



# In search of yield

Investors may consider defensive-theme plays in Reits as headwinds pose challenges in the near term

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**2016** has been a tumultuous year for the global financial markets thus far. The volatility in the equity markets and oil prices, coupled with concerns over China's economic growth as we entered the new year, have spooked investor sentiment, although an overall recovery in the equity markets has been seen since mid-February. Notwithstanding this turbulent environment, the Singapore Reit (S-Reit) sector's share price has outperformed the broader Singapore market. The FTSE Straits Times Reit Index (FSTREI) appreciated as much as 5.1 per cent as at mid-March, while the Straits Times Index barely touched positive territory over the same period.

What then can we expect for the remainder of 2016?

Despite the outperformance by the FSTREI, we believe there may still be increased volatility ahead, given uncertainties over global economic growth and the number of Federal Reserve rate hikes this year. Following the Fed lift-off in December 2015, the Federal Open Market Committee (FOMC) unsurprisingly kept its key rate constant during the January and March meetings. The Fed funds futures market

has factored in a 68.2 per cent probability of at least one rate hike by the end of this year, while the probability of at least two rate hikes stands at only 25.8 per cent. Any subsequent tightening for the remainder of 2016 would be dependent on economic data and financial market developments, but we believe any deviations between market expectations and the Fed's actions may well result in more volatility ahead.

## Prudent capital management

Over the past few years, S-Reits have taken advantage of the low interest-rate environment to carry out debt-funded acquisitions. This has caused average gearing levels to increase from 34.0 per cent (as at Dec 31, 2014) to 35.5 per cent (as at Dec 31, 2015). Nevertheless, Reit managers have also largely implemented sound hedging strategies as they are cognisant of the normalisation trend in interest rates and volatility in the financial markets.

For example, the three-month Swap Offer Rate (SOR) has spiked from 0.74 per cent in end-2014 to as high as 1.76 per cent on Jan 13, 2016 before easing sharply since. Under our coverage universe, the average proportion of debt which has been fixed/hedged stood at 79.6 per cent, as at Dec 31,

2015. Although this was slightly lower than the 80.7 per cent recorded as at Sept 30, 2015, it still represented an improvement of 2.4 percentage points as compared to end-2014.

Notwithstanding this prudent approach towards capital management, S-Reits will not be immune to a higher interest-rate environment, as the value of interest-rate swaps has also increased – implying higher hedging costs ahead.

The issuance of perpetual securities, especially by larger market cap names, came back in vogue in 2015 and we expect this trend to continue. S-Reits which issued perpetual securities last year include Ascendas Reit (S\$300 million 4.75 per cent), Ascott Residence Trust (S\$250 million 4.68 per cent) and Keppel Reit (S\$150 million 4.98 per cent). The Monetary Authority of Singapore (MAS) allows perpetual securities to be treated as equity, and hence they do not increase the gearing ratio of Reits. However, since perpetual securities are hybrid instruments, the cost of funding is higher than that of a plain vanilla bond.

## Overseas expansion and equity financing

Looking ahead, we believe S-Reits will continue to seek inorganic growth opportunities, with an increasing focus on overseas acquisitions to mitigate slowing organic growth domestically. Australia has become an increasingly popular destination for acquisitions, and we expect this trend to continue, given its liquid and transparent market.

Moreover, onshore funding options and the strength of the Australian dollar have become more favourable for acquisitions as compared to previous years. Ascendas Reit, Cache Logistics Trust and Mapletree Logistics Trust made their maiden entry into the Australian industrial market in 2015, while Starhill Global Reit and Frasers Commercial Trust are two examples of S-Reits which increased their Australian exposure last year.

S-Reits would likely have to explore more equity financing options to supplement their expansion plans due to an increase in gearing levels as highlighted earlier. This would make it tougher to generate distribution per unit (DPU) accretion as the cost of equity is higher than the cost of debt.

Moreover, given the new leverage ratio limit of 45 per cent imposed by the MAS which came into effect on Jan 1 this year, Reit managers would likely factor in a buffer and allow their leverage ratios to cross only slightly above the 40 per cent mark. Ascott Residence Trust and OUE Hospitality Trust are two Reits which have tapped the equity markets for financing thus far this year.

## DPU growth

Operationally, we believe the headwinds facing the S-Reits sector will continue to pose challenges in the near term. The vagaries of the macroeconomic environment and concerns over growth prospects have curtailed the expansion plans of retailers and corporates and also resulted in a delay in decision making over the renewal of leases and take-up of new space. Coupled with an expected increase in supply across various sub-sectors, we expect further moderation in rental reversion rates as landlords prioritise the maintenance of their occupancy levels.

Consequently, DPU growth is likely to remain soft. According to market consensus expectations, S-Reit's DPU growth (market-cap weighted) is projected to come in at 2.0 per cent year-on-year for FY16 and 2.1 per cent for FY17.

In light of the aforementioned factors, we prefer defensive-theme plays, and like retail Reits with significant suburban exposure and Reits with longer weighted average lease expiry (WALE) profiles. We thus recommend Frasers Centrepoint Trust (buy; FV: S\$2.25) and Keppel DC Reit (buy; FV: S\$1.24) as our top sector picks.

We like Frasers Centrepoint Trust for its resilient suburban malls portfolio and strong track record. On the other hand, we believe Keppel DC Reit would be a key beneficiary of robust secular growth trends in the data centre industry, and also like its long portfolio WALE of 8.7 years (by leased lettable area). **W**

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