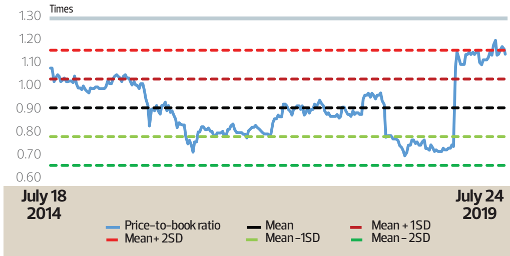
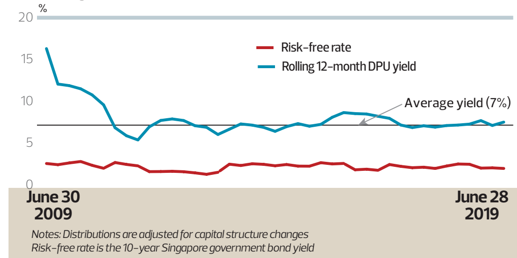
YIELD WATCH

ESR-REIT focuses on AEIs and leases as sponsor creates pipeline with Sabana REIT transaction

ESR-REIT 5-year price-to-book ratio



ESR-REIT 10-year DPU yield



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Adrian Chui, CEO of ESR-REIT's manager, was frank and transparent when asked about the outlook for industrial property, rental reversions, tenants, sponsors and mergers and acquisitions. ESR-REIT owns a portfolio of 56 assets valued at around $3.02 billion, excluding the acquisition of PTC Logistics Hub, which will be completed in 3Q2019.

The real estate investment trust announced its 2QFY2019 and 1HFY2019 results on July 23. Operationally, distribution per unit (DPU) stabilised at 1.004 cents, up marginally y-o-y, which translates into an annualised yield of 7.4%. ESR-REIT trades at a premium to its net asset value (NAV) of 45.7 cents a unit.

Chui acknowledges that dark clouds are forming in 2H. For one thing, the trade war rhetoric is no longer just rhetoric but a reality. Secondly, the International Monetary Fund (IMF) has just cut its growth forecasts for the global economy. It predicts growth of 3.2% for 2019 and 3.5% for 2020 (0.1 percentage point lower than in the April world economic outlook projections for both years). Singapore recorded a 3.4% q-o-q contraction in 2QCY2019, and non-oil domestic exports plunged 17.3% y-o-y in June.

"Risks to the forecast are mainly to the downside. They include further trade and technology tensions that dent sentiment and slow investment; a protracted increase in risk aversion that exposes the financial vulnerabilities continuing to accumulate after years of low interest rates; and mounting disinflationary pressures that increase debt service difficulties, constrain monetary policy space to counter downturns, and make adverse shocks more persistent than normal," IMF says in a statement on July 23.

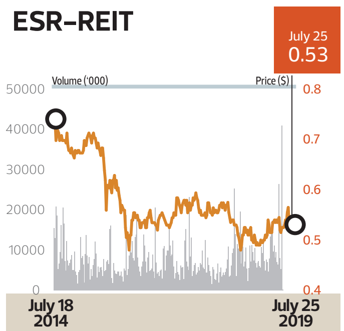
"The implication is that tenants are a bit more cautious and more risk-averse. Their businesses are still profitable, but it takes them a longer time to commit to taking up new spaces. Twelve months ago, we had that [downbeat] scenario, and by the end of last year, things looked more positive, but we are now back to a risk-averse mode," Chui says.

Although industrial supply fell in 2QFY2019, rental reversions for ESR-REIT's portfolio were +0.1% compared with +1.6% in 1QFY2019. The figures are still better than FY2018's -2.9% and 4QFY2018's -2.9%. While ESR-REIT is likely to maintain its occupancy rate in the 90s, rental reversion in 2HFY2019 could be flattish to -2%, according to Chui.

Building blocks

To ensure DPU remains stable, ESR-REIT is carrying out a substantial asset enhancement initiative at 7000 Ang Mo Kio Avenue 5. The AEI will comprise building a new block with gross floor area (GFA) of 270,000 sq ft, taking the plot ratio from 1.4 to 2.1. The new block will be "future-ready" and sufficiently versatile to house data centre operators. Its specifications will include a generous floor loading capacity and ceiling height. An additional substation will be built, providing access

ESR-REIT



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to an independent power source to ensure that the new block will be equipped to support high-value manufacturing functions, with space that provides configuration flexibility suitable for single or multi-tenanted use.

"We have a number of tenants in advanced negotiations and there are pockets of people willing to come in, from companies operating data centres and advanced manufacturing," Chui says. He commends the Singapore government for its initiatives in promoting a future-ready city state. The initiatives are bearing fruit. "The AEIs we undertake are to keep our assets relevant for these new [economy] industrialists because their demand for power and [floor] loading is different from 10 years ago," Chui points out.

The AEIs for 7000 Ang Mo Kio and UE BizHub East — a mixed-use development comprising retail, hospitality and business park near the Expo MRT station — are likely to cost $45.7 million, with a yield-on-cost of 9%.

