INSIGHTS FROM CFA SOCIETY SINGAPORE

By Seow Zhi Qi and Ezien Hoo

Singapore Reits: Faltering but not falling

A look at the more vulnerable ones amid the ongoing pandemic, how they can tide over this turbulent period and how investors are impacted

SINGAPORE real estate investment trusts (Reits) are a favourite among local investors. Perceived by some as an asset class on its own, Reits form a relatively sizeable position in the investment portfolio of a typical investor.

The Reit market in Singapore kicked off in 2002 with the successful listing of CapitaLand Mall Trust. In the same year, Ascendas Reit followed. By 2007, the equity price for S-Reits had gained 230 per cent (28.6 per cent per annum) according to the FSTREI Index. The following year, the 2008 Global Financial Crisis wiped out all of the gains since 2002. Today, we are seeing the Reits go through another volatile phase as Covid-19 disrupts the economy, businesses and our daily lives. Will Reits still remain a must-have for Singapore investors amid the ongoing coronavirus pandemic?

Reits are not equally vulnerable

Retail: Amid this turbulent period, retail and hospitality Reits are more vulnerable in our view. Retail properties derive their values from footfall and tenant sales. Growth on both of these fronts brings about higher rents and property valuation.

As such, a limitation of movement to contain the spread of Covid-19 and temporary closure of shops deemed non-essential directly hit these retail Reits. Even before the Covid-19 outbreak, there were already pockets of weakness in the retail sector in Singapore, where we saw the departure of a mix of home-grown household names and large international chains.

To draw shoppers to malls, property managers have been welcoming activity-based tenants such as gyms, virtual reality arcades, culinary centres and craft workshops, which offer group activities and foster community bonds. Given the ongoing practice of social distancing, this strategy pursued by the malls is expected to weigh on the performance of malls for the time being.

All in, pain for retail Reits is inevitable though the Reits hold "best-in-class" assets. A recovery for the retail Reits is expected to happen earlier than the broad retail sector in Singapore as new tenants move in to replace those that may no longer sustain rents at such malls.

Hospitality: Hospitality Reit issuers have been hard hit as they are directly in the eye of the storm, although the negative impact is more knowable in our view.

Hospitality Reits typically have geographically diversified assets relative to other Reits. This is traditionally a strength as market dynamics in one location could differ from other locations which makes the overall portfolio more defensible against specific headwinds. However, with the pandemic and possible recession global in nature, this geographical benefit is negated.

With the restriction of international people movement and also within countries, occupancies across the globe have fallen sharply with areas hit first by the virus seeing a faster fall. A knock-on effect from low occupancy means that revenue generation for hospitality issuers is uncertain for 2020, at least in the short term, while the issuers continue to bear operating, administrative and financing costs.

While certain cities globally are seeing single-digit hotel occupancies, China's hotel occupancy gradually trended up in the past couple of weeks since the country started re-opening and we think leisure travellers are likelier to return when the outbreak subsides.

Industrial: In the short term, industrial Reits are expected to be more resilient versus other Reits given the higher likelihood that industrial properties cater to industry sectors which are deemed as essential (for example, certain warehouses and data centres) and allowed to operate.

There is also typically a higher switching cost and decisions to move out factory or warehouse operations are not taken lightly. Singapore industrial Reits own business and science park buildings (office-like properties sitting on industrial zoned land outside the central business district), logistics assets such as warehouses, factories (multiple-user and single-user) and increasingly data centres.

Specific industrial Reit performance, though, would differ given the divergence of property types within portfolios. With a recession looming in the horizon, we think industrial properties' catering to small and medium enterprises could find occupancies falling faster. Already, we are seeing business sentiment falling sharply. Further out, properties catering to knowledge-based industries may see less demand as companies get used to remote working.

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Pain for retail Reits is inevitable though the Reits hold "best-in-class" assets. A recovery for the retail Reits is expected to happen earlier than the broad retail sector in Singapore as new tenants move in to replace those that may no longer sustain rents at malls. PHOTO: AFP

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No doubt Covid-19 continues to impact the operating environment for Reits, albeit by varying extent depending on the sector and the nature of the tenants. On the financial environment, we will be focusing on the capital structure of Reits broadly and ways Reits can boost liquidity, if needed.

How Reits can bolster themselves at such times

Reits typically have shareholders who hold equity stakes and receive distributions – that is, dividends which are dependent on the performance of the company and these are neither guaranteed nor fixed. Senior to shareholders in terms of claims in the event of a liquidation of the Reit is the perpetual holders and creditors which includes bondholders.

The aggregate leverage limit which was recently revised to 50 per cent by the Monetary Authority of Singapore cap the amount of the debt a Reit can take on and indirectly protects the interest of shareholders against overly stretched balance sheets.

We think this is important as unlike corporates, Reits do not tend to hold much cash on their balance sheet as 90 per cent or more of their taxable income needs to be paid out for the Reits to enjoy tax transparency treatment by the tax authorities. This does not mean that Reits are obliged to pay out that much of dividends but they typically do so under normal business conditions and have minimal cash on their balance sheet.

With Covid-19 having unprecedented impact on the economy, we expect landlords to render support to their tenants along with efforts from the government. The support can come in the form of flexibility and relief in relation to rents especially for tenants undergoing a cash crunch. However, these efforts can weigh on the Reits and the Reits may have to raise liquidity to tide through this period.

There are many ways a Reit can boost liquidity. Drawing down committed credit facilities with banks is one. We estimate that for most Reits, around S$80 million to S$400 million is available. Second, Reits can seek bank loans. Announced on March 22, DBS Bank has provided an A$212 million (S$194 million) five-year sustainability-linked term loan to Hong Kong-listed Link Reit.

