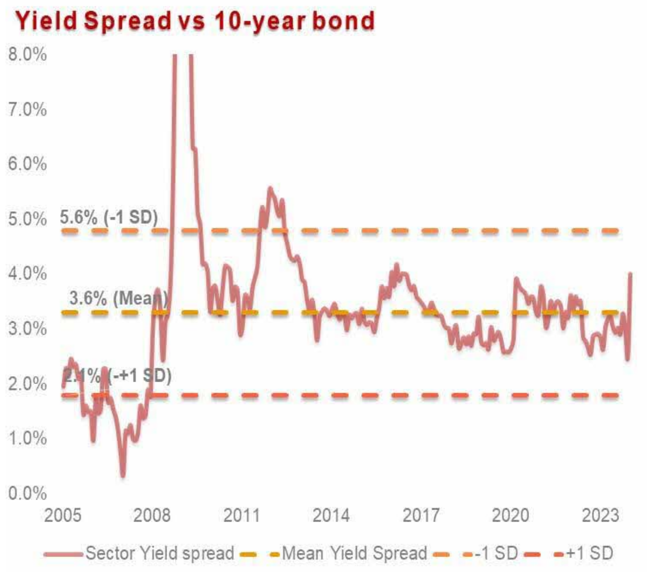
Our investment strategy focuses on identifying relative value within the S-REITs sector at this point. While we remain cautious on the US Office segment due to its challenges, we focus on investments in other sectors. The above analysis provides us comfort that S-REITs are sufficiently prepared to weather the higher for longer interest rate environment. We maintain our sector preference in this order: Retail (FCT, LREIT), Hospitality (CLAS), and Industrial (FLCT, MLT, DCREIT), followed by Office (CICT, MPACT),.

Price to book multiples have hit support levels



Source: Bloomberg, DBS

Attractive yield spreads above mean



Source: Bloomberg, DBS

Key capital management metrics – as at 31 March 2024

S-REIT	ICR ratio	Gearing	% debt expiring (FY24-25)	% debt on fixed rates	Current debt cost (%)
CICT	3.1	40.0%	12%	76%	3.5%
SUN	2.0	42.2%	0%	61%	4.0%
Office REIT	3.3	39.4%	22%	74%	3.2%
OUECT	2.4	38.8%	2%	70%	4.5%
MPACT	2.9	40.5%	15%	77%	3.4%
Office	*2.7*	*40.2%*	*10.2%*	*71.6%*	*3.7%*
FCT	3.3	37.2%	0%	69%	4.2%
LREIT	2.3	41.0%	0%	61%	3.5%
PGNREIT	3.4	29.9%	17%	85%	4.6%
SGREIT	3.1	37.2%	18%	86%	3.9%
Retail	*3.0*	*36.3%*	*8.9%*	*75.1%*	*4.0%*
CLCT	3.0	40.8%	1%	74%	3.5%
SASSR	4.5	25.2%	13%	87%	5.6%
China Retail	*3.8*	*33.0%*	*7.0%*	*80.5%*	*4.5%*
KORE	3.0	43.0%	12%	69%	4.3%
MUST	2.3	63.2%	5%	91%	4.3%
PRIME	3.2	48.8%	34%	79%	4.0%
US Office	*2.8*	*51.7%*	*17.3%*	*79.7%*	*4.2%*
CLAS	3.7	37.9%	12%	82%	3.0%
CDLHT	2.7	36.7%	30%	49%	4.3%
FEHT	3.5	31.3%	0%	43%	3.7%
FHT	3.1	35.5%	17%	75%	3.4%
Hotels	*3.3*	*35.4%*	*14.7%*	*62.2%*	*3.6%*
AAREIT	3.8	32.6%	0%	75%	4.1%
CLAR	3.4	38.3%	14%	83%	3.8%
CLINT	2.6	37.0%	32%	71%	6.3%
EREIT	2.6	37.1%	0%	63%	4.1%
DHLT	12.0	37.3%	29%	100%	1.0%
DCREIT	3.2	35.1%	0%	93%	3.9%
KDCREIT	4.6	37.6%	4%	73%	3.5%
FLT	5.9	32.7%	23%	76%	2.6%
MINT	4.5	38.7%	3%	85%	3.1%
MLT	3.7	38.9%	5%	84%	2.7%
SSREIT	3.5	35.6%	2%	52%	4.0%
Industrial	*4.5*	*36.4%*	*10.0%*	*77.7%*	*3.6%*
CERT	3.6	41.3%	0%	91%	3.3%
ELITE	3.1	41.5%	75%	66%	5.2%
IREIT	7.1	37.0%	0%	97%	1.9%
European-focused	*4.6*	*39.9%*	*25.0%*	*84.7%*	*3.5%*
PREIT	11.3	35.6%	2%	90%	1.3%
FIRT	4.1	38.7%	0%	87%	5.0%
Healthcare	*7.7*	*37.2%*	*0.8%*	*88.5%*	*3.1%*
Sector Average	*3.9*	*38.3%*	*11.7%*	*76.3%*	*3.7%*

Source: Companies, DBS

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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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