The Ang Mo Kio property still has 225,000 sq ft of unutilised GFA. In addition, ESR-REIT owns a building in Tuas that has 500,000 sq ft of unutilised GFA. Altogether, the REIT has seven properties that can undergo AEI and rejuvenation.

"We want to do things slowly. I want to do the first few AEIs correctly so that we have a track record. I want to balance closing down buildings [with income from operating buildings] to ensure a stable DPU," Chui says.

In the meantime, ESR-REIT is acquiring a stake in PTC Logistics Hub, a six-storey ramp-up general warehouse with ancillary facilities on Pandan Road. The total cost is $225 million, and ESR-REIT will own 49% and PTC, 51%. ESR-REIT's cash outlay, including expenses, is likely to be $44.4 million. The acquisition is mildly DPU-accretive, raising pro forma DPU of 4.0028 cents to 4.044 cents, and NAV-neutral, based on fundraising of no more than $150 million, comprising a placement of $100 million and a preferential equity fundraising for the remaining $50 million.

Questions on 8 Tuas South Lane

Hyflux divested 8 Tuas South Lane — with GFA of around 72,569 sq m (780,842 sq ft) — to ESR-REIT in 2017 for $95 million. The REIT also paid JTC Corp an upfront land premium of $11.4 million for the remainder of the first 30-year lease.

According to Chui, Hyflux's lease is for 70% of the building space. "Hyflux is still paying rent and we have not drawn down on the security deposit. We are helping to lease out the space they may not need," he says.

"That area [near 8 Tuas South Lane] is [on the up and up] because of Tuas Megaport — prospective tenants want to look at it. The property is very flexible. If things don't go according to plan, we have an alternative [as] it's not customised. If I want to redevelop it into a ramp-up warehouse, it's possible. The land area is big enough, although we didn't buy it to redevelop," Chui explains.

In 2QFY2019, the manager of ESR-REIT renewed 327,700 sq ft of space. The tenant retention rate was 54.7%; it would have been higher were it not for the non-renewal by **Cisco Systems** at UE BizHub East. However, in 1Q, ESR-REIT announced that DBS Bank had leased 42,600 sq ft at UE BizHub East.

Sponsor and pipeline

ESR — which stands for e-Shang Redwood — has acquired, over the space of several months, a 93% stake in **Sabana Shari'ah Compliant REIT**'s manager. ESR has also acquired over a few years a 20.25% stake in Sabana REIT, with the most recent acquisitions done this year.

e-Shang was founded in 2011 by Warburg Pincus and two Chinese entrepreneurs and focuses on developing institutional quality warehouses to cater to the needs of e-commerce companies, "bricks-and-mortar" retailers and third-party logistics providers in major gateway markets in Asia-Pacific. e-Shang eventually merged with the Redwood Group Asia to form ESR. In June this year, ESR delayed plans for an IPO in Hong Kong.

According to ESR-REIT's announcement, ESR has committed to subscribe to its portion of the $50 million of equity fundraising that will be used to partially fund the acquisition of PTC Logistics Hub and the AEIs at 7000 AMK and UE BizHub East; and also to "backstop" the issue. According to ESR-REIT's 2018 annual report, ESR owns 9.25% of ESR-REIT, with Tong Jinquan holding a 33.83% stake.

"Our sponsor sees the synergies of a larger portfolio. We are not in a rush, and leave it to the independent directors of both REITs [ESR-REIT and Sabana REIT] to decide what is good for the REITs and independent unitholders," Chui says. "We have done a merger [with Viva Industrial Trust], completed our integration and are focusing on AEI and portfolio rejuvenation. Our focus is on the portfolio. When the right time comes, and if it's value-accretive to independent unitholders, the boards will decide."

For now, Chui views ESR's assets under management, including the properties held under ESR-REIT, as a pipeline.

More institutional investors

Last month, during ESR-REIT's placement exercise to raise funds for the acquisition of PTC Logistics Hub, it diversified its investor base, adding some institutional names. "Because liquidity has gone up, we have a lot more institutional names, such as property and insurance funds, and during the recent placement, more good names have come in," Chui says.

More analysts are also covering the REIT, including foreign brokers such as Daiwa and CLSA. In fact, CLSA says valuations are undemanding: "Post the recent equity fundraising, gearing has trended below 40%. While this is high against peers, muted interest rate outlook and [the Monetary Authority of Singapore's] consideration to raise gearing limit will offer some reprieve, in our view. As [ESR-REIT] is trading at 7.3% [for FY2020's] yield and is a laggard [among] the S-REITs, we view valuations as attractive." CLSA has an "outperform" recommendation and an upside of 58 cents.

At a market cap of $1.8 billion, ESR-REIT would have been qualified to be included into the hallowed FTSE EPRA NAREIT Developed Asia Index. However, EPRA NAREIT requires free float, so ESR-REIT may still be some way off, as its major shareholders —Tong and ESR — together hold more than 40%.

"Of course, [EPRA NAREIT] is followed by all the fund managers. It takes time [to get in]. Even if you have the liquidity requirement, you need to be relevant as well," Chui says.

For now, he has his hands full with the AEIs, with the one at 7000 AMK starting in 4Q. E