Within the Reits listed in Singapore, Suntec Reit had announced on March 19, 2020 that it has obtained an A$450 million green loan which can be used for refinancing existing borrowings, acquisitions, investments and general working capital purposes.

These recent transactions boost our confidence in Reits' ability to obtain funding from banks at this time. Thus, we think the other Reits can also seek loans from banks and even consider secured bank loans, if need be.

Apart from seeking funding from banks, Reits with strong sponsors may be able to tap their sponsor for assistance. Some possibilities include a direct loan from the sponsor or acquire properties from the sponsor at a fair price with the sponsor receiving equity units as a form of payment. We view the latter as a win-win situation. The sponsor will be able to increase its stake in the Reits at a time where equity units are at arguably attractive prices given price-to-book is below one for most Reits. The Reit will be able to increase its asset base and reduce its aggregate leverage ratio depending on the structure of the transaction.

An example of this is Mapletree North Asia Commercial Trust's acquisition of two office properties in Japan from its sponsor, Mapletree Investments Pte Ltd. The transaction was funded via 30 per cent new equity to its sponsor and 70 per cent via a mix of debt or cash.

Reits can raise cash from their shareholders through equity rights issuance which is subjected to approval. We note that S-Reits have raised a record S$6.2 billion in 2019 when their share prices were high and that made such an issuance timely and cheap for the Reits.

However, given share prices have taken a hit from Covid-19 outbreak, we think it is becoming less economical for S-Reits to raise equity as time passes. Previously in 2007, S-Reits did raise equity to boost their liquidity. The event, though, resulted in S-Reits' prices crashing lower.

Dividends at risk though debt obligations largely insulated

Reits can also build their cash buffer through distributing less of its taxable income and paying higher taxes. Depending on how taxable income may have fallen relative to the Reit's equity share price, we think optically dividend yield can possibly still be maintained despite a reduction in pay-out ratio.

SPH Reit, which announced results for the quarter ended Feb 29, 2020 on April 2 had cut distribution per unit by 79 per cent year-on-year to just 0.30 cents. This converted to a pay-out ratio of 20 per cent as compared to 98 per cent in the same quarter a year ago.

While the depth of the dividend cut came as a surprise to the market, we think it is highly possible for other Reits, particularly those focused on retail and hospitality assets to follow suit in light of the challenging circumstances ahead due to Covid-19. For office and industrial assets focused Reits, while not immediately impacted, a prolonged recession may lead to a re-rating of valuation from expectations of falling tenant demand.

Takeaway for investors

The Covid-19 outbreak provides a real-time case study of what happens to the income of Reits and thereby dividends during times of adverse stress. This directly challenges the long-held investor perception that Reits are safe vehicles and would pay out 90 per cent or more of their taxable income at all times given the tax transparency requirement. This perception has also led some investors leveraging up to juice returns with the spread between dividends and cost of funding being perceived as a near certainty.

The Ministry of Finance and tax authority have also paved the way for Reits to opt to pay lower dividends by extending the timeline for S-Reits to distribute at least 90 per cent of their taxable income to qualify for tax transparency.

Prior to Covid-19, amid a boom time for Reits with large capital gains, we were asked if investors should view Reit equity as substitutes for senior bonds given their similar risk profile and steady distributions. Events of Covid-19 have shown us that the risk profile of Reit equity and senior bonds are not the same, especially on the downside which should put to rest this persistent question.

We also continue to advocate for (1) diversification at the asset allocation level and (2) diversification across property types in terms of one's investment or a Reit's portfolio of property as different sub-segments have been negatively impacted to varying extents.

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GOLD REPORT

By Avtar Sandu

Gold tug of war between easing lockdowns and weak economic data

A weekly market summary for gold, May 4-8

GOLD futures for most of this week have been consolidating around the psychological US$1,700 level. The precious metal came under pressure as European and US states get ready to reopen their economies from lockdowns.

California, the first US state to shut down its economy to stop the spread of Covid-19, said it will start loosening its lockdown on Friday. In Europe, Italy began to reopen its economy after two months, while Spain also took action to reopen its economy.

Meanwhile, comments from central bankers were bullish for gold. European Central Bank (ECB) President Christine Lagarde said on Thursday that "the ECB will do everything necessary within its mandate to help the euro zone through the coronavirus crisis"; ECB vice-president Luis de Guindos told lawmakers that the bank does not intend to curtail its bond buying just because the German Constitutional Court does not like it.

The Bank of England said it could expand quantitative easing (QE) in June, while the central bank of Brazil cut its key rate by 75 basis points to a new record low of 3 per cent on Wednesday. In the US, the San Francisco Fed president talked up the possibility of further action from the Federal Reserve.

Further, trade tensions between the US and China rose after President Donald Trump promised a "conclusive" report on the Chinese origins of the coronavirus outbreak and said that tariffs on Chinese goods would be the "ultimate punishment" for China for starting the outbreak.

Technical analysis for Comex June Gold Futures (GCM20)

Daily technical indicators are still positive, that is, the 14-day RSI of the contract failed to fall below the 50-level on daily charts, which suggests that gold is supported on a retracement. The bullish trend is intact and is supported fundamentally. Immediate resistance for the June Comex 100 oz contract is at US$1,788, followed by US$1,800. Support is at US$1,662 followed by US$1,592.

Weekly market assessment

As nations start to focus more on economic concerns, there are fears that opening too rapidly may undo the good that measures such as safe-distancing have brought. A resurgence of the pandemic may do considerably more damage, pushing central banks and governments to add more monetary and fiscal stimulus measures. These factors would continue to support gold prices in the near term.

Gold remains a safe haven as currencies are being devalued by massive stimulus programmes. This has also increased physical demand for gold, triggering huge investment demand for gold, especially in Exchange Traded Funds.

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